Creating "Smart" Policy to Promote Entrepreneurship and Innovation

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Abstract

Entrepreneurship is a key to unlocking innovation and fostering regional and national economic productivity. Extensive studies demonstrate that small and young firms contribute to innovation and employment growth. But which of the many types of small firms are responsible? Of the over 30 million U.S. small businesses, most are sole proprietorships or local Main Street shops, and only a small number are high-growth businesses. The heterogeneity of America's small businesses has led to some confusion and missteps in policy circles regarding the best strategies to promote entrepreneurship and innovation. We describe three policy areas: improving access to capital, delivering entrepreneurship advice and education, and creating entrepreneurial ecosystems, and show how policy solutions that drive innovation differ from support for Main Street small businesses.

Keywords: Innovation, Entrepreneurship, Economic Policy, High-Growth, Start-ups

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Introduction

In 2011, as the United States was emerging from the Great Recession, a group of experienced entrepreneurs started a new company seeking to solve the pain points small businesses faced in accessing capital, barriers only exacerbated during the crisis as traditional bank lenders tightened credit to smaller firms. The company, named Kabbage, went on to become one of the most valuable financial technology or 'fintech' companies to date, originating almost $8 billion in loans and nabbing unicorn status with a $1.2 billion valuation by the end of 2019. Initially launched as a single loan product for eBay sellers, Kabbage has since expanded to offer fully automated online financing to small businesses including a purchasing card, payment-processing solution, and a cash flow management tool. Using artificial intelligence, machine learning, and Big Data to power internal loan underwriting algorithms, Kabbage has successfully targeted a market segment ill-served by the traditional banking industry, while using innovative techniques to speed the lending process, manage risk, and continue to hone the accuracy of its predictive models.

Kabbage's meteoric success story is every entrepreneur's dream, but it is not representative of a typical business owner's experience in the United States. About half of small businesses fail within five years of starting (SBA Office of Advocacy, 2016). Moreover, the last several decades have witnessed a concerning decrease in start-up rates and a general fear that entrepreneurship in America is not what it once was, with the share of U.S. employment accounted for by young firms decreasing by 30 percent over the past 30 years (Decker et al., 2014). Numerous academics, economists, and policymakers have attempted to pinpoint the causes of this unsettling trend, but no definitive answer yet exists.

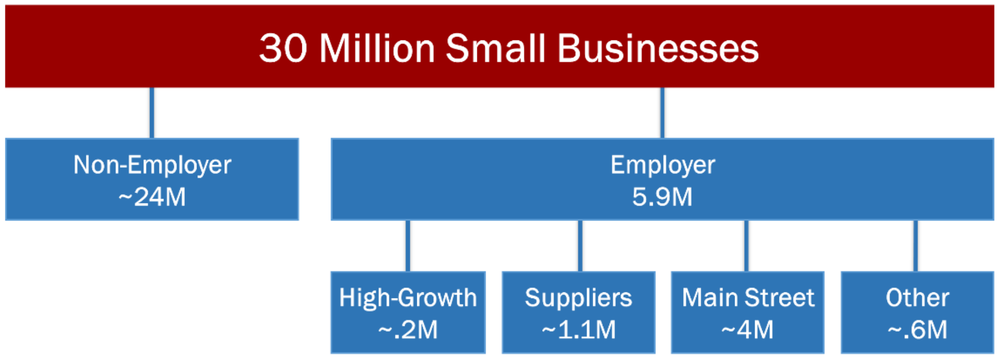
Why are the numbers so concerning? Research identifies entrepreneurship as key to unlocking innovation and fostering regional and national economic productivity (Van Praag and Versloot, 2007; Decker et al., 2014; Acemoglu et al., 2013; Lerner, 2020). Although scholars may disagree on the most accurate measures (inputs versus outputs) of innovation (e.g., proportion of budget spent on research and development versus patent citations versus the introduction of new and meaningful products and technologies), there is general agreement that entrepreneurship has a positive effect on employment, productivity, and growth at the national and local level.

