Testimony of

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Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify before the Committee this afternoon. I am Patrick Von Bargen, Executive Director of the National Commission on Entrepreneurship, a non-profit organization that focuses on public policy that supports entrepreneurship and entrepreneurs. The National Commission on Entrepreneurship is funded by the Kauffman Center for Entrepreneurial Leadership at the Ewing Marion Kauffman Foundation. Our mission is really quite simple: We bring information to federal, state, and local policymakers that makes the case for the importance of entrepreneurship to today's economy; research and describe the characteristics of entrepreneurial companies and highlight those policies are important to them; and design "toolkits" for policymakers at all levels that shows what they can do to provide continued support for entrepreneurs and entrepreneurial companies

While there is no shortage of research and discussion about the importance of small businesses in the United States, relatively little attention has been paid to entrepreneurial companies – those innovative companies that intend to grow large and to grow fast. Here are some things we do know.

Entrepreneurs use innovations to improve our quality of life; small entrepreneurs lead the way in developing ideas; they are responsible for more than half of all innovations – 67 percent of inventions and 95 percent of radical innovations since World War II.

Small entrepreneurial growth companies create jobs – about two-thirds of the new jobs between 1993 and 1996, and even a higher percentage in the recession of 1990-1992.

Entrepreneurs also improve our position in global economic competition. Entrepreneurs have pushed U.S. companies in dominant positions in critical global

industries such as biotechnology, pharmaceutical and the Internet. For example, the US biotechnology industry is about five times larger than all the biotechnology industries in Europe and U.S. companies are expected to account for 80 percent of the worlds top-selling pharmaceutical products by 2002.

Finally, entrepreneurs create economic growth and new wealth for reinvestment in our country. The Global Entrepreneurship Monitor (also funded by the Kauffman Foundation and conducted by scholars at Babson University and the London School of Business) has made the connection between entrepreneurship and economic growth, finding that about one-third of the difference in economic growth rates is due to the impact of entrepreneurial activity. And, the economic growth generated by entrepreneurial companies is reinvested in other entrepreneurial companies, in distributions to their employees (Cisco systems employs 19,000 people, 7,000 of whom are millionaires), and in philanthropic ventures.

Who are these entrepreneurial growth companies? In an NCOE study called *High-Growth Companies: Mapping America's Entrepreneurial Landscape,* we used a Census Bureau database to study every employer in the United States in each of 394 different labor market areas, or regions, comprising the entire country. We found that:

Fewer than 5% of all U.S. businesses and all U.S. start-ups grow at least 15% a year over a five-year period

4.7% of existing businesses increased employment by 100% over five years

4.5% of start-ups grew to more than 20 employees by the end of the five-year period

We also found that these companies were not just in high technology industries:

Business Services	10%
Manufacturing	11%
Distributive	13%

Local Market	40%
Retail	24%
Extractive	2%

And finally, we determined that these growth companies are found in every region of the country. Los Angeles, with a population of 14.5 million people had 14,000. But even tiny Amsterdam, New York – which did not rank high in our report – had 53.

The benefits of entrepreneurial companies are enormous and we believe that public policymakers must continue to insure that public policy encourages the startup and growth of entrepreneurial companies. But in order to understand the kinds of public policies that are most useful to entrepreneurial companies, we need to look at what separates them from other kinds of businesses.

Entrepreneurial growth companies are indistinguishable from all small businesses when they start out; they both start small with the same limited means and require tremendous energy and adventurousness on the part of their founders. They serve important economic functions -- stimulating the economy and creating new jobs to replace those lost by downsizing in other areas.

But the key departure point that allows some small businesses to change into entrepreneurial growth companies is usually in productivity gains in their company's product, service, or distribution scheme. This productivity gain makes fast growth possible but not inevitable. For many business owners the goal is not to see how big and how fast their company can grow but rather to provide prosperity themselves and their employees. But for entrepreneurial growth companies, the extent and rate of growth is the most important goal and that is what separates them from their more traditional counterparts.

