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Should Entrepreneurs Minimize Credit Card Debt?

By Scott A. Shane

A recent study by Robert Scott of Monmouth University found that “every \$1,000 increase in credit card debt increases the probability a firm will close by 2.2 percent.” It also explained that “reliance on this type of financing may lead many businesses into a long-term liquidity drain that affects their financial stability — and thus survival.”

The report’s conclusion that credit card debt is problematic for entrepreneurs has been echoed elsewhere. John Tozzi of Business Week wrote, “start-ups that lean too much on credit cards are more likely to fail...” And the post at the Kauffman Foundation’s Policy Forum that describes the study is titled “Credit Card Debt Threatens Start-Up Survival.”

Maybe, but then again, maybe not.

The study was based on a regression analysis that predicted three-year survival of new firms as a function of their level of credit card debt, using data from the Kauffman Firm Survey, which tracks a sample of new companies from the 2004 cohort of American start-ups.

Another interpretation of the study’s results is that entrepreneurs whose businesses aren’t doing well tend to run up credit card debt faster than entrepreneurs who are doing well because they need to get cash somewhere. Because companies that aren’t doing well are also more likely to fail, we see a correlation between business failure and the size of credit card debt.

But is the *cause* of the failure the credit card debt? The businesses may be doing badly because the ideas behind them aren’t very good or because they are poorly run or because they suffer from the myriad of other things that make some new companies perform poorly. These weaknesses — whatever they are — lead to heavier credit card borrowing and greater odds of failure.

The report included a result that suggests this alternative explanation: the credit card debt of surviving new firms is *higher* than that of the non-surviving firms in 2004, the first year of operation. But, in 2005, the non-survivors added more credit card debt than the survivors, creating the statistical association between the magnitude of the credit card debt and new business failure.

This result suggests that in the businesses' second year of operation, when the performance of the surviving and non-surviving firms begins to diverge, the future non-survivors start borrowing more heavily on their credit cards, perhaps because of their poor performance. While this additional debt might turn the tide at some of the start-ups, it doesn't solve the problems at most of the new businesses. As a result, the failed start-ups end up with more credit card debt, on average, than the survivors.

If you're wondering why I have written this post, the answer is simple: Entrepreneurs need to interpret the results of this study very cautiously.

If credit card debt doesn't *make* businesses more likely to fail, but just reflects the worse performance of some of them, then the belief that credit card debt is bad for new businesses could have unfortunate consequences. Some entrepreneurs might be dissuaded from taking on the credit card debt they need to successfully finance their operations.

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