Labour Economics 16 (2009) 79–88

Contents lists available at ScienceDirect

Labour Economics

journal homepage: www.elsevier.com/locate/econbase

Housing wealth, liquidity constraints and self-employment

Richard Disney [a,b,*], John Gathergood [a]

[a] University of Nottingham, UK
[b] Institute for Fiscal Studies, London, UK

ARTICLE INFO

Article history:
Received 5 November 2007
Received in revised form 28 May 2008
Accepted 29 May 2008
Available online 4 June 2008

JEL classification:
E21; J21; L26

Keywords:
Self-employment
Liquidity
Windfalls

ABSTRACT

This paper investigates the existence of liquidity constraints facing entrepreneurs in the United Kingdom. Using a household-level panel data set, entry to self-employment is shown to be a function of household net worth. We use inheritances and unanticipated movements in house prices as instruments for shocks to liquidity. Results indicate that inheritances are a poor instrument for liquidity constraints because both past *and future* inheritances predict entry to self-employment. House prices shocks are a more plausible instrument because self-employed households disproportionately re-mortgage, but our results again indicate little evidence of house price shocks unbinding liquidity constraints facing the would-be self-employed.

1. Introduction

This paper examines the impact of movements in household wealth on entrepreneurial activity undertaken by households in the United Kingdom (UK), using a UK household panel data set. This is not a wholly new field and, in common with several other studies, we find evidence that household financial wealth is positively related to subsequent entry to self-employment. Several papers have argued that this finding provides evidence for the hypothesis that some households face liquidity constraints when seeking to undertake entrepreneurial activities. However, caution must be exercised in interpreting this relationship: various selection mechanisms, for example household human capital attributes or unobserved abilities (such as financial acumen), may generate an underlying association between financial wealth and a propensity to self-employment without liquidity constraints playing a part.

A standard response to this problem of interpretation utilises positive ‘shocks’ to household financial wealth as a potential instrument for the unravelling of liquidity constraints facing would-be self-employed households. Depending on the particular study, different indicators of ‘shocks’ have been used: inheritances, redundancy payments, lottery wins and changes in self-reported housing wealth are all examples. An obvious problem with some of these indicators is that they measure events that are not truly exogenous to the decision to become self-employed: for example, receipt of redundancy payments may arise from a conscious decision to leave paid employment in order to enter self-employment. Other indicators can be reasonably treated as having some degree of exogeneity (e.g. the exact timing of receipt of an inheritance, or local house price changes) and this provides a test, exploited by Hurst and Lusardi (2004), of whether the *timing* of such events is associated with subsequent self-employment decisions. Timing matters, as those authors argue, because of the likely association of such events with the household’s level of wealth in general. In any event, the role of both levels of wealth *and* (instrumented) shocks to wealth should be tested in an explanatory model.

In our paper, we test or retest several of these ideas in the UK context. The panel data set that we use has been exploited before (Taylor, 2001) but we now have more waves of data with the appropriate variables, so allowing us to test a much richer set of hypotheses. We find that levels of household wealth and business start- ups are indeed positively correlated, but as explained previously, this finding does not necessarily indicate the presence of liquidity constraints. We therefore augment the model with the standard instruments for wealth ‘windfalls’, including receipt of inheritances and ‘shocks’ to local house prices – the latter calculated at a more disaggregated level than the usual regional measure adopted by several other studies.

Several studies have examined the role of inheritances in the UK context and shown significant positive effects on business start-ups but, in common with Hurst and Lusardi (2004) for the US, we cast doubt on the interpretation of this result as evidence of liquidity constraints by examining the *timing* of the inheritance relative to business start-up. However, in contrast to those authors, perhaps because of the finer disaggregation of our instrument and its different construction, we do

* Corresponding author. School of Economics, Sir Clive Granger Building, University of Nottingham, Nottingham, NG7 2RD, UK. Tel.: +44 1159 515619; fax: +44 1159 514159.
E-mail address: richard.disney@nottingham.ac.uk (R. Disney).

0927-5371/$ – see front matter
doi:10.1016/j.labeco.2008.05.002

find some evidence that shocks to local (i.e. county-level) house prices *are* a predictor of a spell of self-employment.

From this last finding, we should find a relationship between re-mortgaging behaviour, business start-ups and house price shocks. So we then examine the relationship between re-mortgaging activity and self-employment, and also between house price 'shocks' and re-mortgaging. We find evidence that self-employed start-ups disproportionately use re-mortgaging as a financing strategy, but that the probability of remortgaging in response to house price shocks is not significantly different between self-employed starters and other households, conditioned on the determinants of becoming self-employed. Our results therefore suggest that local house price shocks, suitably measured, may be the best predictor of small business start-ups from among the several indicators of household financial wealth, but no clear evidence that house price shocks unbind liquidity constraints that deter business start-ups.