This difference results in many characteristics that entrepreneurial growth companies and small businesses don't share. Appreciating the difference between a small business before its growth period and once it has become entrepreneurial is perhaps the most important step towards creating effective support for growth companies.

Entrepreneurial growth companies are often clustered around newly deregulated and emerging industry sectors such as telecommunications, financial services and information technology. Entrepreneurial ventures are particularly uncertain and extremely vulnerable to falling flat because their growth is often in industries with no proven business models and no established network of support. They do, however, have the potential for tremendous returns.

An examination of some key differences between entrepreneurial growth companies and other companies explains why these companies need different kinds of support than traditional small or even large businesses. Some examples include:

One difference, unlike the popular myth, is that entrepreneurs do not accept all the risk themselves; they are notorious for sharing both the risks and rewards of success. They excel in convincing employees, customers, suppliers, and lawyers to share in the risk. And the only thing of value they can offer key employees to entice them to leave more secure and better paid jobs with larger established companies is stock. That is why it is so important for this Committee to convince the Treasury Department through legislation or other means to withdraw proposed January 2003 regulations that would subject incentive stock options and employee stock purchase plans held by rank-and-file workers to payroll withholding tax. The members of this Committee, led by Senators Bingaman and Hatch, who have written Secretary O'Neill to that effect are to be commended for their understanding of, and commitment to, this issue.

Two, entrepreneurial growth companies depend on public policy investments in research and development of new technologies, transfer of those technologies to the business sector, and policies that strike the correct balance between protecting private ownership rights in intellectual property and putting into the marketplace ideas that can be modified and commercialized.

Three, a vibrant entrepreneurial economy depends on a continuous supply of entrepreneurs to use new ideas to form new industries. While some would argue that entrepreneurs are born not made, a sound entrepreneurship education helps equip many people with ideas – especially scientists and engineers -- to get into the marketplace.

Four, the willingness of entrepreneurs to stop on a dime and go a different direction to adapt to changes in the marketplace, must be supported by a regulatory system that is equally flexible and responsive. Overly onerous regulatory agencies (especially at the local level) that are ponderously slow can quickly kill an entrepreneurial venture.

Five, all entrepreneurial growth companies experience one thing in common – the need for growth capital. Traditional debt financing is hard to get for entrepreneurs – they usually don't have a long enough business history or collateral that attracts traditional debt financing. And many banks find the due diligence and other costs of lending less than $1 million to an entrepreneurial company are prohibitive. With traditional debt financing not an option, entrepreneurial growth companies have to rely on sources of equity capital to fund their growth. Therein lies the challenge facing entrepreneurs.

The equity capital challenge does not arise because there is too little venture capital. Federal policy changes in 1979 and 1980 have been remarkably successful in encouraging the growth in venture capital from less than a total of $700 million under management in 1978 to over $100 billion invested in a single year in 2000. Even during these currently tough times, venture capital funds are investing today at a rate higher than any year before 1999. Companies needing more than $3 million in venture capital – the minimum investment size considered by most venture firms -- can generally find it, although the regionally concentrated networks of venture capitals can be difficult to crack for entrepreneurs who are not part of those networks.

Nor does the equity capital challenge arise for most entrepreneurs because they can't put together enough "bootstrap" capital to get started and seed their growth. Most entrepreneurs can combine money from "friends and family," many credit card lines, second mortgage proceeds, and personal savings to get started. Depending on the wealth and savings of these entrepreneurs and their friends and family, they can raise from $50,000 to $300,000 in these ways.

The challenge really arises when an entrepreneur needs to raise more money to grow her company beyond the bootstrap amount but below the venture capital minimum investment – the range of, say, $250,000 to $1 million or $2 million. NCOE believes this challenge constitutes an "early-stage capital gap." There are only three potential sources for this money: (1) reinvesting profits from the firm; (2) the purchases of the company's stock by individual, wealthy ("angel") investors; or (3) SBICs and other government-subsidized community development venture funds that will invest at these dollar levels and that require a lower rate of return than institutional venture funds.

