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Methods and Trends in Financing Entrepreneurship

Qinyuan Liu

Sophomore Class, San Domenico School, San Anselmo, CA, USA
Email: st3venlqy@gmail.com

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Abstract

This paper aims to explore various methods of financing entrepreneurial activity. These methods include utilizing savings and windfalls, credit cards, home equity loans, small business loans, and venture capital. The study examines the potential benefits and drawbacks of each financing model, their compatibility with distinctive business strategies, and the sacrifices or unique advantages that play a role in the firm's success. Furthermore, the research analyzes some trends regarding the various approaches, as well as the tendency to be used under different scenarios pertaining to both the entrepreneur and the business itself.

Keywords

Windfalls, Autonomy, Unicorn, Self-Employment, Finance, Equity

1. Introduction

Small enterprises play a major role in most economies around the world, particularly in developing countries. They represent about 90% of total businesses and more than 50% of employment worldwide (see **Figure 1**). In emerging economies, they are responsible for more than 40% of national income (World Bank).

A crucial component of the development of these firms is the method by which they are able to obtain financing—both for a firm's initial startup and for ongoing operations. For most startups or other early-stage firms, entrepreneurs are presented with a variety of financing methods. These methods range from self-financing using an entrepreneur's own savings, using debt financing like credit cards, home equity loans, or small business loans, or turning to equity financing from sources like venture capital firms. In this paper, we discuss some of the unique advantages and drawbacks of each of these types of financing methods.

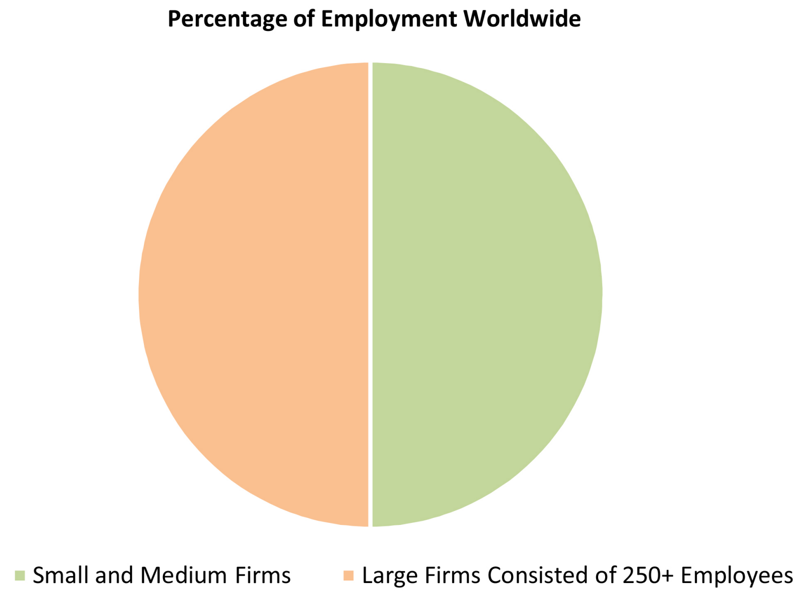

Figure 1. Approximate employment proportion of small and medium firms worldwide (World Bank SME Finance: Development News, Research, Data|World Bank, n.d.).

As one example, opting for a home equity loan as a financing method may put an entrepreneur's most important asset at risk. However, this financing method has the advantage of its convenience. The amount that can be borrowed is almost entirely driven by the equity available in the entrepreneur's house, which varies depending on local house prices. Importantly, the entrepreneur does not need to have an exceptional business plan or a long-standing connection to a bank in order to borrow money using a home equity loan. This makes home equity borrowing an attractive option for those who may not qualify for other types of financing such as a small business loan.

Other types of financing may benefit the firm even beyond the capital being offered. Venture capitalists, for instance, often provide access to expertise in growing and scaling new businesses that can prove valuable to a new entrepreneur. However, selling equity to the VC firm can also result in a loss of autonomy for the firm as the VCs can gain substantial control over business operations and decisions. Using credit cards to finance the business presents a completely different scenario. Credit card financing does not offer any expertise or guidance that venture capital financing can provide but it also does not require any sacrifice of the firm's shares or control rights in order to borrow money.

The financing methods today are diverse and can often be overwhelming for entrepreneurs, making it essential to carefully consider and opt for the most compatible option. This study will explore the various financing methods available and provide an overview of financing businesses.

