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Advancing Opportunity, Prosperity, and Growth

POLICY BRIEF 2018-09

The Main Street Fund: Investing in an Entrepreneurial Economy

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We believe that today's increasingly competitive global economy demands public policy ideas commensurate with the challenges of the 21st Century. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by fostering economic growth and broad participation in that growth, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments.

Our strategy calls for combining public investment, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers — based on credible evidence and experience, not ideology or doctrine — to introduce new and effective policy options into the national debate.

The Project is named after Alexander Hamilton, the nation's first Treasury Secretary, who laid the foundation for the modern American economy. Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces. The guiding principles of the Project remain consistent with these views.

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The Main Street Fund: Investing in an Entrepreneurial Economy

By a number of metrics, economic dynamism is on the decline in the United States. The rate of new business starts has fallen over the past 30 years and the share of employment represented by young businesses has also declined. Americans are moving to different geographical locations less often than they used to and are switching jobs less frequently. At the same time, market concentration is increasing, with potentially important impacts on competition and productivity.

Against this backdrop of declining dynamism, it is striking that many of our public policies are still tilted toward large, established companies at the expense of new entrants. One of the most important such policies is the $45 billion to $80 billion in incentives provided by states, cities, and counties in their efforts to attract business development. These incentives transfer public funds—via tax breaks or direct payouts—to incumbent firms rather than to start-ups, putting the latter at a disadvantage. Moreover, subsidies to large companies run counter to the public policy goal of supporting entrepreneurship and small businesses.

In a new Hamilton Project policy proposal, Aaron Chatterji of Duke University aims to level the playing field between large, established firms and new entrants by discouraging the use of incentives. His proposed Main Street Fund would encourage states to divert these funds to investments in evidence-based programs and policies that support entrepreneurship. If even a small fraction of funds currently spent on economic incentives were used to support new businesses instead, this would easily become the largest public investment in entrepreneurship.

The Challenge

The Importance of New Firms

In recent years academic scholars of entrepreneurship have identified key differences between young businesses—which are usually small—and the much larger overall population of small businesses. Young businesses drive net job creation in the economy, while older small businesses are far less likely to grow. Prior to this research, the conventional wisdom was that small businesses created most of the private sector jobs in the economy. By contrast, new research described by the author finds no relationship between firm size and job creation.

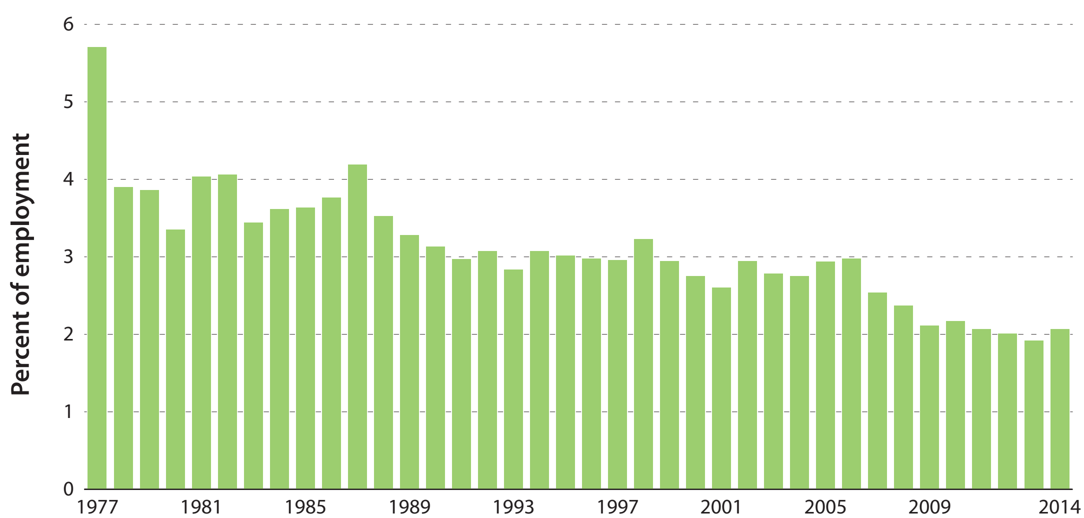
Young and fast-growing firms are pivotal: 20 percent of total job creation comes from new start-ups, which represent only 10 percent of all firms. The fastest-growing firms, defined as those with employment growth of more than 25 percent per year, account for half of all jobs created in the United States. These firms tend to patent and commercialize innovative ideas and increase overall productivity. It is this small set of firms that are most responsible for what we think of as the enormous economic benefits of entrepreneurship.

