

Entrepreneurship and Self-Finance

– theoretical explanations for the empirical importance of the capitalist-entrepreneur

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Abstract:

It is a well-known empirical result that self-finance is an important option for people when financing entrepreneurship. It is, however, not entirely clear what the theoretical explanations for this might look like. In fact, the leading entrepreneurial theories even seem to indicate that questions about the existence and extent of entrepreneurship more or less are disconnected from the question of self-finance.

The purpose of this paper is to clarify and distill some distinctive theoretical arguments for why self-finance is so important and to clarify what the barriers to self-finance look like.

The decisive theoretical argument is that problems related to individual differences in information, perception, interpretation and implementation always will arise as soon as external financing is considered; such problems will not arise when entrepreneurs are able to rely on self-finance.

However, there are barriers to self-finance and they fall into two wide categories, (1) barriers to the building up of privately held wealth, regardless of magnitude, and (2) barriers to the preservation of privately held wealth. Many of these barriers are created by political means and can therefore – here they differ from the problems related to external financing – also be alleviated by political means. The conclusions have clear policy implications.

JEL: B53; D14; D82; G24; G32; G38; H20; L2; M13

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1 Introduction

It is a well-known empirical result that self-finance is an important option for people when financing entrepreneurship. It is, however, not entirely clear what the theoretical explanations for this might look like. In fact, the leading entrepreneurial theories even seem to indicate that questions about the existence and extent of entrepreneurship more or less are disconnected from the question of self-finance.

The purpose of this paper is to clarify and distill some distinctive theoretical arguments for why self-finance is so important and to clarify what the barriers to self-finance look like.

The next section contains an overview of the empirical results as well as of the more conventional theoretical views. Section 3 will present and clarify the argument of the new and emerging synthesis in this area, while section 4 will discuss the barriers to self-finance and how these could be alleviated. Finally, some concluding remarks are made.

2 The Conventional Views

The conventional view on entrepreneurship and its financing looks, grossly simplified, the following somewhat paradoxical way: On the one hand, there is an empirically established fact that self-finance plays an important role, yet, on the other hand, the theoretical support for this fact is vague. Indeed, there seems to be more theoretical support in favor of the opposite conclusion; it is not of major importance if entrepreneurship is financed by external means (by venture capitalists, banks, the government etc) or by self-finance, i.e. self-finance is of no particular importance.

The Empirical Relation

Obviously, it is hard to measure 'entrepreneurship' and because of this 'self-employment' has often been used as an approximation in the empirical literature. One fundamental idea in this literature is that prospective entrepreneurs face 'liquidity constraints'; they are constrained by limits on the access to liquidity. Consequently, possession of and access to own capital would imply a higher likelihood of entrepreneurship. This idea on why self-finance matter was confirmed empirically by Evans & Leighton (1989) and Evans & Jovanovic (1989). This result has later been verified by for example Kidd (1993), Holtz-Eakin et al. (1994a, b), Bernhardt (1994), Laferrere & McEntee (1995), Black et al. (1996), Lindh & Ohlsson (1996), Cowling & Mitchell (1997), Blanchflower & Oswald (1998), Aldrich (1999), Johansson (2000a, b), Burke et al. (2000, 2002), Hurst & Lusardi (2003) and Moore (2004).

Moreover, Parker (2002) has pointed out why banks are likely to limit the external financing of prospective entrepreneurs, while Blanchflower et al. (2003) have shown that it sometimes is harder for prospective entrepreneurs among minorities to gain access to such external means. Closely related to this literature are those studies that see venture capital as a means to improve on the external financing of new ventures (see for example Gompers & Lerner 2001).

While it might seem wrong to call the idea of liquidity constraints a theory – after all, our resources are inherently scarce, they will always be limited, a fact not restricted to entrepreneurs and thus not much of a theory on entrepreneurship – there is nevertheless strong empirical evidence that self-finance of entrepreneurship for some reasons matter. What about theoretical evidence?

Schumpeter and the Innovation Process

The perhaps most well known theoretician when it comes to entrepreneurship is Joseph Schumpeter. However, since his ideas have not yet been integrated in the mainstream theoretical body, a short overview is provided.