The article is organized as follows: In Section 1, we introduce the importance of opting suitable methods of finance for small firms' entrepreneurs and outline the objectives of our study. Moving on to Section 2, this paper delves into the first finance method—self-financing and windfalls, where we examine the advantages and disadvantages of relying on internal sources of capital or unexpected capital gained by fortune. In Section 3, we compare credit card finance with other financing sources through graphs whilst introducing its shedding light on the suitability and risks entailed in this financing approach. Section 4 takes a deep dive into home mortgages and lines of credit, offering insights into how entrepreneurs with assets can utilize them for their business growth and pointing out the prevalence of this method among distinctive scales of firms. In Section 5, we explore small business loans and analyze their benefits and drawbacks for small firm financing. Finally, in Section 6, we assess venture capital, highlighting its focus on potential growth, expertise provision, and the trade-off of autonomy for funding and guidance.

2. Literature Review and Methodologies

This paper's methodology is a comparative review of existing researches where we discuss and consider their findings in a broader spectrum. We aim to synthesize their key findings and insights to create a comprehensive understanding of the various factors that influence funding decisions. This is to offer an overview of the relative benefits and drawbacks across a number of disparate funding sources. For instance, the study "What do Firms do with Cash Windfalls?" (Blanchard & Lopez-de-Silane, 1993) and "Shale shocked: Cash windfalls and household debt repayment" (Cookson, Gilje, & Heimer, 2022) have illustrated the behavior and response of firms in the circumstances of encountering windfalls. Meanwhile, the study "Squaring Venture Capital Valuations with Reality" (Gornall & Strebulaev, 2018) and "Financing Ventures" (Greenwood et al., 2020) both discuss the critical role that Venture Capitalists play in financing startups and driving economic growth. They also highlight the importance of accurate valuation models for venture capital-backed companies. Moreover, the journals "How Credit Constraints Impact Job Finding Rates, Sorting & Aggregate Output" (Herkenhoff et al., 2016) and "The Impact of Consumer Credit Access on Self-Employment and Entrepreneurship" (Herkenhoff et al., 2018) have both demonstrated the significance of personal credit access and its impact on entrepreneurial decisions. These two journals have pointed out that personal credit access leads to an increase in self-employment and employer business ownership.

3. Self-Financing and Windfalls

It is a longstanding practice to utilize one's own savings for investment in a new small business. Many entrepreneurs are able to tap into their own cash reserves or savings rather than seek external financing. This financing decision may be driven by several factors, including a desire to maintain control over the firm, the availability of an entrepreneur's own resources relative to outside financing, and the cost of such outside financing.

Specifically, utilizing the wealth from an entrepreneur's own savings provides an interest and collateral-free source of financing for the firm, along with full control over any future cash flows. If the entrepreneur has the means to self-finance, the risks of a poor reputation or poor credit hindering outside financing are alleviated, making it a more accessible option for financing the growth of the firm. In addition, it is also a sign of commitment to the firm's expansion and potential, as it indicates the entrepreneur's willingness to invest their savings into the firm rather than relying on external sources of capital.

In fact, research on self-financing and entrepreneur's savings (Gentry & Hubbard, 2004) noted that asymmetric information in imperfect credit markets can lead to external lenders being negatively disposed towards certain firms and a consequent refusal to lend money to these firms. To alleviate this risk of reliance on outside creditors, entrepreneurs are prone to have a notable amount of savings in order to self-finance at any time. In this scenario, self-financing provides a secure foundation for sustaining the business's operations and maximizing returns to the entrepreneur. In other words, differences in the perceived merit and risks of a given small business from outside viewers may result in insufficient external financing options, which can make self-financing an ideal strategy.

Nevertheless, the constraints of self-financing or utilization of windfall are not negligible. Particularly for first-time entrepreneurs, self-financing demands thorough consideration before investing funds into the business due to the potential for business failure. When confronting business failure, the entrepreneur may lose not only their current means of income and employment but also their personal savings and assets.

The lower potential scale of self-financing may also suppress the long-term development of the firm. A recent study (Kabbage Inc., 2019) notes a high likelihood of insufficient startup capital among entrepreneurs of early-stage firms. In fact, research found that approximately a third of sampled firms had access to less than $5000 of additional capital. Therefore, entrepreneurs who are not willing to bear the cost of limited capital or who are expecting a fast growth rate and large scale within a short period may not be the most suitable fit for this model.