Declining Dynamism

Given the economic importance of young firms, Chatterji explains that it is disconcerting to learn that the U.S. economy is becoming less dynamic. For example, the rate of new business starts has been declining for most of the past three decades, and the share of employment in young firms has declined by almost 30 percent over the same period (see figure 1). These trends are apparent even in high-technology sectors where dynamism is believed to be strongest. There is also evidence that workers are changing jobs less frequently and moving to different geographical locations less often. This is directly related to the

FIGURE 1.

Share of U.S. Employment in New Companies, 1977–2014



Source: U.S. Census Bureau. 1977–2014. "Business Dynamics Statistics." U.S. Census Bureau, Washington, DC.

Note: New companies are defined as those one year old or younger.

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declining rate of start-ups, given that young firms contribute importantly to employment growth and worker reallocation.

State Incentives

Concerns about declining dynamism have refocused attention on an important way that public policy may be contributing to the problem: state business incentives that disproportionately flow to large, incumbent firms.

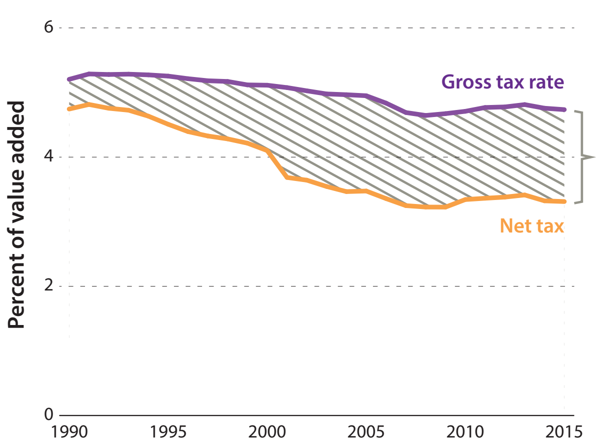
States use these incentives to attract new headquarters, expansions, and relocations of existing businesses. Recent research conducted by economist Timothy Bartik estimates that states and other jurisdictions spent approximately $45 billion in 2015 on incentives, and research from the New York Times suggests the incentives used could amount to as much as $80 billion. Bartik finds that the amount of such incentives tripled from 1990 to 2015. Two-thirds of this increase has been driven by tax credits tied to specified job creation milestones. Figure 2 draws on this analysis, showing that increasing state incentives have lowered effective corporate tax rates substantially.

The author notes that these incentives typically benefit large, established firms. The differential availability of incentives to small versus large firms—and young firms versus incumbents—is likely damaging to business dynamism.

Discussion of business incentives often presumes that they benefit the states concerned through increased employment and business activity. However, it is far from clear that many (or even most) state incentives are beneficial for the states that use them. Evaluations of incentives programs, both in the U.S. and abroad, generally find mixed or no effects on job creation or other outcomes of interest. Where incentives do generate employment, the incentives are often not cost effective. The author points out that, even if a particular incentive program does produce benefits for a single state, it still dampens competition and dynamism by giving select companies economic advantage over other firms and potential new entrants.

FIGURE 2.

Net Tax, Gross Tax, and Incentive Rates as a Percentage of Value Added, 1990–2015



Source: Bartik, Timothy J. 2017. "A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States." W. E. Upjohn Institute for Employment Research, Kalamazoo, MI.

Note: The net present value of incentives is calculated by using a 12 percent discount rate, which is the rate commonly applied within businesses. Bartik's (2017) database includes state and local taxes for 33 states and 45 industries. Incentives are calculated for export-base industries, defined as those that primarily sell goods and services outside their local economy.