Extensive studies demonstrate that small and young firms contribute to innovation and employment growth (Haltiwanger, Jarmin, and Miranda, 2013; Henrekson and Johansson, 2010; Fritsch and Mueller, 2004; Almeida and Kogut, 1996). The question is: which businesses are responsible for what kind of contribution? In the United States, small businesses form an important part of the national economy, comprising a significant portion of total firms (30.7 million businesses, equaling 99.9 percent of all firms), markedly contributing to employment (47.3 percent of private sector employees), and representing every two out of three net new jobs (SBA Office of Advocacy, 2019). However, behind these numbers lies a great deal of heterogeneity. As defined by the U.S. Small Business Administration, a small business is any independent business with fewer than 500 employees. Of the 30 million small businesses, 24.8 million or 81 percent are sole proprietorships—businesses without any employees. Efforts examining the remaining 'employer' small businesses underscore the massive variation amongst small firms in the United States (Mills, 2019; Guzman and Stern, 2019; Chatterji, 2018), particularly highlighting the difference between local firms and the fledgling innovative start-ups that will grow to become the next tech behemoths.

A recent categorization (Mills, 2019; Delgado and Mills, 2020; see Figure 1) shows that of the 6 million U.S. small businesses with employees, approximately 4 million operate in the local business-to-consumer (B2C) economy, firms conventionally labeled as "Main Street" businesses. These are the restaurants, coffee shops, dry cleaners, and other local businesses that make up the fabric of our communities. Another 1.1 million are supplier businesses, those that operate within the supply chain and traditionally sell to other businesses (B2B) or to the government. Only a small proportion of

America's 30 million small businesses—an estimated 200,000—are high-growth start-ups like Kabbage, generally viewed as the entrepreneurial source of transformative innovation.

Figure 1: The Types of Small Businesses



Source: Karen G. Mills, Fintech, Small Business & the American Dream (Palgrave Macmillan, 2019)

The heterogeneity of America's small businesses has led to some confusion and missteps in policy circles regarding the best strategies to promote entrepreneurship and innovation. Many policies that create ideal conditions for large businesses to innovate (such as R&D tax credits) are often less effective for smaller firms. And it has become increasingly evident that small business policies for local Main Street businesses require a different template from actions that support the much smaller number of high-growth innovative firms, such as those that flourish in Silicon Valley and other tech ecosystems. This sliver of high potential firms requires specially designed, nuanced policies that fuel high-growth entrepreneurship and target innovation (Aulet and Murray, 2013).

Policy Playbook for High-Growth Entrepreneurship

In the face of declining start-up rates and fears of sinking economic dynamism in the United States, both federal and local governments have increased their focus on encouraging entrepreneurship. Some locales have centered their economic development strategies on luring large innovative corporations by offering millions of dollars in tax breaks and other incentives, as seen by Amazon's well-publicized and much debated search for a second headquarters. The hope is that these anchor companies will create an innovation center of gravity and spur other companies to move to or start up in the area. Over the last several decades, state and local governments have pledged significant resources to target these large incumbent firms, with some estimates putting the total amount of incentives at $45 billion annually, tripling in size from 1990 to 2015 (Bartik, 2018).

In recent years, however, this strategy, sometimes called "elephant hunting," has been replaced or supplemented by a series of policies designed to boost innovation and job creation through the direct encouragement of entrepreneurship. These various government policy efforts tend to fall into three main categories: improving access to capital, delivering entrepreneurship advice and education, and creating entrepreneurial ecosystems (see Figure 2). For each category, the policy options differ significantly depending on the type of small business targeted, with most of the innovation efforts directed at the smaller segment of high-growth firms expected to deliver the most productivity growth.

Figure 2: Policy Options to Promote Different Types of Entrepreneurship

	High-Growth Firms	Main Street Businesses
Access to Capital	• Angel and R&D Tax Credits • Regional VC Support (SBIC) • SBIR/STTR • Scale Up Capital • Grants / Business Plan Competitions	• Bank Loan Guarantees (SBA) • Fintech / Challenger Banks • Tax Policy
Advice / Education	• Entrepreneurship, education, and mentorship programs • Startup academies	• Small Business Development Centers / SCORE Advisors
Ecosystems	• Accelerators / Incubators • Clusters	• Main Street Associations • Small Business Saturday

Source: Examples from authors' analysis.