Profits from early-stage sales of entrepreneurial company products or services can be critical to the continued growth of the company. Early-stage companies can go through what some experts have called a "no-man's land," where they are making profits but experiencing negative cash flow, because of the need to invest in new equipment, inventory, and new personnel. Therefore, every dollar that the IRS takes in corporate taxes from these profits worsens the negative cash-flow situation for these companies. The money used to pay these taxes is not available to purchase materials for more inventory as they increase sales to customers, to pay for new equipment to produce more products, or to hire new employees to provide more services to customers. If an entrepreneurial company cannot find the money to pay for these growth-related expenses, it will either go out of business altogether or dramatically slow its growth.

The Committee has asked whether the Business Retained Income During Growth and Expansion (BRIDGE) Act of 2002 (S. 1903, sponsored by Senators Kerry, Snowe, Bingaman, and Bennett) would effectively address this problem. I believe it does, in a manner that produces more revenue for the Treasury over a period more than 10 years. By allowing growth companies to use deferred corporate tax payments as collateral against which they can borrow bank funds to meet their growth needs, the BRIDGE Act would not only help fill this early-stage capital gap, but it would also have the side benefit of establishing banking relationships for these growth companies that will continue to serve them well as they expand even more beyond their early-stage growth period. I have attached a summary of the provisions of the bill to this testimony.

The second major source of equity investment that can fill this early-stage capital gap is from wealthy individual investors, sometimes called "business angels." These angel investors have two important characteristics to keep in mind. First, they enjoy a panoply of investment options – everything from oil and gas deals to real estate investments to public securities, and mutual and indexed funds that combine these and other investment opportunities in every combination imaginable. Second, these investors are extremely tax-sensitive. Tax-free or lower-tax investment options make them pause to consider.

With just a few interruptions, federal policy has long offered capital gains tax rates that are lower than ordinary income tax rates. That policy has provided individual investors with some incentive to consider long-term investments in equity securities over interest-bearing investments, and certainly that has included investments in the stock of entrepreneurial growth companies. But until 1993, there was no particular incentive to consider investing in higher risk, early-stage growth companies over, say, blue-chip public stocks. The capital gains tax rate was the same for both types of investments.

Section 1202 of the Internal Revenue Code, enacted in 1993, was designed to address this problem. The section cuts the capital gains rate by half for investments in "qualified small businesses" – those that would meet our definition of "entrepreneurial growth companies." The critical contribution of Section 1202 is that its operation could provide angel investors a powerful incentive to consider investments in early-stage growth companies in preference to other equity investments. If many more angel investors channeled funds to these companies, they would do much to address the early-stage capital gap.

Unfortunately, the imposition of the alternative minimum tax to these Section 1202 gains and a set of Treasury regulations that encumbered the use of the provision discouraged these investors. The Committee has asked whether S. 1676, The Affordable Small Business Stimulus Act of 2002 (sponsored by Senators Kerry and Cleland) would help revive Section 1202, and once again the answer is "Yes." The bill would expand the definition of qualified businesses to those with less than $100 million in paid-in-capital, increase the capital gains exclusion to 75% (and 100% for critical technology companies), and extend the period for tax-free rollovers on investments in one qualified small business to another from 60 days to 180 days. The bill does not address the alternative minimum tax problem, but another bill authored by Senators Collins, Breaux, and Hatch (S. 455) would.

Finally, a provision of S. 1676 and a companion bill sponsored by Ranking Member Grassley (S. 2022) makes an important contribution to the availability of funds from the third source of funds to help fill the early-stage capital gap, specifically the debenture small business investment companies (SBICs). The bill would allow tax-exempt entities, including pension funds and university endowment funds, to invest in these SBICs without incurring unrelated business taxable income (UBTI) liability. This could vastly increase the sources of funding available to these SBICs and could encourage more of them to invest in early-stage growth companies.

Thank you for this opportunity to testify before the Committee today. I look forward to the discussion and appreciate the opportunity to provide input from our experience with entrepreneurial growth companies.