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A New Approach

New research on the importance of start-ups, together with analysis of the decline in dynamism, has encouraged policymakers to think about new policies to support young businesses that have growth potential. Chatterji outlines a policy strategy that achieves two goals simultaneously: discouraging state business incentives for incumbent firms and encouraging state investments that promote successful entrepreneurship. The proposed Main Street Fund would support states that adopt evidence-based programs to promote entrepreneurship, innovation, and small business.

The Main Street Fund

Federal funds provided through the Main Street Fund would work in the following way. Each state would be allocated payments according to a formula that takes into account the state's population, demographics, and economic activity. States would have their Main Street Fund payments reduced if they provide new incentives, and they would receive extra funds if they canceled existing incentives. General incentives to the business community—whether they are improvements to infrastructure, changes to overall corporate tax rates, or subsidies to community colleges that help provide a trained workforce—would not be deemed "incentives" under this plan. Rather, the Main Street Fund is designed to discourage firm-specific or incumbent-specific subsidies that make it more difficult for new firms to enter the market.

States would be asked each year to report both newly created incentives and incentives they have discontinued as well as any evidence of other states using incentives to encourage firms to leave their state or as part of a competition to attract a business. Funds that were left over—because states were losing their allotments due to their use of new incentives—would be reallocated to states that did not extend new incentives.

The Main Street Fund would be administered in the Commerce Department by the Economic Development Administration, given its focus on economic development and regional economies. A fixed amount of annual appropriations—set at $5 billion in the first year—would be provided by Congress. States could use the federal support provided through the Main Street Fund to fund their investments in management training for new firms, enhanced reciprocity for licensed workers, new broadband infrastructure, and customized initiatives for new firms. A fraction of the appropriated funds would be used for research and evaluation of existing state programs to support entrepreneurship.

The author acknowledges that there are serious implementation challenges—some that are common to all intergovernmental transfer programs—that would need to be addressed. One of the most important is that without proper oversight, states could avoid labeling incentives spending as such, thereby increasing the value of the state's federal allocation. While this gaming behavior would still result in investment in entrepreneurship and small business, it would reduce the effectiveness of the Main Street Fund in discouraging business incentives that are aimed specifically at incumbents.

However, the Main Street Fund is designed to mitigate this problem. Under the author's proposal, states would have two reasons to report misclassification by other states. First, each state has an interest in the rest of the country spending less on business incentives, because this spending draws economic activity away from that state. Second, because the cap on a state's allocation from the Main Street Fund is increased when other states receive smaller grants, each state has an interest in appropriately assessing and reporting its neighbors' use of incentives. It should also be noted that the total cap on Main Street Fund spending, as well as each state's individual cap, lowers the risk for the federal government. Experience in the early years of the program, along with further consultation with federal and state budget experts, would be required to minimize opportunities for misclassification of incentive spending.

Main Street Funds could be spent on several different types of support for entrepreneurship and economic dynamism. Specifically, investments in management training, enhanced reciprocity for licensed workers, investments in broadband infrastructure, and customized initiatives for new firms would all be eligible for Main Street Fund support. Chatterji presents the evidence that links each type of investment with improvements in economic dynamism and growth.

Investments in Management Training

The author discusses a growing body of economic research that finds impacts of specific management practices on firm performance, including that of start-ups. These management practices involve aligning pay with performance, providing clear feedback to employees, and enacting consistent evaluation and quality improvement processes.

Firms with better management practices tend to have superior performance—growing more quickly, becoming more productive, and surviving longer. One study found that firms that adopt these best practices experience a 17 percent increase in productivity in the first year (equivalent to $300,000 in profitability); after three years these firms are opening more plants than their counterparts who do not adopt the same practices.

One interesting finding discussed by the author is that firms managed by the original founder tend to be poorly managed compared to other firms. This result suggests that some of the characteristics of entrepreneurs might not be conducive to the implementation of effective management practices. Implementing high-quality management practices would likely have positive effects on growth, productivity, and profits for many young firms. The experimental evidence that management techniques can be learned suggests the possibility of improving outcomes.

