

Dec 11.2022

Dear Rema,

Thank you very much for reading our paper and for your kind words.

The comments from the first reviewer are useful, and I take the comments from that reviewer that I do not agree with as a guide to areas where we need to be more clear.

While I am not writing to ask you to reconsider your decision, I would like to express my frustration with the second reviewer. I think that when reviewers do a bad job, authors should provide feedback to the editors and this is the purpose of this email.

I'm mainly addressing the first comment by the second reviewer, which appears to be their main comment.

"The conclusions of this paper depend on several assumptions. Specifically, one key assumption is that the probability of investment success is not exogenous, instead more investments increase the chance of success. I'm not sure if this is true in reality. For example, poor households might work on agricultural related projects, which can be influenced by random weather or price shocks. Some other business projects could be affected by exogenous supply chain shocks, unexpected policy reforms, etc. Another assumption is that poor people believe the production function has an "S-shape", where the marginal return is only high at higher levels of investment. This is suggested in some existing literature but there is no evidence showing the study sample also hold such beliefs."

A key assumption of our paper is, as argued by the reviewer, that investment has an effect on the probability of success of a business. There are, of course, exogenous reasons for the failure or success of a business, but this reviewer claims that because there are exogenous reasons, they question that assumption.

First, there is no logical link between the existence of exogenous effects and the lack of endogenous effects. Second, it is so obvious that investment does affect the probability of success of a business that I never even imagined we would need to justify this assumption (which is easy to justify). Not a single member of the audience raised this as a concern, in several presentations of the paper in seminars and conferences. To be on the safe side to some extent, but mainly for sharing with my colleagues this unlikely criticism, I asked many of them, 'If I tell you that in the real world investment has a significant effect on the probability that a business is successful, would you think this is: reasonable but needs supporting evidence (if it's an assumption in a model); plausible, or obvious?' They all answered that it is obvious, and they were all shocked by this complaint.

The second reviewer's next substantial criticism of our paper is that we assume that the poor have false beliefs in an S-shape production function.

We don't make such an assumption. Nothing even close.

In fact, the main contribution of the paper is that we do not rely on any non-convexities in technology or false beliefs.

You might think, in reading this criticism from the second reviewer, that we weren't clear.

This isn't the case. We state explicitly in the abstract: "We show that this could be explained by risk aversion without relying on fixed costs or other forms of non-convexity in the technology." We specifically mention an S-shape production function in the third paragraph of the introduction: "We propose an explanation that doesn't rely on any form of increasing marginal returns to investment, such as a fixed cost or an S-shape production function."

But the reviewer argues that we claim that the poor believe the production function is S-shaped. This is not an assumption in our paper.

To clearly state that we do not rely on an S-shape production and to later state that we rely on false beliefs that an S-shape function exists, would be dishonest of us. We are not dishonest.

So where does this idea about an S-shaped production function come from? False beliefs in an S-shape production function is a theory proposed by Banerjee and Duflo in their book Poor Economics. We mention it when discussing the existing literature, so the reviewer would have seen it in section two, "Related Literature."

We write:

"There are only a few other explanations for why the poor avoid small affordable investments with high expected returns. Banerjee and Duflo (2011) suggest that the poor typically believe that the production function has an "S-shape" – the marginal return is low at low levels of investment and high at higher levels. Thus, the poor believe, despite the facts, that in order to enjoy a high return, the investment should be large."

...and then we politely explain why we think that's not a good assumption.

Of course, Section 2 appears after the Introduction, in which we explain our mechanism. If one reads the Introduction with the purpose of understanding (which is different from reading for the purpose of finding reasons to reject) one understands very well our mechanism, and that it doesn't rely on any false beliefs.

The other comments of the reviewer seem rather minor, so the recommendation to reject cannot be justified by the latter parts of this report.

Thank you for reading this email.

If you feel comfortable doing so, please forward it to the second reviewer.

Best,
Omer

Dec 16. 2022

Hi,
I went through, and while it will not change the overall decision, I am happy to forward to the referee. Hope things are well,
Cheers,
Rema