Access to capital

Financing is a key determinant of small business growth and success. Entrepreneurs in new and young firms need capital to build their businesses and pay their employees, purchase inventory and start-up equipment, and obtain other resources. Depending on the type of small business, access to capital can come from a host of different sources. Traditional Main Street businesses commonly access financing through banks, ranging from large financial institutions—like Bank of America and JPMorgan Chase—to regional banks, Community Development Financial Institutions (CDFIs), and community banks. High-growth start-ups, on the other hand, seek financing from entirely different capital markets, looking to venture capital and private equity firms for funding.

Venture capital (VC) is structured as high risk capital which pursues early stage entrepreneurial opportunities with high potential for dynamic growth and market disruption. The success rate of investments is low for the vast majority of VC firms, with only one or two out of every ten portfolio companies accounting for the majority of the returns to a particular fund (Kerr, Nanda, and Rhodes-Kropf, 2013; Nicholas, 2019; Sahlman, 2010). Because expertise and relationships are required to access and evaluate venture capital deals, funding has historically been unevenly distributed, geographically and demographically. In 2018, over 80 percent of venture capital funding in the US went to companies in just three states—California, Massachusetts, and New York (NVCA, 2019). Similarly, in 2019, only 12.1 percent of venture money went to fund businesses co-founded by women, with an even smaller 2.8 percent going to businesses founded solely by women (Pitchbook, 2019). From 2013 to 2017, only about 23 percent of VC funding went to minority founders (RateMyInvestor, 2019).

To address these market gaps, several governments have crafted policy initiatives to increase access and diversity in venture capital. One approach has been to encourage new risk capital formation by stage, such as through angel capital tax credits[1] (Lerner et al., 2015) and R&D tax credits (Becker, 2015) in the United States and scale-up capital schemes in the United Kingdom.[2] Other policies have

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[1] Section 1202 of the U.S. Internal Revenue Code details an exclusion for both angel investors and entrepreneurs, providing 100 percent of tax-free gains up to $10 million. This angel capital tax credit is designed to incentivize investors to finance promising start-ups, as well as to stimulate entrepreneurship by providing an additional viable source of capital.

[2] The UK government provides similar tax credits to promote entrepreneurship and investment, including the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS), both of which seek to incentivize the funding of innovative startups through 30 and 50 percent tax breaks, respectively, and up to a capped amount. In

focused on geography, such as the Small Business Administration's Small Business Investment Company (SBIC) programs. This initiative funds over 300 small venture and private equity capital providers in geographies where there is less available risk capital for high-growth firms. Federal set-asides from research budgets fund substantial research and innovation grants to small companies through the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs. These activities support new entrepreneurs across multiple industries in their discovery and growth phases.

Advice & Entrepreneurship Education

The second critical area of support for entrepreneurship is the construction of advising networks that help entrepreneurs navigate the highly uncertain world of starting a business. Entrepreneurship education has come to the fore in numerous universities, business schools, and even high schools and continuing adult education. There is an insatiable appetite for counseling and advice, particularly from low-cost or free venues such as Small Business Development Centers (SBDCs) or the SCORE counselor network, both of which are supported by the U.S. Small Business Administration. The SBA also provides resources to underserved and underrepresented entrepreneurs who may face increased barriers in achieving their business goals, through specially targeted Women's Business Centers and Veterans Business Outreach Centers.

Here again, however, high-growth innovative start-ups tend to seek counsel via distinct tracks such as specialized boot camps and start-up academies geared towards high-tech and innovation-driven entrepreneurs and teams. Founders of high-growth firms can access tailored advice from venture capital and private equity partners with intimate knowledge of the particular sector they inhabit. They can also reach out to industry peers and build networks of likeminded entrepreneurs

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addition, Innovate UK, part of UK Research and Innovation, provides funding to innovative businesses (about 2.5 billion pounds since 2007, matched by industry funding).

and funders in advance of officially launching their product or service, gaining intangible benefits and lessons in management skills, crisis leadership, and goal setting (Chatterji et al., 2018).