Schumpeter defined the entrepreneur as follows: "The carrying out of new combinations we call 'enterprise'; the individuals whose function it is to carry them out we call 'entrepreneurs'" (Schumpeter 1934/2000, p. 58). Such 'new combinations' of labor and capital goods called innovations are not the same thing, though, as inventions. Instead, the concept of innovation covers the following five cases: (1) a new good or of a new quality of a good, (2) new methods of production, (3) the opening of a new market, (4) new resources, and (5) new organizational forms (Schumpeter 1934/2000, p. 52). Thus, innovation is a much broader concept than that of invention.¹

Schumpeter (1934/2000, p. 58) meant that his definition "agrees with the usual one on the fundamental point of distinguishing between 'entrepreneurs' and 'capitalists'" (by capitalist Schumpeter means the one that contributes capital). This purely theoretical distinction between entrepreneur and capitalist was made already by 18th century economists like Cantillon, Say and Turgot, and it is this distinction Schumpeter called "the usual one". As Foss & Klein (2004) points out, "Schumpeter carefully distinguished the entrepreneur from the capitalist (and strongly criticized the neoclassical economists for confusing the two). His

¹ Schumpeter (1934/2000, p. 58) discards the idea that the entrepreneur as a risk bearer – "[t]his distinction [...] disposes of the conception of the entrepreneur as risk bearer". With risk Schumpeter had in mind the meaning that follows from Knights (1921) distinction between risk and uncertainty. Also Kirzner (1973 and 1990) seems to follow this Knightian distinction (he speaks of risk vs. genuine uncertainty). In this paper risk and uncertainty is treated as synonyms.

entrepreneur need not own capital, or even work within the confines of a business firm at all.”

According to Schumpeter (1934/2000, p. 60), you are an entrepreneur *only* if you carry out new combinations. Since nobody is doing that all the time, ‘entrepreneur’ cannot really be regarded as a separate profession. He meant that “the entrepreneur’s essential function must always appear mixed up with other kinds of activity; which as a rule must be much more conspicuous than the essential one” (Schumpeter 1934/2000, p. 60). Despite the purely theoretical distinction between entrepreneur and capitalist, Schumpeter conceded that, in practice, an innovator very well also could be a capitalist.

Kirzner and the Discovery Procedure

Israel Kirzner perhaps is the second to Schumpeter most well known theoretician in the field. But while Schumpeter saw the entrepreneur as a force that disturbs earlier equilibrium, Kirzner sees the entrepreneur as someone that makes the markets tend towards equilibrium (although in an ever-changing world never will get there before it’s time to move somewhere else)². According to Kirzner (1973, 1990), the entrepreneur plays a decisive role in the competition on various markets by continuously making new discoveries. This might appear elementary, but as Hayek (1968/2002, emphasis in original) explains:

“It might at first appear so obvious that competition always involves such a discovery procedure that this is hardly worth emphasizing. When this is explicitly underscored, however, conclusions are immediately obtained that are in no way so obvious. The first is that competition is important *only* because and insofar as its outcomes are unpredictable and on the whole different from those that anyone would have been able to consciously strive for; and that its salutary effects must manifest themselves by frustrating certain intentions and disappointing certain expectations.”

Thus, discoveries differ from such knowledge that you could consciously strive for³. The entrepreneur contributes by being alert and using knowledge and insights that no one else see or possess. Kirzner (1973, p. 67, emphasis in original) wrote that “[t]he aspect of knowledge which *is* crucially relevant to entrepreneurship is not so much the substantive knowledge of market data as *alertness, the ‘knowledge’ of where to find market data.*” Such knowledge could be very specific and practical⁴. Kirzner (1973, p. 68) pointed out that “the kind of ‘knowledge’ required for entrepreneurship is ‘knowing where to look for knowledge’ rather than knowledge of substantive market information”.

2 A difference also Kirzner (1973, p. 73) himself notes.

3 This kind of knowledge is discussed further also in for example Hayek (1945, 1968/2002). Kirzner (1973, p. 94) means that “entrepreneurship and competition are two sides of the same coin: that entrepreneurial activity is always competitive and that competitive activity is always entrepreneurial”. While there of course also are differences between Kirzner and Hayek, von Mises might be their common denominator.

4 O’Driscoll & Rizzo (1985) means that “[t]here are five general characteristics of knowledge with which a Hayekian view of competition is concerned. Knowledge is (1) private, (2) empirical, (3) often tacit, (4) not all gained through price signals, and (5) often the source of surprise.”