2. Background and previous literature

The prevalence of financial constraints facing would-be entrepreneurs is an important issue for government policies directed towards business creation. There are an estimated 3.2 million sole proprietors in the UK, accounting for 12% of employed workers.[1] Publicly funded schemes established in the UK provide assistance for workers entering self-employment through loan guarantees and grants for research and development.[2] Moreover, specific schemes are aimed at entrepreneurs from deprived areas who are less likely to be able to access financial capital from banks or within the household.[3]

Previous studies have presented evidence consistent with the existence of financial constraints, as proxied by household wealth, facing the would-be self-employed (see, for examples studies on US data by Evans and Jovanovic, 1989; Evans and Leighton, 1989 and Meyer, 1990, and of the UK by Black et al., 1996).[4] However caution must be exercised in interpreting lower levels of household financial wealth as a barrier to entry into self-employment. The more recent empirical literature on financial constraints and self-employment has drawn on models in which workers engage in asset-accumulation strategies prior to entering self-employment (as in, for example, Buera, 2003; Astebro and Bernhardt, 2005; Cagetti and Di Nardi, 2006). Hence, the observation that self-employed households exhibit greater financial assets prior to undertaking self-employment may not necessarily be indicative of financial constraints *per se* but rather of the joint determination of financial wealth and firm capital given human capital (Xu, 1998; Astebro and Bernhardt, 2005).

Empirical studies have attempted to resolve this potential endogeneity problem by estimating the impact of financial *windfalls* on the probability of becoming and remaining self-employed (as in Holtz-Eakin et al.., 1994; Lindh and Ohlsson, 1996; Taylor 2001, and Hurst and Lusardi, 2004; and, for the UK, Blanchflower and Oswald, 1998; Taylor, 2001; Henley, 2005a, b). The argument for using financial windfalls is that they represent exogenous movements in household wealth which relax capital constraints arising due to households' inability to borrow. If households that receive a financial windfall can be shown to be more likely to enter self-employment than households not receiving such a windfall, then access to finance appears to be a limiting factor in self-employment entry. On the other hand, if there is *no* evidence that financial windfalls impact on self-employment entry, there is little support for the idea that would-be self-employment workers are undercapitalised and require financial windfalls in order to finance their entrepreneurial activities.

However, the well-cited study by Hurst and Lusardi (2004) has questioned whether there is *any* evidence for liquidity constraints facing entrepreneurs. Using data from the Panel Study of Income Dynamics (PSID), their results indicate at most a weak relationship between household wealth and subsequent self-employment entry.

They question the use of inheritances as examples of 'windfall gains' providing liquidity to households. Instead they suggest using movements in housing wealth as an alternative instrument for household liquidity, but find no statistically significant relationship between unexplained variations in regional house price movements and the propensity to start a business.

The present paper uses a UK household panel survey to replicate some of Hurst and Lusardi's tests on UK data. In contrast to those authors, we use a much more disaggregated measure of unexplained house price movements, and we do find some evidence of a relationship between 'shocks' to house value and subsequent entry into self-employment. However, in support of those authors, and in contrast to some other studies for the UK, our evidence finds no support for the idea that other types of 'windfall' predict entry into self-employment.

This finding on the importance of housing wealth should not be too surprising. Housing wealth potentially provides a rich source of finance to the would-be self-employed seeking to fund lumpy start-up costs such as purchasing machinery, hiring premises or accruing inventories (Black et. al., 1996). Housing acts as collateral against which households can borrow on cheaper terms than uncollateralized borrowing such as business loans, personal loans or other forms of consumer credit. The majority of home-owning households of working age are experienced in mortgage refinancing and can access mortgage markets cheaply and on favourable repayment terms. The increasing prevalence of self-certification mortgages (whereby borrowers certify their own income) in both the US and UK indicates the ease with which households undertaking changes in labour market status can continue to access mortgage finance. Moreover, home-owning households have experienced considerable appreciation in the value of housing over the last decade, suggesting that for many households housing wealth might provide ample entrepreneurial finance. Henley (2005a) indeed finds that the *level* of household housing wealth is positively related to entry to self-employment.

3. Methodological and empirical issues

3.1. Defining 'windfalls'

Financial windfalls typically described in the literature include receipts from lottery winnings, inheritances, redundancy payments, bonus payments and personal accident claims. Such windfalls, it is argued, reduce the capital constraint faced by a household and are exogenous to an asset accumulation strategy. Studies on UK data employing a variety of 'windfall' occurrences tend to show strong coefficients on inheritances and lottery winnings, providing evidence consistent with the financial constraints hypothesis (Taylor, 2001; Blanchflower and Oswald, 1998). Lindh and Olsson (1996) provide evidence on the impact of lottery wins on self-employment from Sweden.

However, the various measures of 'windfalls' differ in their plausibility. Some such financial accruals may be anticipated by households and should not be treated as wholly exogenous. Bonus

[1] Small Business Service (2006), Small and Medium Sized Enterprise (SME) Statistics 2007.

[2] As examples of each: The Small Firms Loan Guarantee Scheme, established in 2005, underwrites 75% of the value of loans taken out by small and medium size enterprises in their first five years of trading. Grants for Research and Development up to a value of £20,000 provided by the Department for Business, Enterprise and Regulatory Reform include 'micro grants' targeted to businesses with fewer than 10 employees.

[3] As examples: New Entrepreneur Scholarships, provided by the National Federation of Enterprise Agencies (NFEA) funded by the Learning and Skills Council (LSC), are targeted to households in bottom 25% Super Output Areas (SOAs). Government funded 'Community Finance Development Associations' also operate in these areas to provide loans to business start-ups that are unable to gain loans from banks or raise internal finance. These schemes have provided over £110 million of grants and loans to small enterprises since 2004.

[4] The literature on the economics of self-employment and entrepreneurship has been recently surveyed by Parker (2004).