

Household Inequality, Corporate Capital Structure and Entrepreneurial Dynamism

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Summary

Very Important Research Question:

- What is the effect of inequality on an entrepreneur's (start-up's)
 - organizational type (sole proprietorship, cooperation,...)
 - financing decision
 - Bank vs. equity finance, inside vs. outside equity
 - investment decision
 - risk of the project
 - research/product innovation
 - business area (high tech or not)

Summary

Approach:

- Measure for county inequality (land ownership distribution in 1890)
- Series of panel data regressions using data from 2004 to 2008 on ~3400 start-ups.

Findings

- Higher county inequality leads to
 - more sole-proprietorships
 - more bank financing
 - more inside equity than outside equity
 - more bank financing
 - less risk-taking

Comment 1: Which Theory is Tested?

- Perotti and von Thadden (2006): How different corporate governance systems emerge in a democracy.
 - Human capital risk cannot be diversified, financial risk can.
 - If there is no redistribution of labor income, limiting labor income risk requires influencing corporate choices directly.
 - Thus, a voter wants the control over his employer to be in the hands of the stakeholders whose interests are most aligned with the voter.
 - Voter with only human capital prefers banks (concave payoff) in charge.
 - Wealthy voters prefer well established equity markets (higher return).
 - In an unequal society, the median voter is poor => prefers banking system.
- Theory cannot be tested using inequality differences between US counties because the regulation of financial markets happens at different levels (state & federal).

Comment 2: Location of Entrepreneur

- If the effect of the location of the entrepreneur is of interest I would use a different definition than county, e.g. **metropolitan statistical area (MSA)**:
 - MSA is a geographical region with a relatively high population density at its core and close economic ties throughout the area
 - Collection of counties => should be relatively easy to calculate since the paper uses already the county information.
 - Still the question remains: **what is the economic area that matters for the financing choice of an entrepreneur.** Entrepreneurs might move to those areas that fit best in terms of technological spillovers and expertise and recourses of potential financiers.

Comment 3: How the Income Distribution in the Entrepreneur's Location Could Matter I

(Departing from the original model)

Using only the basic setup of Perotti and von Thadden (2006):

Idea: The **wealth distribution** tells us something about the **financial situation of a potential entrepreneur** which influences

1. her **risk-taking behavior** and
2. the **capital structure decision**, if there exists a pecking order.

Remarks:

- The authors seem to use this reasoning to develop some of their hypotheses.
- Assumption: The **median voter** is something like the **expected type to become entrepreneur**. The probability that a person becomes an entrepreneur is symmetric.
- Problem: Data shows that over 50% of entrepreneurs have a college degree. So **entrepreneurs are special**, the median voter is not likely to become entrepreneur.

Comment 4: How the Income Distribution in the Entrepreneur's Location Could Matter II

(Departing from the original model)

Idea: The **wealth distribution** indicates **which form of capital is available** to start-ups. Interesting approach.

– Your conjecture:

- Unequal counties have a large supply of bank loans.
- Equal counties have a large amount of potential shareholders.

Potential challenges:

1. **The conjecture itself requires empirical evidence.** It could be the other way round. In order to become equity investor you need to be “sufficiently” wealthy. In unequal counties the chance could be higher that some people are wealthy enough.
2. Are potential entrepreneurs really limited to the financing sources in their county?
3. Disentangling supply and demand effects: You write that your results suggest that “owners are forced to rely on inside equity”. What if the want to and are wealthy enough?

Variation in the Dependent Variable?

DEPENDENT VARIABLE

Variable Name	10%	Median (50%)	90%
<i>Dependent Variables</i>			
Firm Is Proprietorship	0	0	1
Firm Equity	0.00	0.15	1.00
Firm Family Financing	0.00	0.00	0.00
Firm Angel and Venture Capital Financing	0.00	0.00	0.00
Firm Owners' Personal Bank Financing	0.00	0.00	0.30
Firm Bank Financing	0.00	0.00	0.47
Firm is High Tech	0	0	1

Additional Comments

- Could you provide us with some evidence that the distribution of landownership in 1890 is related to the wealth distribution in 2004?
 - The danger is that your proxy picks up some other particularity of the county (rural areas vs cities).
 - Maybe you could use the today's income distribution in the counties as a proxy for the today's wealth distribution and see how well this is explained by your wealth proxy.
- Could you be more explicit on how the way state judges are elected affects the extent to which the historical land distribution effects today's wealth inequality?

Additional Comments

- Why do you use a panel and not only the cross-section of the initial setup (organizational form, capital structure, investment) of the start-up?
 - County inequality doesn't change but organizational form, capital structure might change over the years. (I guess you want to capture this then with your controls).