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The Role of Legislation Affecting the Small Business Administration's Investment Programs

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Madame Chairman, Mr. Chabot, and members of the Committee, I appreciate the opportunity to appear before you today to discuss potential legislative changes affecting the Small Business Administration's (SBA) investment programs, particularly those affecting angel investors. I commend you for addressing this important issue of how the SBA can do an even better job of supporting entrepreneurship and new firm formation, and I strongly support this legislation.

I am president of the Information Technology and Innovation Foundation. ITIF is a non-partisan research and educational institute whose mission is to formulate and promote public policies to advance technological innovation and productivity internationally, in Washington, and in the states. Recognizing the vital role of technology in ensuring American prosperity, ITIF focuses on innovation, productivity, and digital economy issues. I have been involved with economic development and entrepreneurship for many years, including as the first Executive Director of the Rhode Island Economic Policy Council, a public-private partnership including as members the Governor, legislative leaders, and corporate and labor leaders. I have also written extensively about these issues, including most recently in the ITIF report, "The 2007 State New Economy Index," which assesses the extent to which the 50 state economies are structured according to the tenets of the New Economy and outlines the next generation of innovative state-level public policies needed to meet the challenges of the New Economy.

The Role of Entrepreneurship in U.S. and State Economic Success: In the new global economy, competitive advantage for the United States, states, and local communities is increasingly based on innovation and the generation of new business models. With low-wage developing nations an increasingly attractive option for U.S. firms, fewer U.S. companies are establishing greenfield plants domestically. Indeed, the number of industrial manufacturing relocations and significant expansions in the United States has fallen from an average of 5,139 per year for 1995-2000 to 3,162 in 2005.[1]

As a result, in order to succeed in the new global economy, the United States, as well as states and sub-state regions, have to look more to innovation and entrepreneurship for economic advantage. Entrepreneurship is particularly important because new and fast growing firms are precisely the kinds of firms that don't become commodity producers searching for any number of interchangeable low-cost locations. This means that entrepreneurial firms tend to be more "sticky," with local entrepreneurs usually growing their firms in the state they live in. For example, more than 80 percent of scientists in California research institutions that went on to start their own firms did so in California.[2] Just how important is entrepreneurship? Although only one in twenty entrepreneurial firms are high growth in terms of adding jobs, firms that survive the first few years create jobs and also often innovative goods, services and processes.[3] In fact, this relatively small number of fast-growing firms account for the lion's share of new jobs created. Between 1993 and 1999, the number of these fast growing "gazelle" companies (companies with annual sales revenue that has grown 20 percent or more for four straight years) grew almost 40 percent, to over 350,000. One study estimates that such "high expectations" entrepreneurs are responsible for 80 percent of the jobs created by entrepreneurs.[4]

While entrepreneurship is an important source of economic opportunity in the U.S., the role of such gazelle entrepreneurs differs significantly by state. While in 2006, about 8 percent of U.S. jobs were in these fast-growing companies, in Nebraska, the leading state in the nation, over 16.6 percent of jobs were in gazelle companies. The next four leading states were Delaware (13.5%); New York (11.7%); Maryland (11.6%) and Arkansas (11.3%).[5] What is perhaps most striking about these data is that this kind of entrepreneurial energy is not just confined to the wealthiest and most high-tech states.

The Role of Government in Supporting Entrepreneurship and Entrepreneurial Financing: At its core entrepreneurship is driven by individuals willing to take risks and able to execute their plans. Government can never be a substitute for that, nor should it try. But what government can and should do is make entrepreneurship and new business formation easier for individuals. One key way to do that is to help enable capital formation, which is a core part of the mission of the Small Business Administration. Indeed, studies show that access to capital is a key factor in small business success.

However, some might argue that the federal government should have little or no role with regard to venture, seed, and angel investing. To be sure, the United States has vibrant capital markets and the world's best venture capital sector. To be sure, the lion's share of funds for new ventures come from and should come from the private sector. It's the private sector that can best assess risk and opportunity.