In such a process of market coordination entrepreneurs always find new ways of making a good return. This happens through (1) pure arbitrage, (2) intertemporal arbitrage or (3) through creativity in production (new products or cost-saving technologies) (Kirzner 1990, p. 72).

Also Kirzner makes the purely theoretical distinction between entrepreneur and capitalist. He means that “[o]wnership and entrepreneurship are to be viewed as completely separate functions [and] we have automatically excluded the asset owner from an entrepreneurial role. Purely entrepreneurial decisions are by definition reserved for decision-makers who own nothing at all” (Kirzner 1973, p. 47). However, also Kirzner means that entrepreneurship isn’t limited to a certain profession but that we all act as entrepreneurs at times. In practice, “the same individual may be both entrepreneur and capitalist” (Kirzner 1973, p. 49).

Critique, Positive and Negative

Thus, it seems that both Schumpeter and Kirzner support the purely theoretical distinction between entrepreneur and capitalist. Blaug (2000) shows the importance of this distinction for the development of theories on entrepreneurship; the distinction makes it possible to focus on the decisive role of the entrepreneur and the capitalist, respectively. Hence, it is possible to study the important features of entrepreneurs making new innovations and discoveries, while ignoring how they are financed. Meanwhile, it is also possible to study the financial side of entrepreneurship while ignoring the way in which innovations and discoveries are made. Schumpeter and Kirzner could be said to have contributed to the purely entrepreneurial side, while others have studied questions about venture capital vs. risk capital, government vs. private seed capital, in other words, the organization of the market for external capital. By employing this distinction, theoretical improvements are likely to follow in both areas, and, at least according to Blaug (2000), generally have.⁵

However, while the distinction between entrepreneur and capitalist seems to be both crucial and valid, it has also led to a division of this particular field of economics into an entrepreneurial and a financial literature (this division, by the way, is fully in line with the general division of the overall subject of economics into smaller parts that has occurred). Moreover, and most importantly, the distinction seems to have led to the paradoxical

⁵ The classical economist, like Smith, Ricardo and Marx, did however, not make the distinction explicitly. Schumpeter 1934/2000, p. 59) wrote “most economists up to the time of the younger Mill failed to keep capitalist and entrepreneur distinct because the manufacturer of a hundred years ago was both.” That is, excluding at least Cantillon, Say and Turgot. Within the modern mainstream theories the capitalist and the entrepreneur play a less important role (see for example Baumol 1968 and Barreto 1989), although there are many empirical studies. It seems Blaug’s (2000) point above holds in this regard.

situation that the empirics indicate one thing and the theory another; self-finance is of importance in practice, but not in theory.

The theories presented above have met criticism. Rothbard (1985, p. 283) criticized Kirzner and meant that “[e]ntrepreneurial ideas without money are mere parlor games until the money is obtained and committed to the projects.” He meant that “the capitalist-entrepreneurs, economically the more important type of entrepreneur [...] are the men who invest in ‘capital’ (land and/or capital goods) used in the productive process. Their function is [...]: the advance of money to owners of factors and the consequent use of the goods until the more nearly present product is later sold”⁶. It should be noted that Cantillon (1755), Say (1803) but foremost Turgot (1774/1921) earlier had pointed out the importance of this so-called capitalist-entrepreneur⁷. The practical (or economical) importance of the capitalist-entrepreneur allegedly stems from advancing funds for capital goods and labor⁸. However, none of these prominent thinkers seem to have provided no reason for why this advancing of funds had to be made by self-financing rather than by external financing.

Another critic, Shostak (1999), means that “it is not the Kirznerian entrepreneur who contributes to economic growth, but only an entrepreneur who employs funding in accordance with consumers’ most urgent needs”⁹. Foss & Klein (2004) criticize Kirzner for implying that, “[i]n Kirzner’s formulation, the worst that can happen to an entrepreneur is the failure to discover an existing profit opportunity. Entrepreneurs either earn profits or break even, but it is unclear how they suffer losses.” Shane (2003, p. 18) points out that “[b]ecause entrepreneurial opportunities are not always profitable, they should not be thought of as Ricardian, Schumpeterian or any other kinds of rents. Such a view would require entrepreneurial opportunities always to be profitable.” Because this is far from the case, Kirzner would then be wrong on this particular account.

