
Discussion of Paper “Aggregate Costs of Uninsurable Business Risk” by Boar, Gorea and Midrigan

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Overview of the paper

- Paper focuses on the lack of risk sharing as explanation to weak growth of small firms ; design and expansion of risk-sharing institutions may yield much larger aggregate gains than further credit market reforms
- Solid and innovative model coupled with a careful fitting to data
- Interesting micro data from both commercial sources (Orbis) and household surveys (Spain)
- Timely and relevant topic as (i) SMEs represent the bulk of employment (ii) policy focus is shifting to growth companies (iii) credit constraints (insufficient collateral, high risk weights) may be causing shifts in financing from banks to non-banks and (iv) improved access by firms to equity and debt capital is actively promoted
- Some additional elements would make the paper even better

The analysis

- Starting point: a model of entrepreneurial dynamics with firms facing financial frictions (Quadrini (2000); Cagetti and De Nardi (2006))
- Includes a “traditional” credit wedge (credit constraints) -> consequence: limited access to finance reduces investment and firm size (Buera et al., 2011; Midrigan and Xu, 2014; Moll, 2014; Bau and Matray, 2023)
- Contrasts this with a “risk wedge” (output and profits fluctuate excessively due to fat-tailed and transitory shocks) -> consequence: small firms tend to operate at inefficiency small scale to avoid hitting credit constraints (Tan (2018), Robinson (2021), and David et al. (2022a))
- In practice: entrepreneurs bear non-optimally large share of risk, and manage risk by operating at a smaller scale (less labour and capital)

The analysis, cont'd

- Timing of the model is original -- labour and capital are chosen before the productivity shock hits
- This allows for limited covariance between input and output, and creates large profit fluctuations (especially when shocks are large, as they are can be in the data)
- The aggregate loss calculations follow Hsieh and Klenow (2009) and Gopinath et al. (2017) who analyse production distortions and misallocation
- A rather realistic setting under labour market rigidities, and fits the data well
- Overall, fat tailed, transitory shocks to output drive the outcomes, and labour market frictions (fixed inputs) prevent quick adjustment

The analysis, cont'd

- Key finding: risk wedge constraints aggregate output a lot more than credit constraints
- Eliminating the risk wedge would increase output by 15.4%; eliminating credit constraints would only increase output by 0.4%
- Policies that focus solely on improving credit access will have limited impact unless they also address risk sharing
- The results are robust to alternative model specifications, lower risk aversion, and the inclusion of unconstrained firms

Data

- The authors use both firm-level data (Orbis) and household survey data (Spanish EFF)
- The firm data covers the period 1995-2019 and has harmonized information on annual balance sheets and income statements of privately and publicly traded firms; shows large, fat-tailed, and transitory fluctuations in firm profits
- Focus on Spain, owing to good coverage across firm size distribution
- The Household survey is a representative survey of 6, 000 households; “entrepreneur” is defined as a household who owns a business, is actively involved in running or managing that business, and reports positive business wealth
- Observation: Private businesses are poorly diversified, with most entrepreneurs owning a single business and holding a large share of its equity

Alternative specifications and robustness

- Eliminating each of the distortions (fat tails, transitory shocks and labour market rigidities) from the simulations makes the risk wedge decrease relative to the credit wedge
- Firms can then operate at a larger scale and are more likely to hit the credit constraints => “classic” outcome. The role of transitory shocks seems particularly important in driving the results
- Results hold very well for Spain -> future work should further explore the heterogeneity of frictions and robustness of the results across sectors and countries

Suggestions for improvement

- The paper is thin in stressing its key conclusions and in suggesting policy recommendations
- Cut the tails of the distribution by introducing insurance/subsidy/ safety net (but moral hazard)?
- Labour market reform to allow inputs to adjust to shocks (but since the firms are small and shocks are transitory, costly re-hiring process may follow) => other countries may show different results?
- Risk sharing with public or private equity partners /venture capital firms
- Informational frictions may prevent diversification, as investors are unsure about the entrepreneurs' wealth / ability to withstand shocks => Need for signalling devices?
- Unrated firms in the EU vs. rated firms in the US, less risk-sharing in the EU ?
- How to reduce the size of the transitory shocks?



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