Roadmap

Congress will appropriate $5 billion in the first year for the Main Street Fund, to be administered by the Economic Development Administration in the U.S. Department of Commerce. The Fund will operate as follows:

- Each state will be allocated baseline payments according to a formula that considers the state's population, demographics, and economic activity.
- These payments may be spent on a set of evidence-based policies that support dynamism and entrepreneurship, including management training and customized initiatives for start-ups, investments in broadband infrastructure, and enhanced reciprocity for licensed workers.
- States will be asked each year to report both newly created incentives and incentives they have discontinued, as well as any evidence of other states using incentives to encourage firms to leave their state or as part of a competition to attract a business.
- For any newly created incentive, states will lose funds they were slated to receive, dollar for dollar. States will also receive credits for incentives that they can demonstrate they have ended.

Training programs, networking, and business education are all potential channels for entrepreneurs to learn management. Entrepreneurial training programs have a mixed track record of success but very few have been rigorously evaluated and a small percentage focus only on management. The Main Street Fund would support programs that teach the practices identified in the academic literature as being the most valuable for growth. In addition, it would fund efforts to better train the staff of accelerators and other entrepreneurship programs using lessons from recent research.

Enhanced Reciprocity for Licensed Workers

State subsidies to large incumbent firms are not the only state policy that impedes economic dynamism. Occupational licensing is often an important barrier to entry and specifically serves as an impediment to worker mobility across states, given the typical necessity of relicensure after a move. Chatterji notes recent research finding that occupational licensing can also reduce new business entry, particularly for those with less education and experience.

To mitigate the negative impact of licensing on dynamism, states could elect to use the Main Street Fund to reimburse themselves for recognizing out-of-state licenses. Currently, states generate new revenue when licensed workers move to their state and are required to apply for a new occupational license in order to continue practicing their professions. While this is not the only

Learn More about This Proposal

This policy brief is based on the Hamilton Project policy paper, "The Main Street Fund: Investing in an Entrepreneurial Economy," which was authored by

AARON K. CHATTERJI
Fuqua School of Business
Duke University

incentive for states to require relicensure, it is likely an important part of states' motivation.

The Main Street Fund would encourage reciprocity—and thereby support worker mobility—by providing equivalent revenue for each out-of-state license that is recognized. In order to receive funds, a state would have to demonstrate that workers holding licenses granted by other states had applied for recognition of those licenses with the state's licensing boards or relevant regulatory agencies.

Investment in Broadband Infrastructure

The Main Street Fund would also support investments in infrastructure as a way to promote entrepreneurship and innovation. One example would be access to high-speed internet, which is essential for many entrepreneurs. Research indicates that investments in broadband are associated with economic growth and can lead to increased entrepreneurship, depending on specific regional characteristics. A budding entrepreneur with a device connected to high-speed broadband can do more-efficient market research, receive feedback on their ideas, and promote their product or service.

Marketing is a particularly important business function that effectively requires broadband. In other important functions like finance and human resources, cloud-based software programs are increasingly being used by entrepreneurs to save time and money. Finally, broadband access in a particular place can draw more foot traffic, increasing demand for local retail and restaurants.

The Main Street Fund could be used to support the formation of public–private partnerships like the North Carolina Next Generation Network that brought together municipalities, universities, and firms to bring high-speed broadband networks to the Research Triangle Park region at an affordable price. It could also fund investments in a conduit system like the one in Lincoln, Nebraska, that has laid the foundation for collaborations with telecommunications providers to offer new and higher-quality services to city residents.

Customized Initiatives for New Firms

The author discusses research that has identified characteristics of new businesses that are associated with the highest potential for growth. Entrepreneurs are a varied group, with some aiming to build a small business and others hoping to expand rapidly. Public investments in these high-growth firms have the greatest potential to increase overall economic growth.

The Main Street Fund would therefore support state programs that explicitly target young high-growth potential firms with attributes that have been linked to growth in prior research. For example, states could create accelerators, capital programs, or export promotion initiatives that specifically target these high-growth firms or encourage them to be founded in the first place.

Chatterji discusses emerging evidence that accelerators can have a positive effect on entrepreneurship. The author discusses research finding that start-ups supported by accelerators are more-efficient investments than other companies. Accelerators provide entrepreneurs with valuable information they can use to decide whether to pursue the venture or allocate their efforts elsewhere. In addition, providing training together with physical space has been shown to increase the performance of start-ups.