Because self-financing is constrained by available financial resources, the arrival of additional liquidity in the form of windfalls—substantial and unexpected financial gains from other sources—has been shown to drive substantial increases in entrepreneurial activity. Whether it arrives through lottery, inheritances, or unexpected business success, windfalls carry both beneficial and challenging factors that require evaluation.

For instance, Cookson et al. (2022) illustrate the connection between windfall receipt and debt repayment, shedding light on post-windfall scenarios. The study identified and corrected an inaccurate estimation made by the forward-looking debt model, which suggested that household debt might increase after receiving a windfall due to asset purchases. The study's analysis demonstrated a declining trend in sampled household debt following a windfall. This decline was attributed to the debt repayment behavior practiced by households, rather than the use of funds for new asset acquisitions. Furthermore, the study also revealed that debt repayment may have three times more significant impact on the personal credit of subprime individuals compared to prime individuals, which may explain the debt repayment behavior mentioned above.

Furthermore, Lindh and Ohlsson (1996) helped to clearly reveal the relationship between a windfall receipt and self-employment behavior. Utilizing Swedish microdata, the study demonstrated that the likelihood of self-employment increases upon receiving a windfall. The study pointed out that this finding supports the hypothesis that liquidity constraints are binding on the decision to become and to remain self-employed. Another study (Ring, 2020), examining the impact of negative shocks to financial resources, reached similar conclusions. The author stated that as the decline of the economy impacts potential entrepreneurs through negative wealth shocks, the number of new businesses declines sharply. These findings underscore the significant role that personal financial circumstances and resources play in entrepreneurial decision-making.

In the presence of imperfect capital markets, financial windfalls can present numerous opportunities for growth even beyond the financing of the initial beginnings of a firm. With a sudden increase in its funds, the firm can alleviate urgent financial pressures, providing breathing room and enhanced financial flexibility. For instance, the funds previously reserved for debt repayment can now be strategically invested in the firm's products, workforce, or services, enabling a broader scope to generate revenue. For instance, Blanchard and Lopez-de-Silane (1993) noted that small firms receiving financial windfalls do not simply return excess cash to shareholders but increase investment, suggesting that other sources of capital may be deficient for small firms.

Besides managing internal circumstances, the study also suggested that firms utilize the funds to acquire other firms, regardless of their relevance to the first firm. However, the acquisitions of less relevant firms feature a higher possibility of business failures, according to the study, and are divested after a few years. In addition, the study shed light on the agency model of managerial behavior that sampled firms manifested after receiving a cash windfall; through examination of decisions made by sampled firms, the study demonstrated that managers are prone to maintain the capital within the firms and invest in unattractive projects in order to diversify, and indicate the firm's independence, ability, and potential for future growth.

Despite the substantial opportunities that an unexpected windfall may present to the firm, it is worth noting that such a windfall may also introduce certain constraints. Unrealistic revenue predictions, for example, may occur when a firm receives a windfall. When such behavior takes place, the firm's business strategy can be severely impacted, leading to potential misallocation of resources. Not only does the sudden influx of the firm's capital lead to overestimation from internal analysis, external shareholders may also display unrealistic expectations towards the firm's future performance. Under circumstances when the firm failed to reach those expectations, shareholders may cast doubts and critiques toward the firm that result in damages to reputation.

4. Credit Cards

When entrepreneurs do not have sufficient personal funds to launch their business, they may turn to outside financing by means of borrowing capital. Credit cards have long been a popular method of financing for small firms. Utilizing credit cards to finance small businesses may be an advantageous approach, offering entrepreneurs an easily accessible method to fund and invest in the firm's growth that does not require any collateral or assets to borrow against and thus expose to potential loss.

As a consequence, it is a relatively attractive strategy for those who don't have enough initial assets and it can also continue to aid a firm in financing growth over time. In fact, according to recent research, 44% of small firms now have revolving credit card debt, up from 39% in the year 2021 (Power, 2022). The study suggested that entrepreneurs and small business owners are increasingly finding that credit cards are an accessible and convenient source of financing for their firms.