This kind of critique seems to be well founded. At the same time, it does not make the theoretical support for the empirical fact of the importance of self-financing much stronger. On the other hand, it also seems that the critique is not so much aimed at the theoretical distinction between entrepreneur and capitalist *per se*, but rather at the lack of synthesis in this field; a synthesis between theories from entrepreneurial studies and from financial ditto;

⁶ Rothbard (1962/2001, p. 463).

⁷ Turgot for example distinguished between those that with own funds could advance means of production (undertakers or capitalists), from those that couldn’t, i.e. between the capitalist entrepreneur and others. He meant that “that the class of cultivators may be divided, like that of manufacturers, into two branches, the one of undertakers or capitalists, who make the advances, the other of simple stipendiary workmen” (Turgot 1774/1921, paragraph 65).

⁸ The connection between Turgot (1774/1921) and Rothbard is obvious; see Rothbard’s (1999) biography over Turgot.

⁹ Also Salerno (1993) shares this view.

and synthesis between empirics and theory. Fortunately, attempts to provide this kind of synthesis are available.

3 The Emerging Synthesis

Casson (1982/2003, p. 127), a leading proponent of the emerging synthesis of earlier theoretical insights, means that:

“It is tempting to suggest that if there were a perfect market in capital, then the wealth [or liquidity] constraint would disappear and the entrepreneur could borrow as much as he wished at the prevailing rate of interest. But this is false [...]. // The entrepreneur who believes that he has relevant information believes that other people have got the allocation of resources wrong. If he cannot license the information, then he exploits it by backing his own judgment against theirs. This entire policy rests on the fact that other people think differently to him. He cannot expect people who think differently to lend him money to back his judgment against theirs, when if their judgment is proved correct he will be unable to repay the loan.”

Thus, it turns out that various kinds of differences between individuals play an important role. Entrepreneurship and its financing is more than just a question of people being innovative and alert or the organization of the market for external capital. According to the emerging synthesis, which emphasizes ‘judgmental decision-making’, the private ownership and self-finance by the entrepreneur himself plays an immensely important role. The question of how to finance entrepreneurial ideas thus seems to be inseparable from how such entrepreneurial ideas will materialize in the first place. Here I will try to distill, clarify and elaborate on this perspective.

Judgmental Decision-Making

When it comes to judgmental decision-making, Foss & Klein (2004) notes:

“Judgment is distinct from boldness, innovation, alertness, and leadership. Judgment must be exercised in mundane circumstances, for ongoing operations as well as new ventures. While alertness tends to be passive [...], judgment is active. Entrepreneurs ‘are those who seek to profit by actively promoting adjustment to change. They are not content to passively adjust their . . . activities to readily foreseeable changes or changes that have already occurred in their circumstances; rather, they regard change itself as an opportunity to meliorate their own conditions and aggressively attempt to anticipate and exploit it’ (Salerno, 1993: 123). Those who specialize in judgmental decision-making may be dynamic, charismatic leaders, but they need not possess these traits. Decision making under uncertainty is entrepreneurial, whether it involves imagination, creativity, leadership, and related factors or not.”

The judgmental decision-making is the crucial attribute of the individual entrepreneur. Shane (2003) seconds this view, adding that “psychological characteristics are not sufficient conditions and so do not cause people to exploit entrepreneurial opportunities. Rather, they influence the exploitation decision” (p. 96). This view is also shared by Casson (1982/2003) that defines the entrepreneur as “someone who specializes in taking judgmental decisions about the coordination of scarce resources” (p. 23). Individuals with equal taste acting under similar circumstances but with different information available and different perception

might very well reach different decisions (p. 13). From this Casson draws the following interesting conclusion (p. 14):

“Thus the essence of entrepreneurship is being different – being different because one has a different perception of the situation. It is this that makes the entrepreneur so important. Were he not present, things would have been done very differently. In this way the entrepreneur’s perception of the situation exerts a material influence on the allocation of resources.”