Benefits and Costs

The author's proposal would have two primary benefits. First, by discouraging states from using targeted business incentives that accrue to large, incumbent firms, the proposal would reduce barriers to entrepreneurship and make it easier for new firms to compete with established firms. Funds not spent by states on economic incentives would be available for other public objectives, including improving education, rebuilding infrastructure, or broadly lowering tax rates for all individuals and businesses.

Second, by supporting interventions like targeted management training that have been demonstrated to promote successful entrepreneurship, the proposal would increase the number of start-ups that eventually make significant economic contributions. Through both channels, the author expects broad positive effects on productivity, employment, and wage growth.

Conclusion

While government at all levels spends significant sums promoting entrepreneurship, far more is spent on economic incentives for large incumbent firms. This bias toward established companies places entrepreneurs at a marked disadvantage. Given the outsized influence on job creation and productivity of young high-growth firms, impediments to their growth can do significant harm to the American economy.

Unfortunately, it can be difficult for any one state to reduce its use of business incentives unilaterally. The Main Street Fund is an answer to this problem, designed to nudge states toward allocating a larger share of their economic development dollars to new businesses in the form of evidence-based programs that spur entrepreneurship. If implemented, the Main Street Fund would be a significant step toward leveling the playing field for all businesses and creating a more competitive economy.

Questions and Concerns

1. Are states—as opposed to cities or counties—the right partners for the Main Street Fund?

It is certainly true that cities and counties also provide incentives. While the Main Street Fund could eventually expand to address other levels of government, focusing first on the 50 states will make the program easier to implement. However, there is a risk that states could push down incentives to city and county governments so as to report a reduction in their own incentive spending while still subsidizing large firms. Thus, overall incentive trends would have to be tracked to monitor this kind of gaming.

2. Would reduction in state business incentives put the U.S. at a competitive disadvantage relative to other countries?

If states were to reduce incentive spending dramatically, other nations could be more successful in attracting U.S.-based firms to relocate. The Main Street Fund would ramp up slowly and it is unlikely that the incentives would decline dramatically in the short term. Moreover, creating a stronger entrepreneurial environment and building broad-based infrastructure will also attract larger companies, possibly offsetting any negative effects. To the extent that it is necessary to provide U.S. businesses with subsidies, this should be done at the national level in a way that balances national economic objectives and does not discriminate between incumbents and start-ups.

3. What would prevent states from misclassifying their business incentives and thereby receiving their full allotment under the Main Street Fund?

The author's proposal relies on two safeguards to minimize misclassification. First, oversight conducted by the Economic Development Administration would be essential to maintaining uniform standards across the states and for preventing misclassification of undesirable incentives as innocuous state budget policy.

Second, the proposal encourages states to alert the Economic Development Administration in the event of misclassification by other states. Any given state is eligible for a larger transfer from The Main Street Fund if other states' transfers are reduced due to their use of incentives. Moreover, states are often in competition with each other for business activity, and likely benefit from reduced incentive use by other states. Both considerations provide reasons for states to monitor each others' incentive activities.

Highlights

In this paper, Aaron K. Chatterji of Duke University outlines the inefficiencies of state business incentives and the anticompetitive effects they generate. He suggests a policy strategy that both discourages state business incentives for incumbent firms and encourages state investments that promote successful entrepreneurship and other policies that enhance dynamism.

The Proposal

Encourage states to reduce incentives targeted at large, established firms. The proposed Main Street Fund would reduce its contributions to states that continue to use economic incentives targeted at incumbent firms, while increasing allocations to states that eliminate their incentives.

Support investments in initiatives that foster a competitive economy. The Main Street Fund would support state investments in management training, enhanced reciprocity for licensed workers, investments in broadband infrastructure, and customized initiatives for new firms.

Benefits

Policies that support young firms yield increased dynamism and competition. In turn, enhanced competition benefits not only new businesses and entrepreneurs, but also the economy more broadly through lower prices, higher wages, and greater economic output and efficiency.

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1775 Massachusetts Ave., NW
Washington, DC 20036

(202) 797-6484

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