Beyond a lack of need for collateral, financing with credit cards offers a number of additional benefits to entrepreneurs. Credit cards are revolving credit, which is a more flexible form of financing than a fixed loan amount and fixed term loans as it allows entrepreneurs to partially choose their own full repayment dates. In addition, entrepreneurs do not need to pay interest on the full amount of the credit limit, but only the amount they utilize at a given time.

The power of credit access in driving entrepreneurship was noted in research by Herkenhoff et al. (2016). In this paper, the authors presented statistics regarding the relationship between credit availability and an individual's time to seek employment. In particular, the study indicated that the flexibility afforded by an increase in credit limits worth 10% of prior annual earnings allowed individuals to have 0.15 to 3 weeks longer to find a job. According to the study's findings, the additional time allocated for job searching led to a substantially greater probability of transitions towards self-employment and entrepreneurial endeavors.

Finally, using credit cards to finance an entrepreneurial venture means that an individual does not need to have a strong personal reputation or relationship with a bank or loan officer. This can be especially important for non-traditional entrepreneurs who may face bias from loan officers, as discussed later in Section V. Overall, credit cards can provide business owners with a convenient way to manage their firms' growth across a range of financial circumstances.

Nevertheless, credit card financing does have certain downsides relative to alternative sources of financing. For example, credit cards typically feature substantially higher interest rates than competing financing options. Specifically, research by Forbes (2023) indicated that the annual interest rate of credit cards is approximately 24.5%, while the annual interest rate of small business loans is roughly 6% to 7% among borrowers with good credit (Porter, 2023). This dramatic difference in rates can drive substantial differences in total interest expenses paid by entrepreneurs when financing their businesses (**Figure 2**).

In addition to requiring substantially higher rates, the size and horizon of borrowing are generally more limited for credit card financing than other small business lending. For instance, small business credit cards feature an average limit of $56,100 (MyBankTracker, 2020). Personal credit cards often feature even lower limits: a study by Crail (2021) demonstrated that the average limit of personal credit cards in the US in 2020 was $30,365, approximately 46% lower than those of business credit cards.

5. Home Mortgages and Lines of Credit

While credit cards can be utilized to fund entrepreneurial ventures without the use of any collateral, larger amounts of funding may be accessible through secured lending. In particular, home mortgages are loans taken out against the net value of one's house. In such a loan, the home itself is pledged to the lender in the case that the borrower fails to repay their loan. Typically, the bank will utilize a set scale to determine the maximum loan size given the value of a property.

Entrepreneurs and small business owners frequently utilize home mortgages or home equity lines of credit as a financing method for small firms for a number of reasons. For starters, borrowing against a home using a second mortgage or home equity line of credit can provide a relatively longer term of borrowing with a lower interest rate than with unsecured borrowing using a borrower credit

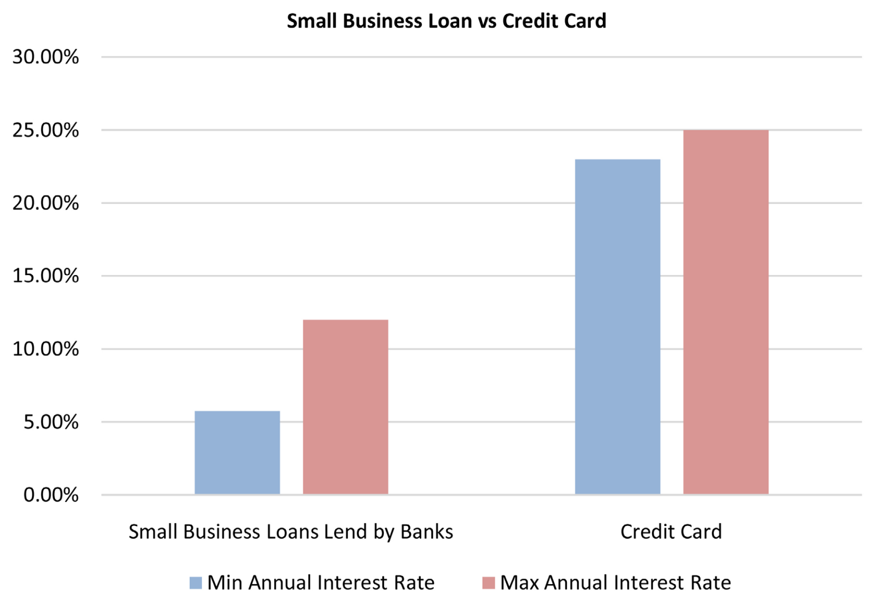

Figure 2. Annual interest rate of small business loan vs credit card finance (Crail, 2021; Porter, 2023).

card. These lower rates are driven by the fact that banks can seize the home if a defaults on a loan, reducing the risk to the bank and allowing them to offer lower interest rates for longer periods of time.