Hence, Casson means, among other things, that a single individual’s perception can have a direct effect on the material resource allocation, regardless of whether it is shared by others or whether it is correct or not. The entrepreneur always is an individual – not a group, a team, a committee or an organization. This follows from the fact that only the individual can perceive. Of course, several persons can always cooperate and guide each other, but the innovation or discovery always takes place at the individual level¹⁰. Casson (1982/2003, p. 22) also means that:

“There will be a demand for entrepreneurial services so long as opportunities for coordination exists. Opportunities will exist as long as new information is becoming available, in the light of which the existing allocation of resources appears inefficient. The new information may be a net addition to the stock of knowledge, in the sense of a discovery of something about which people were previously ignorant, or a replacement for obsolete knowledge. The former case is exemplified by scientific breakthroughs, successful prospecting for minerals and so on. The latter case, which is far more common, is exemplified by the updating of knowledge in the light of a recent event, that is by information that the state of the world has changed.”¹¹

It might be argued that Casson is somewhat limited in his emphasis on the importance of individual differences in information and perception. Perhaps it should be made explicit that also individuals with similar taste, under the same circumstances and with the exact same information and perception might reach different decisions. After all, the perceived information still has to be interpreted. It is also likely that people have different ability when it comes to implementing such decisions, an ability that even might vary over time for the same individual. Thus, individual differences when it comes to information *and* perception *and* interpretation *and* implementation explain why some act more as entrepreneurs than others.

Also Shane (2003) shares this view on entrepreneurship¹². He means that entrepreneurship assumes the existence of possibilities; entrepreneurial possibilities are not only something that exist in the conscience of the entrepreneur but rather contain a component of objectivity

¹⁰ Blaug (2000, p. 85) shares this view.

¹¹ The similarity with Hayek’s and Kirzner’s view on knowledge and discoveries clearly makes its presence. What is more vague is how scientific breakthroughs are made, new mining prospects discovered, etc, and Shane (2003, p. 23) seems to share Casson’s vagueness in this particular regard. After all, is this kind of information something that falls upon the individual? Rather, it seems that judgmental decision-making applies in such instances as well.

¹² Blaug (2000, p. 85) believes this view to be promising, although perhaps not fully having accepted it. Instead, Blaug (2000, p. 76) means that “a businessman needs not be a ‘capitalist’ or ‘manager’ but he must be a decision-maker, whether he liked it or not. It is this function alone that deserves the title of ‘entrepreneurship’.”

(p. 6)¹³. Thus, entrepreneurship is not inherent in some individuals (and not a profession) but rather depending on the judgmental individual's response to such objective possibilities.

Thus, according to the perspective of entrepreneurship as judgmental decision-making, we have the following important conclusion: *when it comes to external financing of entrepreneurship, problems related to information, perception, interpretation and implementation are always likely to occur*. This insight leads to another insight of great importance.

The Market-Making Entrepreneur

Casson (1982/2003), fully in line with both Schumpeter and Kirzner, means that the entrepreneur is the one that actually creates markets, not only makes them work better. This market-making include a number of activities that carries with them expenses, expenses not always emphasized by economists. This includes everything from making prototypes to writing business plans¹⁴. To be able to try out an innovation or discovery, *the entrepreneur tends to face expenses long before there is a trustworthy or reliable plan or product to present to prospective external financiers*.¹⁵

Admittedly, Kirzner (1973, p. 49) writes that "analytically the purely entrepreneurial role does not overlap that of the capitalist, even though, in a world in which almost all production processes are more or less time-consuming, the entrepreneurial profit opportunities typically require capital." This seems to be a confirmation of the fact that Kirzner was aware of this point, but it is far from evident. Kirzner seems to have in mind intertemporal arbitrage, not pure arbitrage. Pure arbitrage is always made between different places, i.e. to buy cheap in one spot and sell dear in another. This form of arbitrage, however, also involves advancing money; even if the payment took place at the same moment in time, which is not very often, the entrepreneur would still have to advance funds in one place¹⁶. A certain amount of capital is needed also for pure arbitrage, not only intertemporal arbitrage.

In relation to this, Shane (2003, p. 161) means that:

"Because the exploitation of an entrepreneurial opportunity requires the acquisition and recombination of resources before the sale of the output from that recombination, it must be financed. This financing process can and does include financing by the entrepreneur herself. In fact, in the vast majority of cases, founders finance the exploitation of entrepreneurial opportunity out of their own savings."

13 This is in line with Kirzner (1973, p. 74), who earlier noted: "I view the entrepreneur not as a source of innovative ideas ex nihilo, but as being alert to the opportunities that exist already and are waiting to be noticed."

14 Casson (1982/2003, p. 148) mentions at least nine different activities.

15 This has led researchers within the management literature to conclude that it's not even worth the attempt for prospective entrepreneurs of trying to convince external financiers (see for example Bhide 1999, p. 149).

