Testimony of Brink Lindsey,
Senior Scholar in Research and Policy,
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Before the
Subcommittee on Technology and Innovation,
House Committee on Science, Space, and Technology
On "Creating and Growing New Businesses: Fostering Innovation"
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Chairman Quayle, Ranking Member Edwards and distinguished members of the Subcommittee, my name is Brink Lindsey and I am a senior scholar in research and policy at the Ewing Marion Kauffman Foundation. I thank you for the invitation to appear at today's hearing and share some perspectives on the crucial challenge of reviving new firm formation and restoring dynamism and prosperity to the U.S. economy.

Today's hearing is premised on a connection between encouraging new businesses and fostering innovation, and that premise is well supported by the evidence. Existing firms contribute much to innovation as well, but such innovation tends to be incremental: improvements in existing products or production processes or introduction of new products through pursuit of well-established R&D agendas. But when it comes to so-called discontinuous or disruptive innovation – the kinds of breakthroughs that topple the status quo and give rise to whole new industries – the agents of change tend to be new firms. Think FedEx, WalMart, Microsoft, Google, all of which were upstarts without any stake in the existing way of doing things. In this regard, the remarkable career of Steve Jobs at Apple is the exception that proves the rule. The reason he was so exceptional was precisely that he launched multiple business revolutions from the same company. That is a rarity.

Economic research bears out the importance of new firms to America's economic dynamism. It turns out that a significant fraction of U.S. productivity growth comes from the entry and exit of firms – what Joseph Schumpeter called creative destruction. Generally speaking, exiting firms are less productive than existing firms, which in turn are less productive than surviving new firms. According to a recent paper written by economist John Haltiwanger and supported by the Kauffman Foundation, net entry of firms has contributed about 30 percent of total productivity growth in the manufacturing sector and virtually all productivity growth in the retail sector.[1] New firms are thus the lifeblood of rising productivity, and, consequently, rising living standards.

[1] John Haltiwanger, "Job Creation and Firm Dynamics in the U.S.," National Bureau of Economic Research, May 2011, http://www.nber.org/chapters/c12451.pdf.

And, when it comes to promoting prosperity through job creation, the role of new enterprises can hardly be overstated. According to research from the Kauffman Foundation, there were only seven years from 1977 to 2005 in which existing firms created more jobs than they destroyed. The bottom line is simple: Without startups, there would be no net job creation in the United States.[2]

Unfortunately for both the short-term prospects for a rebound in employment and the long-term prospects for productivity and growth, the creation of new businesses in America is in a deep slump. And what is more, additional research from the Kauffman Foundation reveals that slump predates the Great Recession that began in 2008. Census data show that the number of new employer businesses created annually began falling after 2006, dropping 27 percent by 2009. Meanwhile, the average number of employees per new firm has been trending gradually downward since 1998. And the pace of job growth at new firms during their first five years has been slowing since 1994.[3]

A picture of even longer-term decline is revealed by the recent paper from John Haltiwanger mentioned above. Average annual gross job creation by startups has fallen from 3.5 percent of total employment in the 1980s to 3 percent in the 1990s to 2.6 percent since 2000 – 25 percent cumulative drop. With this slump has come a drop in overall gross and net job creation for the U.S. economy.

The timing of this deterioration suggests that the problem is structural, not merely cyclical. And structural problems call for structural solutions. Specifically, the ultimate answer to restoring both innovation and vigorous job growth lies in policy reforms that create a more favorable environment for the creation and growth of new businesses. Barriers to entrepreneurship need to be identified and systematically dismantled.

This conclusion is further supported by my own research into the growth challenges confronting not only the United States but all advanced economies operating at the technological frontier. My findings can be summarized as follows: The available sources of growth, and the policy requirements of growth, change over time with a country's advancing economic development. In particular, as countries get richer, they become ever more heavily dependent on home-grown innovation – as opposed to simply expanding existing activities or borrowing good ideas from abroad – to keep the growth machine humming. And since new firms play an absolutely vital role in the innovation process, that

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[2] See Tim Kane, "The Importance of Startups in Job Creation and Job Destruction," Kauffman Foundation Research Series: Firm Formation and Economic Growth, July 2010, http://www.kauffman.org/uploadedFiles/firm_formation_importance_of_startups.pdf.

[3] E.J. Reedy and Robert E. Litan, "Starting Smaller; Staying Smaller: America's Slow Leak in Job Creation," Kauffman Foundation Research Series: Firm Formation and Economic Growth, July 2011, http://www.kauffman.org/uploadedFiles/job_leaks_starting_smaller_study.pdf.

means that removing barriers to entrepreneurship becomes increasingly important to maintaining economic dynamism and prosperity.[4]