Consequently, by opting for this alternative, small firms can gain access to a much longer duration loan (15-year mortgages are common) and have lower interest rate payments than unsecured borrowing using a credit card. This diminishes the firm's cash flow pressure and financial expenses, and diminishes the risk of credit being suddenly withdrawn in an economic downturn.

One similarity with credit card borrowing is that this means of financing a small business does not require any prior relationship with a bank or financial lender. Research has shown that the ability to borrow against one's home brings opportunities for the new entrants into a particular field of business. For instance, Jensen, Leth-Petersen, and Nanda (2021) find that increases in the accessibility of mortgage financing increases the entry into entrepreneurship, especially in areas where the entrepreneur had no previous business or financing relationships. Moreover, these new entrants were typically higher quality and created longer-lasting businesses, demonstrating the value unlocked by the increased ability to borrow against a home.

Similarly, others have shown that increases in local home prices, which affect the value of collateral available to homeowners, lead to a higher probability of becoming an entrepreneur. Schmalz, Sraer, and Thesmar (2013) leverage the differences in behavior between individuals who own a house and those who rent a home in the same area to control for local demand shocks. Moreover, conditional on entry, entrepreneurs with access to more valuable collateral create larger firms and more value added, and are more likely to survive, even in the long run.

Finally, research conducted by Patnaik (2017) has pointed out a distinction in prevalent financing options between micro firms (less than 50 employees) and small firms (less than 10 employees). According to the research, businesses are prone to opt for different financing options at different sizes. Micro firms rely more on home mortgage financing, yet they may be impacted by fluctuations in local house prices. On the contrary, small firms tend to lean more on small business loans offered by banks. Small business loans may provide a larger scale to borrow and a path to additional banking services, but opting for bank financing also exposes small firms to the risk of bank failure or financial crises.

6. Small Business Loans

For entrepreneurs needing financial support for the development of their new businesses, small business loans may also be a beneficial option for capital. An entrepreneur may apply for a loan of a specific size by presenting a business plan and financial data for the utilization of that capital to a lender (usually a bank). If the bank approves the loan, the entrepreneur can then utilize this loaned capital to invest in the firm and will be subject to a schedule in order to pay off the debt over a period of time. In fact, applying for small businesses loan is a generally common financing option word-wide, especially for small to medium enterprises.

According to a research by Small Business Administration (SBA, 2020), 37% of startup entrepreneurs have opted for a small business loan in 2020, falling somewhat to 31% in 2021. This demonstrates the significant importance of small business loans in the corporate world.

The popularity of this type of financing option can be attributed to several factors. One significant advantage is the low risk exposure entailed in applying for a small business loan. Due to the fact that small business loans are a type of debt financing, rapid growth of the firm is not expected or required, unlike its counterpart such as venture capital. Specifically, the profit of the firm does not have an absolute impact on the profit of the lender. This means that small business owners can focus on growing their business at a steady pace without the pressure to meet high growth expectations.

One of the benefits of choosing a small business loan as a financing option is the potential for lower interest rates and the ability to borrow on a larger scale than with credit cards or other personal loans. Moreover, small business loans can often be longer in horizon, reducing cash flow pressures of short lending horizons and the need to rapidly pay back principal of a loan. Entrepreneurs running small firms may utilize the excess funds for long-term investments, such as real estate assets or for paying off existing higher-interest debt. This behavior can ensure that the company has a relatively stable financial position in any economic condition, and is prepared for potential economic downturns.

Having access to a larger borrowing scale can provide small businesses with the financial resources they need, leave a larger margin for product experimentation and offer a wider long-term opportunity. The funds may be utilized to hire more employees, potentially enhancing the company's scale and benefits the businesses' profit. Another example is that certain portions of the fund may be exploited to experiment with different business strategies.