16 Arbitrage in one and the same spot at the same moment in time is rare, to say the least. Kirzner (1973, p. 58) seems to contradict himself in a hypothetical example involving a hunter. The hunter starts by purchasing (or renting) a gun, something that normally requires some capital to advance. The return from the hunting venture then is ascribed to the purchase of the gun, according to Kirzner. However, he does not explain how this return would have been possible without the advance of capital, either by the hunter or the owner of the gun. It seems there would have been no return at all without first having purchased or rented the gun.

There is a clear connection between this view and for example Turgot's (1774/1921) and Rothbard's (1985) view on the importance of the capitalist-entrepreneur. *The capitalist-entrepreneur, as the person that advances own funds in production, is not only important because of the need to advance funds, but perhaps even more important is the fact that without capitalist-entrepreneurs there might be far less innovation, discoveries and entrepreneurship.* The capitalist-entrepreneurs have been acknowledged as important in practice. One might add that they also are important theoretically.

The Theoretical Significance of Self-Finance

"[T]he only widely endorsed test of entrepreneurial ability is to try out in practice", as Casson (1982/2003, p. 198) put it. Self-finance and privately held wealth, of large or small magnitude, will always play an important role when people decide whether to explore entrepreneurial opportunities or not, and hence also be important for the overall extent of entrepreneurship in society. Privately held wealth often is a direct requirement for obtaining external financing, something Shane (2003, p. 167) points out. Thus, by the existence of privately held wealth, also the market for external financing improves. Such private wealth might also serve as a cushion against unforeseen negative events (Shane 2003, p. 162). But even if the entrepreneur actually would have the possibility of convincing external financiers, there often are reasons not to reveal the ideas before they are saleable because of the risk that such financiers should copy the idea themselves. There are ways of circumventing problems like these, but they can never ever fully disappear. Self-finance is the natural solution.

Economists like Casson (1982/2003) and Shane (2003) has provided a synthesis that has taken theories on entrepreneurship and it's financing further. Also Foss & Klein (2004) seem to support this view, at least implicitly. It should be pointed out, though, that Casson does not at all emphasize the importance of self-finance (he devotes only 8 paragraphs to it in a 270 page book). Despite this, Blaug (2000, p. 85) has noted the Casson point and approves of it. On the other hand, Shane (2003, Ch. 8) devotes a full chapter to this subject and hence must be said to be the foremost proponent of this view (however, with some very important omissions as we soon will see).

By this kind of synthesis, we can note that self-finance and the capitalist-entrepreneur, i.e. the entrepreneur with own means, not only plays an important role in practice, but also in theory. Blaug (2000, p. 85) means that this "throws new light on the long-lived reluctance in economic thought to divorce proprietorship from entrepreneurship, thus identifying the capitalist with the entrepreneur." Economists that have failed to make the distinction between entrepreneur and capitalist have in a peculiar way been right anyway, although

they of course had no real explanation for it. This explanation instead comes from those that employ the distinction, like Schumpeter and Kirzner, Turgot and Rothbard, Casson and Shane.

4 Barriers to External Financing and Self-Finance

When it comes to the entrepreneur's access to financing, Casson (p. 193) means:

"A person who has entrepreneurial ability and access to capital in one form or another is said to be a qualified entrepreneur. [...] A person who has entrepreneurial ability but no access to capital is said to be a unqualified; to all intents and purposes he may as well have no ability either, for whatever ability he has cannot be exploited"

A person with access to neither external financing nor self-financing is less likely to be able to explore the entrepreneurial opportunities that are out there. Thus, the question arises how the barriers to such financing look like?

Barriers to External Financing

The idea that external financing brings with it problems related to information, etc., is nothing new. Information related problems like 'moral hazard' and 'adverse selection' have for a long time been subject of inquiry in the literature on financing¹⁷. It is for example conceivable that a rich flow of external capital will make entrepreneurs act less prudently than had it been their own (an example of moral hazard) and that it happens that 'non-entrepreneurs' receive funding despite close scrutiny (an example of adverse selection).

Venture capital is in a way more 'intelligent' than ordinary risk capital, since it is a better way of dealing with the inherent problems¹⁸. The intelligence lies, of course, with the persons and organizations that specialize in this kind of activity, an activity that also is a kind of entrepreneurship.