However, notwithstanding these strengths, it does not mean that there are not gaps in the market and that there is not a supportive role government can play. There are a number of reasons why governments can play a supportive role, particularly in the area of early stage and angel investing. One reason is that over the last decade the venture capital market has increasingly shifted toward later-stage, larger deals. Even though the United States has the most well developed venture capital markets, significantly less is invested in zero and first stage venture deals than a decade ago. While venture capital has increased nationwide since 1996 by almost double, the amount invested in zero and first stage investments has fallen by half.[6] There are perfectly good reasons for why this has happened – primarily that VC firms can make as much money investing in one large deal as in two smaller deals, but with less time and expense. But while it's rational for venture and other investment firms to do this, it does mean that there is a gap in the market that makes it hard for firms requiring less capital that might in fact be viable, high-growth firms to get financing.

Second, venture capital is highly concentrated in a few states. In fact, since the height of the VC boom in 2000, venture capital has become even more geographically concentrated. In 2005, 79 percent of investments went to the top 10 states, up from 69 percent in 2000. For example, as a share of their economies, Massachusetts and California receive almost 4 times more venture capital than the national average. This matters because in spite of what we all read in our college economics textbooks about rational investors, venture capitalists are human beings who tend to make their investments close to home. The same holds true for angel investing; it has been reported that 90 percent of firms receiving such investments are located within a half-day's travel time of their principal investor. This could be a result simply of inertia or perhaps an understanding that the best investments are the ones that can be regularly monitored, and physical proximity enables that. But either way it means that many parts of the country have less access to early stage financing.

One result of this geographic concentration and the focus on bigger, later-stage deals is that state governments are playing important roles in ensuring access to early stage equity capital. In 2006, 44 states had established 155 programs investing more than $5.5 billion.[7] And perhaps the area that is seeing the most rapid growth of state interest is angel capital, the capital invested by (usually) wealthy individuals in a region's businesses. States are playing a key role by helping to link angels and entrepreneurs.[8] For example, the Wisconsin Angel Network (WAN) represents more than 200 individual investors and helps match them with start up and young companies. Similarly Pennsylvania's Ben Franklin Investment Partners (BFIP) guarantees up to 25 percent of any loss experienced by a qualified private investor who makes an investment in a qualifying southeastern Pennsylvania emerging technology enterprise. A number of states also provide a modest tax credit to angel investors for investing in an in-state firm.

Indeed, angel investing is becoming as important as venture capital in supporting entrepreneurship. In 2005, angel investors actually invested more ($23.1 billion) than did venture firms ($22.4 billion).[9] State venture capital programs invested about a tenth of this amount ($2.2 billion).

But states are limited in what they can do. They have more limited budgets than the federal government. Moreover, angel and seed funding investments take time to pay off in terms of economic activity and jobs, and for most states the political pressures lead them to focus on economic development policies that lead to more immediate and highly visible results. Recruiting the big factory is often a more politically appealing strategy than supporting entrepreneurship. Moreover, spill-overs from entrepreneurial activities to other states mean that states have less incentive to invest in entrepreneurship.

For all these reasons, it's important that the federal government through the SBA plays a supporting role in helping ensure access to equity financing.

Specific Comments on the Legislation: Overall this legislation is an important step in helping spur the entrepreneurial economy. While I focus most of my comments on Title III, I will make one comment on Title I that addresses the SBIC program. Since it was revised over a decade ago, the SBIC program has been a very effective tool. However, if all the SBIC program does is provide lower cost capital to venture firms investing in late and large deals, it is not fulfilling its purpose of addressing a market failure or limitation. Therefore, the bill's provisions to target SBIC investments, especially to smaller enterprises, are an important and needed reform. The Committee may want to consider going even further and requiring that some share of funds (perhaps not less than 25 percent) also go to smaller deals (perhaps less than $2 million), not just smaller enterprises.