Ecosystems

Entrepreneurs learn from each other, as well as suppliers, customers, universities, and support organizations within their sector or cluster. Just as in other policy areas, ecosystems conducive to helping innovative high-growth entrepreneurs look quite different from communities designed for businesses on Main Street. For the local mom and pop shops in the town square, Main Street business associations and other types of neighborhood commercial alliances provide a valuable source of business counseling and referrals, and often serve as conduits to the local and regional governments, with an eye towards the advancement of business owner interests.

For high-growth businesses, innovation ecosystems of clusters, incubators, and accelerators have gained momentum in recent years. Prior studies show the importance of industry clusters in entrepreneurship and economic performance and growth (Porter, 1998; Saxenian, 1994; Delgado, Porter, and Stern, 2010, 2016). Well-known examples of clusters in the United States include information technology in Silicon Valley and biopharmaceuticals and medical devices in Boston. By co-locating with similarly focused companies in a particular field, young firms stand to gain agglomeration benefits and externalities, sharing in the technology, skills, knowledge, and innovations facilitated by both their collaborators and competitors (Chinitz, 1961; Feldman and Audretsch, 1999; Glaeser and Kerr, 2009; Delgado, Porter, and Stern, 2010). Clusters also tend to draw large pools of specialized talent, which is especially important for the increasing number of STEM employees required by new innovative services businesses.

The proven efficacy of industry clusters has not been limited to the traditional coastal cities. For example, strong "fintech" clusters have emerged outside the conventional financial hubs of New York City and San Francisco. Kabbage, highlighted earlier, is headquartered in Atlanta, Georgia, which also serves as home to major American credit reporting agency Equifax, bitcoin payment service BitPay, and international payments giant Global Payments Inc. The wider Atlanta metropolitan area also boasts a major location for financial systems provider Fiserv and an engineering office for payments processor Square.

Entrepreneurs and early-stage companies also gain significant knowledge and value by participating in mentorship programs designed specifically for high-growth start-ups. Accelerators and incubators, established by both private and public actors, provide young firms with access to mentorship and potential seed funding to test their business models and refine their innovations. These ecosystems also fuel environments where start-ups can collaborate with other members of their cohort to gain advice from peers and a broader network of investors and mentors. Research has shown the various beneficial effects of accelerators and incubators on regional entrepreneurship and innovation (Hochberg, 2016; Gonzales-Uribe and Leatherbee, 2017), leading to many levels of government employing them as tools to promote innovation and economic productivity (e.g., MassChallenge in Boston, LAUNCH accelerator by NASA, USAID, and the Department of State).

Conclusion

The Kabbage journey to success has by no means been a completely smooth ride. Although the ultimate effects of COVID-19 and the economic downturn remain to be seen, it is clear that the likes of Kabbage are indeed not immune to the shocks created by the pandemic. Soon after the United States declared a state of emergency due to coronavirus in mid-March of 2020, Kabbage announced it would furlough a significant number of its employees in America and shut down its Bangalore outpost completely. At the same time, however, Kabbage reorganized and funneled its resources to help small businesses in a different way, setting up a website where customers could purchase gift cards to support their local businesses and repurposing its technology to facilitate loans to small businesses through the Paycheck Protection Program authorized by the CARES Act. Entrepreneurial firms are critical contributors of new energy and ideas. As illustrated by the nimble actions of Kabbage and other financial technology companies in responding to the coronavirus, innovation in times of crisis is a hallmark of entrepreneurship.

America is fortunate to have a strong heritage in both innovation and entrepreneurship. It is part of the national spirit of independence and the belief in economic mobility and the American Dream. Over the last several decades, the U.S. economy has been built on a bedrock of innovations that have dramatically transformed traditional industries, from communications to financial services to Big Tech. However, the continuation of these strengths is far from assured. A relatively small number of high-growth entrepreneurs are crucial elements of the nation's innovation and productivity. Their continued health requires a nuanced understanding of and targeted investment in entrepreneurship, and the ecosystems and policies that support it.

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