The government has attempted to provide seed capital for start-ups, but normally fail to address both the information related problems and the issue of advancing funds (funds are required to even be able to make an application to the government board). Fuest et al. (2003) even go far enough to state that such government grants create too much entrepreneurial entry. Shane (2003, p. 167-91) devotes a lot of space to describing how the various problems could be addressed from the perspective of judgmental decision-making. Schuetze & Bruce (2004) supply an extensive overview of the state-of-the-art literature on the relation between entrepreneurship and tax policies.

¹⁷ See for example Shane (2003, p. 233-4).

¹⁸ See for example Keuschnigg & Nielsen (2004).

Common to all of these studies is, however, the fact that they almost exclusively focus on the barriers to external financing and how these can be alleviated. None of them discuss the barriers to self-financing of entrepreneurship. Not even Shane does this, allocating only one single paragraph to stating the obvious fact that the individual always will face limits to self-financing (p. 171). Hence, literature studying the barriers to self-financing of entrepreneurship seems to be non-existing, and, alas, also from the perspective of judgmental decision-making¹⁹.

Barriers to Self-Financing

Despite this, the barriers to self-finance of entrepreneurship apparently exist. The entrepreneur's access to capital is limited for different reasons and to different extent. This is a topic that it seems wrong not to address, and indeed, given the importance of self-finance, this is a topic that rather should be emphasized. As a matter of fact, *many barriers to self-finance are largely created by political means and can therefore – here they differ from the problems related to external financing – also be alleviated by political means.*

The barriers to self-finance naturally become a question related to barriers and limits to the keeping of incomes and privately held wealth. There are already a number of studies, both empirical and theoretical, of the effects of taxes and regulations on incomes and privately held wealth that could be integrated with the perspective of judgmental decision-making. This might appear somewhat elementary, but considering the importance and neglect of this perspective, it might be appropriate to provide a rough classification of the barriers to self-finance. *The barriers to self-finance thus falls into two categories, (1) barriers to the building up of privately held wealth, regardless of the magnitude, and (2) barriers to the preservation of privately held wealth.*

When it comes to the first category, privately held wealth basically comes from savings, i.e. abstaining from consuming current income. Such saved means can then be used for future consumption or investment (perhaps in entrepreneurial activities). A number of factors influence decisions about saving, consuming or investing – both at the level of the individual, group and on aggregate – and some of these decisions are influenced by various political barriers. Taxes and regulations that limit the possibilities and incentives to save thus influence the amount of privately held wealth. Taxes and regulations that limit the possibilities and incentives to earn an income also influence the amount of privately held

¹⁹ I'd love to be proven wrong on this statement. A literature search on the Internet (NBER, EconPapers, IDEAS, WoPEc, SwoPEc as well as google.com) provided no proof to the contrary. Shane's book is only about one year old and could be considered the state-of-the art.

wealth. In practice, such taxes and regulations include everything from forced savings to income taxes.

The significance of savings for entrepreneurship has been studied empirically in for example Caner (2003) and Gentry & Hubbard (1999). The relationship between marginal taxes and entrepreneurial entry has been studied empirically by for example Gentry & Hubbard (2000, 2004) and Poterba & Samwick (1999). Carroll et al. (2000) conduct an empirical study on personal taxes and growth of small businesses. Schuetze & Bruce (2004) provide an up-to-date overview of this field. Hence, there are studies available that could be integrated into this perspective of judgmental decision-making, but there is of course also room for studies that take this perspective as the starting point.

When it comes to the second category, there certainly are numerous barriers to the preservation of privately held wealth. Some of those are created by political means, like for example wealth, real estate, inheritance and gift taxes. Such taxes and regulations not only hamper the preservation of but also incentives to build up wealth. As entrepreneurship not only involves new businesses, similar barriers hamper also already existing entrepreneurs in financing new innovations and discoveries, depending on to what extent they are allowed to keep the fruits of their labor (more on this below).

The government has in a way already recognized the importance of self-financing. There are for example attempts made by various governments to solve the problem of lack of self-financing by ways of a general grant, available for everyone starting a new business. This might look promising, especially since the problems related to information, etc., and the advancing of funds are avoided²⁰. However, this kind of grant or subsidy is no real solution. Rather, it is a part of the problem, since the money grants are raised most often by taxation. This means that while such grants might turn out to be helpful for some, it might prove not so helpful for others. While some benefit and overcome financial barriers, other loses as barriers are raised.