The establishment in Title III of a new angel investment program is a positive step forward that will help spur the availability of angel capital, not just nationally but in regions and communities that up until now may have had limited access to angel capital. There are however, in my opinion, several changes the Committee may want to consider to strengthen this provision. First, as currently drafted, the program defines an angel group as "two or more angel investors." I believe this number is too low and should be expanded, perhaps to five or ten angel investors. There are two reasons why the Committee might consider this. First, I believe that it would reduce the likelihood of fraud if there was a requirement to have a larger investor group. Second, one of the goals of federal programs like this is not just to provide capital, but to spur the establishment of new kinds of organizations to facilitate entrepreneurship. In other words, one of the keys to this effort is to leverage and encourage angel *networks*, not just angel *investment*. Requiring larger angel groups will help spur more networks and more investors. Moreover, given the relatively modest level of funding in the bill, I do not believe that such a requirement would limit the program's ability to invest all of its resources.

Second, while it is important to require matching investments by angel investors, I believe that the language in Sec. 382 (g) could be clearer. It should state clearly that angel investors do not need to get approval from the SBA for every deal they invest in. This kind of approval requirement would limit the investors' flexibility and need for prompt decision-making. The provision that they must put up at least 50 percent of their own funds in the sum of all the deals involving federal support makes sense. I would suggest, though, that the legislation (or SBA) place some kind of time limit on the angel groups in terms of when they invest the funds. For example, if they have not invested the funds in less than three years, they will not receive the rest of the funds for investment.

Toward the goal of helping establish angel networks, I believe that the grant program for the establishment of angel groups (Sec. 384) is a positive step forward. Often, the biggest market failures are failures of information and coordination. States like Wisconsin that have put modest resources toward establishing angel networks have found that the process of bringing angel investors together and helping entrepreneurs get in front of them have paid off with more entrepreneurial financing. The proposed grant program can help build on the experience of these programs and extend these models nationwide. My one suggestion that the Committee might consider would be to add in a match requirement (perhaps 50 percent in cash for state or local governments and in-kind for the other organizations). Adding a match requirement would not only ensure that organizations applying for the grants have "skin in the game" but would also help leverage non-federal resources.

Finally, I strongly support the idea to create a Web-accessible angel capital database (sec. 383). However, I would encourage the Committee to include language that makes the data in the database available for anyone else to use in their own databases. If the database is only accessible on the SBA website, I believe that it will have only limited use. However, if SBA is required to make the data available in machine readable form to anyone else that wants it, it would be available on websites of many other organizations that entrepreneurs frequent more often than SBA's site. These might include entrepreneurial magazines (e.g. *Inc. Magazine*), specialized entrepreneurial web sites, (vfinance.com), etc.

Overall, ITIF supports this legislation as a positive step in spurring America's entrepreneurial economy. Thank you for letting me share my views with you and I would be happy to answer any questions you might have.

Notes:

[1] "Year-to-Date New Plant Report," (Conway Data, Inc, 1991-2005).

[2] Junfu Zhang and Nikesh Patel, "The Dynamics of California's Biotechnology Industry," (Public Policy Institute of California, 2005), cited in Joseph Cortright, "The Young and Restless in a Knowledge Economy," CEOs for Cities (Dec. 2005). <www.ceosforcities.org/rethink/research/files/CEOs_YNR_FINAL.pdf>..

[3] Erkko Autio, "High-Expectation Entrepreneurship 2005," *Global Entrepreneurship Monitor* (2005). <http://www.gemconsortium.org/document.asp?id=444>.

[4] Ibid.

[5] Robert D. Atkinson and Daniel K. Correa, "The 2007 State New Economy Index," (Washington, DC: The Information Technology and Innovation Foundation, Feb. 2007). <www.itif.org/index.php?id=30>.

[6] National Science Foundation, "Science and Engineering Indicators 2006," (Washington, DC, 2006). <http://www.nsf.gov/statistics/seind06>.

[7] Susan P. Strommer, George Lipper, and Daniel Sandler, "Seed and Venture Capital: State Experiences and Options," (The National Association of Seed and Venture Funds, May 2006). <www.nasvf.org/web/nasvfinf.nsf/pages/svcp.html/$file/Seed%20and%20Venture%20Capital%20Report%20-%20Final.pdf>.

[8] See National Governors' Association, "State Policies for Supporting Angel Investing," (2007).

[9] Council on Competitiveness, "Competitiveness Index: Where America Stands," (2006).