Nonetheless, opting for small business loans brings potential drawbacks to the firm as well as the upsides discussed above. For instance, applying for a small business loan may require ownership of certain assets or collateral to prevent the bank from losing money in case the business fails. In particular, relevant research (Black, 2022) suggested that small business loan lenders may require real estate, inventory, vehicles or cash as collateral in order to obtain the loan. Therefore, startup entrepreneurs without an abundant accumulation of assets may face difficult circumstances while applying for the loan.

Besides the loans that require collateral, research has also pointed out constraints when applying for small business loans without collateral. One example is that the interest rate may increase if utilizing unsecured borrowing. An excessive interest rate may render the loan undesirable to the borrower as it would result in substantial pressure on the near-term cash flow of the business. For startup or micro businesses with a limited amount of capital, this behavior may be especially unfavorable. In addition, the accessibility of the loan may also diminish, due to higher requirements of the borrower's credit for unsecured borrowing. Thus, startup businesses typically with less experience and credit may not satisfy a lender's requirements.

Small business loans also have the potential for biases on the part of the lender. A study conducted in the UK, focusing on lending decision data from a high-cost loan lender, indicated potential biases towards immigrant and older applicants. The study discovered significant biases against immigrant and older applicants compared to the profits gained by the lender. When setting the profit made from white applicants as the benchmark, the study found that the profits made by older and immigrant applicants were 10% and 21% higher, respectively, suggesting that many marginal borrowers of these unfavored types were being denied loans (see **Figure 3**).

Moreover, as firms rely more on bank financing, they are naturally more exposed to variations in the supply of credit provided by banks. Patnaik (2017) notes that as firms grow, they tend to utilize bank financing and are much more affected by bank failures due to falls in bank lending. Another study (Chen et al., 2017) demonstrated a significant correlation between the economic environment of a given region, the magnitude of bank lending, and the prosperity of small firms situated within the region. This study focused on the 2008 Financial Crisis, finding that as the volume of bank-issued business loans diminished due to an unfavorable economic environment, the vitality of local enterprises also exhibited a declining trend. Therefore, entrepreneurs should not neglect the prominent risks stemming from a dependence on bank financing.

7. Venture Capital

In contrast with the previously discussed methods of financing entrepreneurial ventures using savings or debt, Venture Capital is a method of equity financing.

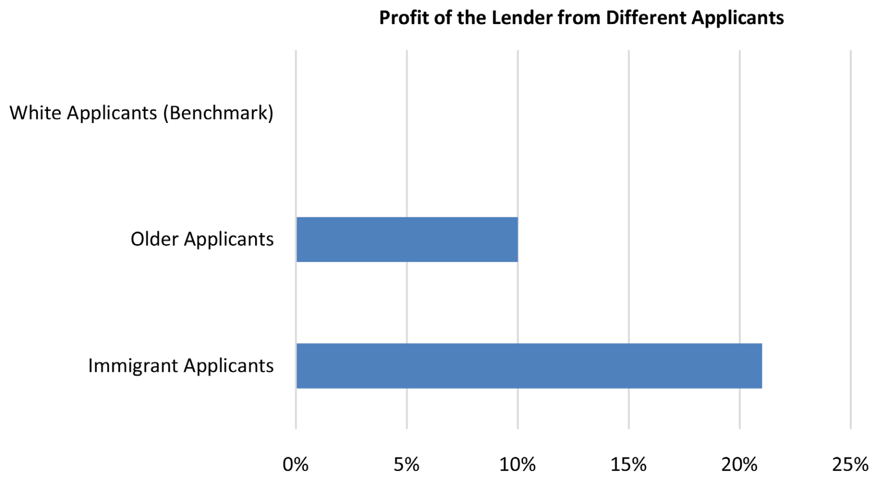

Figure 3. Profit of the lender from different applicants (Dobbie et al., 2018).

Consequently, VC investments generally do not involve any collateral or interest payments. Moreover, unlike traditional loans, VC investment decisions are not primarily driven by a company's current cash flow or physical assets.

Venture capital firms primarily invest in firms that have significant potential for future growth, regardless of their current status. Accordingly, startups that utilize venture capital financing are expected to experience substantial growth in the years ahead and reach a larger scale than other entrepreneurial ventures. Because of this desire for high future growth rates, the majority of venture capital financing rounds also entails high levels of risk, attributable to both the early stage nature of the investment and the speculative industries that venture capital tends to specialize in.