All the political barriers to self-finance that exist today make it difficult for a lot of people to explore the entrepreneurial opportunities that in fact exist. These people "may as well have no ability either", as Casson put it.²¹

²⁰ See Carling & Gustafson (1999) for a positive account of this kind of grant.

²¹ This might serve as an explanation as to what has been called the "Swedish Paradox" - despite relatively high Swedish R&D intensity few high tech products reach the markets (Edquist & McKelvey 1998). After all, on an international comparison, barriers to self-finance are relatively high in Sweden.

Holds Regardless of Size of Enterprise

Entrepreneurship often is equated with new businesses, self-employment or small businesses but, of course, entrepreneurship can also exist within larger businesses. Does this imply that the strong relationship between entrepreneurship and self-finance holds regardless of size of the enterprise? Does size matter?

It turns out that there might be some differences and that size matters. There is a difference between (1) persons that seek to finance a new innovation or discovery and thus having to attempt taking the step from being only prospective entrepreneurs to being qualified entrepreneurs and (2) those that already are qualified entrepreneur but want to finance a new innovation or discovery. It matters if you are already in business (regardless of size) or not. Existing businesses already have an own working capital to employ when necessary (although this capital of course always will be limited). This will allow an existing business to advance funds in a way more difficult for prospective entrepreneurs. Differences between smaller and larger existing businesses are not as striking in this regard.

The already established entrepreneur also has, because of the existing own capital, better chances at bringing in external capital (as noted above) and thus perhaps need not employ as large share of the own funds as is needed for the prospective entrepreneur. This makes the financing of a new opportunity less risky from the viewpoint of the entrepreneur, but only to a degree. The same holds for the external financiers in such cases.

Hence, it matters if the entrepreneur is established or not when it comes to overcoming the kind of information-related problems discussed in this paper. But while it seems that there are some important differences, they seem to be mostly of degree, not of kind – the strong relationship between entrepreneurship and self-finance still holds.

5 Concluding Comments

Self-financing of entrepreneurship is important and this is an empirical fact. In this paper I have attempted to clarify and distill the theoretical arguments that exist as explanations for why self-finance seems to be so important and to clarify what the barriers to self-finance look like.

First of all, different kind of problems will almost always arise in relation to external financing of entrepreneurial innovations and discoveries. This fact stems from inherent differences between individuals when it comes to such things like information, perception, interpretation and implementation. Moreover, the prospective entrepreneur tends to face expenses long before there is a trustworthy or reliable plan or product to present to

prospective external financiers. These problems related to external financing can be lessened in various ways, but never fully avoided.

Secondly, with self-finance, such critical problems are avoided. And as self-financing presents itself as the natural solution to such problems, the extensive empirical results have found a comprehensive theoretical explanation.

Thirdly, the many barriers to self-finance existing today are largely created by political means and can therefore – here they differ from the problems related to external financing – also be alleviated by political means. The barriers to self-finance falls into two wide categories, (1) barriers to the building up of privately held wealth, regardless of the magnitude, and (2) barriers to the preservation of privately held wealth. Studies of how various taxes and regulations affect decisions about saving, consuming, investing are indeed nothing new, but nevertheless seem to be so from the perspective of judgmental decision-making. Thus, there are reasons to once again study these two wide categories of barriers.

The conclusion reached about the theoretical importance of self-financing seems to hold regardless of size of enterprise and are in this sense general. The size matters, but the differences are of degree, not kind. The conclusions have clear policy implications.

Fuest et al. (2003) correctly note that “governments in many countries frequently take measures at local and state levels to stimulate entrepreneurial activity.” Given the importance of self-financing of such activities, one would expect them to adopt policy measures lessening the barriers discussed here.

That would indeed stimulate entrepreneurship. However, it appears to me that such policy changes shouldn't be called political 'stimulation' of entrepreneurial activity. Tearing down barriers to entrepreneurial activity in fact is more like ending the politically imposed limits to entrepreneurial activity; doing so is not stimulation, but rather imposing less restraint. Thus, if anything, governments should impose less restraint. In that way more people are likely to be able to explore the many entrepreneurial opportunities that actually exist.

In relation to this, the following words by Mises (1922, p. 167) make sense:

“Progress cannot be organized. [...] Society can do nothing to aid progress. If it does not load the individual with quite unbreakable chains, if it does not surround the prison in which it encloses him with quite unsurmountable walls, it has done all that can be expected of it. Genius will soon find a way to win its own freedom.”

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