The (Lack of) Boundaries of Small Businesses

Carlos Parra (PUC-Chile)

Summary

Small businesses are prevalent both in developed and emerging economies. For example, in the U.S., small firms employ 47.5% of the private workforce (Decker et al., 2014). In addition, 80% of these businesses are owner-operated (2016 Statistics of U.S. Businesses (SUSB)). Furthermore, the Covid-19 crisis and the programs introduced to subside small businesses (e.g., PPP that provided $793 billion in loans and cash grants in the U.S. or the large-public credit guarantee program in Chile) have further shown the importance of understanding these owner-operated businesses.

However, despite the importance of these types of firms, there is little credible evidence for small private companies in developed economies to questions such as how do small businesses respond in their financing choices to business shocks (e.g., cash flow shocks)? Who takes on the debt, the owner or the business? Is the response different in recessions? Does the type of business entity (e.g., sole proprietorship, LLC) matter?

In addition, since the seminal work of Coase (1937), extensive theoretical literature has analyzed the determinants and consequences of firm boundaries (e.g., Williamson (1975), Grossman and Hart (1986), Holmstrom and Milgrom (1991)). However, less attention has been devoted to small businesses. In particular, since most businesses are owner-operated, an important question is to understand the "boundaries" of small businesses, for example, how are owners' and businesses' finances interrelated.

In this project, we study the "boundaries" of small businesses by looking at how small businesses and their owners' balance sheets are connected by estimating their responses to cash windfalls.

To provide credible estimates, first, in our research design, we will exploit a setting that provides a randomized assignment of cash to small businesses (i.e., retailers that sell jackpot-winning tickets in the U.S.). In particular, we exploit the bonuses that retailers earn when selling jackpot-winning lottery tickets, usually a percentage of the jackpot prize. Second, we compile a dataset that allows us a holistic view of small businesses and their owners to shed light on the interconnection of the balance sheet of the businesses and the entrepreneur (which are jointly determined in equilibrium).