As one example, in addition, other research from Puri & Zarutskie (2010) has suggested that VC-backed firms tend to reach larger scales at all points of their lifecycle, regardless of success or failure, relative to non-VC-backed firms. That is, VC-backed firms tend to demonstrate more rapid growth when compared with firms that opted for a range of other different financing models. However, the research pointed out that the rapid growth of such firms did not necessarily exhibit as direct an effect on the firms' profitability. This may be attributable to the fact that VC investors tend to focus on the scale and top-line growth of the firm, rather than the unit economics or profitability in the near term.

As equity-based financing, venture capital requires entrepreneurs to sacrifice a portion of the shares and autonomy of their firms in exchange for both financial resources and the expertise that the VC firms can share with a growing startup. This expertise and capital from venture capital firms comes alongside increased control over the businesses. For instance, VC firms may be then allowed to take part in or even drive critical company decisions such as hiring executives, strategic business decisions, or even the decision to sell the firm.

Going beyond providing financing for startups, VCs are prone to continuously monitor the viability of the firm as the company grows and provide operational advice and expertise. Moreover, they are able to adapt their funding strategy to the business as the firm grows and enters different stages of financial need (Greenwood et al., 2020). This aspect of venture capital can be a significant advantage over other financing sources as it entails the continual provision of crucial funding and knowledge to the firm, contributing to rapid growth and helping to overcome operation problems as they arise.

Nevertheless, sacrificing the autonomy of the firm may also result in the underrepresentation of the firm's value to external stakeholders. Research focused on evaluating the true value of VC-backed unicorns (Gornall & Strebulaev, 2018) has found that the stake obtained by a VC firm is often much more valuable than the headline post-money value suggests. That is, VC firms not only gain a substantial portion of the portfolio company's equity, but they also obtain many additional rights in terms of both cash flow and control. However, other work by Ewens and Farre-Mensa (2022), has noted that recent competition for access to the best VC deals has yielded a dramatic increase in the favorability of terms presented to entrepreneurs.

As Venture Capitalists may target rapid early stage growth of the firm, aggressive strategies may be applied to the firm. Finally, VCs will naturally focus on financial returns for their investment rather than any other potential outcomes such as social benefit or employee satisfaction. Therefore, Venture Capital finance may not align with the entrepreneur's long term vision or desires and giving up large amounts of control rights to the VCs can worsen non-financial outcomes for the entrepreneur.

8. Conclusion

This study analyzes a range of circumstances that aspiring entrepreneurs may encounter when seeking financing for their firms. By reviewing the overall landscape and different approaches to financing, such as venture capital, small business loans, and self-financing, I assessed the potential benefits and disadvantages of each option. Additionally, I elaborated on relevant trends and behavior from existing literature that can offer different perspectives and relate to factors affecting decision-making.

This paper sheds light on the compatibility and characteristics of each of the aforementioned financing options. For instance, venture capital seeks higher returns yet is comfortable with higher risks and thus may be suitable for firms with an aggressive growth projection. A small business loan does not require high growth, but personal credit and collateral may be key to gaining access to it. On the other hand, a home equity loan barely demands personal credit but will place an applicant's assets at risk. Finally, credit card financing and self-financing represent significant risk-free financing options. However, the former entails higher interest rates, while the latter involves the sacrifice of the entrepreneur's personal wealth and requires substantial assets to be of use.

The variety of funding options available today can be confounding towards startup entrepreneurs and owners of small firms. Our analysis carried out in this study, as well as the literature reviewed offers insights towards the aforementioned approaches that may serve as a guidance to seize appropriate opportunities for these entrepreneurs. Apart from the entrepreneurial guidance, the study may assist with the government's policy making procedure. Specifically, the conducted examinations of the distinctive financing approach inform policymakers regarding their effectiveness and various impacts on small business growth and entrepreneurship. The reviewed literatures play a critical role in revealing certain drawbacks of the market today; examples may be the asymmetrical information between Venture Capitalists and entrepreneurs that led underestimation of certain startup businesses, or the potential biases receipt of marginalized population when seeking for business loans. Finally, this study promotes financial literacy among the general public. The promotion of relevant knowledge may lead to empowering individuals to make refined decisions and optimize their strategies, as well as to assist financial stability and a more secure future for individuals and their households.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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