Statement by

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Access to Capital: Fostering Job Creation and Innovation through High-Growth Start-Ups

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Chairman Johnson, Ranking Member Shelby, and other members of the Committee, my name is Ted Zoller, and I serve as Vice President of Entrepreneurship at the Ewing Marion Kauffman Foundation, am a faculty member in the business school at the University of North Carolina at Chapel Hill, and an entrepreneur. I appreciate the opportunity to share some perspectives on capital access to start-up and scale businesses in the United States.

The Entrepreneur's Dilemma

I would invite members of the committee this morning to put yourself in the shoes of a founder of a new firm in the United States—this is perhaps one job more exciting than being a United States Senator. As a promising entrepreneur, your business concept solves a problem, fills a customer need, and fulfills what the market demands. However, starting any new enterprise requires capital. The investment period every business experiences until it reaches cash flow breakeven—a concept termed the "J-curve"—is a perennial issue to any start-up. This natural need for investment is precipitated by capital requirements, labor costs, and the negative cash flow you will experience until your business is established in its market and has gained a loyal set of customers. The "J-curve" can only be remedied by access to capital, and when capital is not forthcoming, represents a substantial barrier to new firm starts. While a small percentage of firms can be "bootstrapped" or self-financed and can achieve breakeven through their own cash flows, the vast majority of all new enterprises—and in particular high-growth firms that rely on innovation and capital investment—require outside funding in the form of equity and debt to shoulder the J-curve.

Pressure on Early Stage Capital Access

The picture I will paint for you this morning is that your job is harder today than it has been prior to the financial crisis and recession in the United States, because both equity and debt financing are not as readily available. The J-curve is now a barrier to your entry as opposed to simply a hurdle in becoming a going concern. Why is it harder today to finance the start-up? Three reasons:

First, venture capital and other forms of private equity have largely vacated early stage investing, opting instead to form syndicates to pursue more reliable returns in later-stage ventures, largely abandoning early stage concerns.

Second, while angel and friends and family investors have entered the early stage financing market to fill the gap, these angels are not as adept in connecting to later-stage capital partners to continue the financing needs of the venture over its lifecycle to fuel the firms' growth, and angel capital availability is a fraction of equity investment that was available in the past.

Third, the consolidation of banking institutions and their current conservative posture toward risk precipitated by the Wall Street financial crisis has choked off needed debt financing. If you cannot access equity financing, you no longer can start a business without collateralizing the debt against your personal assets and signing a "personal guarantee," and the line of credit that you need to smooth your cash flows now comes with higher interest rates, more punitive terms, and generally not at the limits needed to finance your firm. The large banks are no longer a partner to small business. Indeed, I have personally operated a family business now for three years and recently contacted my bank for service—one of the three largest banks in the United States that for the sake of my testimony will remain nameless—and they could not even find my account, claiming on the phone that I was not their customer. This is a bleak picture that we all face as entrepreneurs.

Macroeconomic Relevance of the Start-Up

While we have seen a clear resurgence of angel investors and the trend toward democratization of equity investing and are hopeful by innovation occurring in our community and commerce banks, our early stage pipeline is under unprecedented stress. This has staggering implications on our economic future. Since the recession began in 2008, Kauffman data indicate that more firms than ever are being formed each year. Unfortunately our research reveals that this result is hollow—as the new firms are largely sole proprietorships and "consultancies" as opposed to job-creating firms. New firms with employees during this same period in fact have been dropping—a troubling indicator suggesting a slowdown in the formation of potential scale companies.

Contrast this fact to another series of studies published by the Foundation—that up until the financial crisis and subsequent recession, United States job and output growth was driven by the formation of new firms or start-ups, and firms younger than five years old were responsible for all net new job creation. Moreover, we have concluded from our research that if the United States economy could consistently generate 30-60 new companies whose annual revenues eventually reach $1 billion, the United States would enjoy permanently a one-percentage-point increase in its growth rate. This promises a solution to our fiscal future. So if our goal is to motivate our economy and create new jobs, then we must focus on job-creating, early stage firms--especially those firms that will achieve high-growth and scale and require long-range financing. Achieving this goal will require a continuous stream of new, bold entrepreneurs, fewer roadblocks to the formation of new enterprises, and low-cost capital available to finance startup and growth.

A Solution to Our Entrepreneurial Future

How can we do this in light of the looming budget austerity at all levels of government? We must do this, as our fiscal future is at stake. Yesterday, the President of the Kauffman Foundation, Carl Schramm, presented a solution we are calling the Startup Act. This proposal speaks to many of the dilemmas faced by the entrepreneur that I have framed in my testimony and are the subject of this hearing—providing access to capital, by:

- First, modifying the tax code to facilitate the financing of small business, with a permanent capital gains exemption on investments in start-ups held for at least five years. There is a strong case, given the job creation and innovation benefits of start-ups, for exempting from any capital gains tax patient investing in early stage companies—an idea supported by the National Advisory Council on Innovation and Entrepreneurship.

- Second, reducing corporate tax burdens for new companies in the first three years they have taxable income. To ease the pressure on start-ups precipitated by the J-curve and initial cash flow, the National Advisory Council has also suggested a full exclusion on corporate taxable income earned by qualified small business on the first year of taxable profit, followed by a 50-percent exclusion in the subsequent two years—an idea our research would support.

- Third, making it easier for growing private companies to go public, allow shareholders who invest in firms with a market cap of $1 billion or less and are in the best position to judge the cost-benefit of financial auditing mandates to decide whether to comply with the requirements of the Sarbanes-Oxley Act. If the IPO window is opened, investors will be a lot more willing to finance early stage companies and their continued growth when those companies have at least the option of going public after they have reached scale, rather than simply selling out to a large firm, thereby retaining the entrepreneurial energy of the scale enterprise as a long-term business venture and employer.

- Fourth, reforming federal regulation by sunsetting all major rules after 10 years, requiring all new major rules to pass a benefit-cost test, and collecting data on regulation at the state and local levels to allow for the objective evaluation of how regions can promote business-friendly climates.

These proposals, among others, are needed to undertake the course correction required to make the United States once again the best place to found, grow, and scale an entrepreneurial venture. The economic shocks of the financial crisis coupled with the challenges of our debt have fundamentally changed our direction. Putting us back on course will require the creativity of our government policymakers and business leadership and, of course, our entrepreneurs. I am confident we will achieve these aims and look to your leadership in making our entrepreneurial future again possible.

Thank you.