To get more specific, our long-term growth prospects are dimmed today by shifting demographics. Over the course of the twentieth century, U.S. growth rates got a steady and considerable boost from the ongoing rise of women in the workforce. As a result, the American labor force climbed from 56 percent of the adult population in 1900 to 67 percent in 2000. This is a classic form of non-innovative growth: boosting inputs into the production process, as opposed to figuring out how to get more output from a given quantity of inputs. But now this source of growth is all but exhausted. The female labor force participation rate peaked in the 1990s and then began dipping well before the Great Recession. Meanwhile, male participation has been falling gradually for decades because of later entry into the workforce, longer retirements, and the aging of the population. Consequently, according to a study by the McKinsey Global Institute, growth in the workforce will add only 0.5 percentage points to the overall growth rate between 2010 and 2020 – as compared to 2.0 percentage points in the 1970s. Because of these unfavorable demographics, McKinsey estimates that productivity growth will have to increase by almost 25 percent to keep real per-capita growth going at its long-term historic rate of 1.7 percent a year.[5]

In an effort to identify the kinds of policy reforms needed to reduce structural barriers to entrepreneurship, innovation and job creation, the Kauffman Foundation unveiled in July of this year a series of legislative proposals called the Startup Act of 2011.[6] Let me review now the major elements of this plan:

Welcoming job creators to the United States. First, we propose an entrepreneur visa along the lines of the revised Kerry-Lugar Startup Visa Act. Initially, entrants would be screened for temporary visas based on either the outside capital they had attracted or revenues from U.S. sales they already had recorded. Permanent work visas (green cards) would be granted once these entrepreneurs had hired a minimum number of U.S. workers. Although the Kerry-Lugar bill imposes a limit on the number of visas granted, we believe a strong case can be made for a visa without any caps. A second, mutually reinforcing idea would grant green cards to foreign students when they receive their so-called STEM degrees – degrees in

[4] Brink Lindsey, "Frontier Economics: Why Entrepreneurial Capitalism Is Needed Now More Than Ever," Kauffman Foundation Research Series on Dynamics of Economic Growth," April 2011, http://www.kauffman.org/uploadedFiles/frontier_economics_4_06.pdf.

[5] McKinsey Global Institute, "Growth and Renewal in the United States: Retooling America's Economic Engine", February 2011, http://www.mckinsey.com/mgi/publications/growth_and_renewal_in_the_us/pdfs/MGI_growth_and_renewal_in_the_us_full_report.pdf.

[6] Kauffman Foundation, "The Startup Act: A proposal for new legislation aimed at jump-starting the U.S. economy through successful startups," http://www.kauffman.org/uploadedFiles/startup_act.pdf.

science, technology, engineering and mathematics – from U.S. universities. Admittedly, most STEM graduates who are given visas will compete with U.S. workers for jobs. In the long run, however, given the greater propensity of immigrants to found businesses, it is likely many of the STEM graduates permitted entry now eventually will go on to form scale businesses that hire American workers.

Facilitating early-stage financing for new firms. The first proposal here is for a capital gains tax exemption for long-held investments in startups. The Small Business Jobs Act of 2010 currently provides such an exemption for investments in "qualified small businesses" (those with less than a $50 million valuation at the time of investment) held for at least five years. The exemption is currently due to expire at the beginning of 2012, but the National Advisory Council on Innovation and Entrepreneurship (NACIE), created by the Department of Commerce, has recommended a permanent exemption for these critical initial investments in startups. It is appropriate for this idea to be included in any comprehensive startup legislation. NACIE also has suggested a 100 percent exclusion on corporate taxable income earned by qualified small businesses (again, using the same test as for the proposed capital tax exemption) on the first year of taxable profit, followed by a 50 percent exclusion in the subsequent two years. We believe additional incentives along these lines are worthy of support.

Facilitating access to public capital markets. The provisions of the Sarbanes-Oxley Act, especially the verification of internal controls embodied in Section 404 of the act, impose a disproportionate burden on new, small companies and thus act as a barrier to going public. In 2010, Congress implicitly recognized this problem when granting a permanent exemption from the Section 404 audit requirements for public companies with market capitalizations of less than $75 million. Any comprehensive startup legislation should go further, for a very simple reason: The best judges of whether the benefits of the SOX requirements outweigh their costs are the shareholders of the companies for whose benefit the law was enacted in the first place. Accordingly, rather than simply raising the market cap threshold for exempting smaller public companies from SOX's requirements, the most logical SOX reform is to allow shareholders of public companies with market valuations below $1 billion to opt in to at least Section 404 compliance, if not to all of the SOX requirements. Companies whose shareholders do not elect to comply with SOX should have special designations in their exchange listings to denote this fact so that all shareholders, current and potential, are put on notice.

Accelerating the formation and commercialization of new ideas. Recently enacted patent reform legislation contains various provisions whose likely impacts on innovation and startups are not clear. We believe that at least one provision of the legislation – namely, higher fees for faster or better service – is very likely to be positive in its effects. To obtain patent protection for new ideas, inventors first must receive a patent from the U.S. Patent and Trademark Office

(USPTO). In recent years, however, USPTO examiners have been unable to keep up with the pace of new applications, to the point where there is now a backlog of more than 700,000 patent applications at the office. There is an old saying that “justice delayed is justice denied,” and the same certainly applies to a patent regime that is too slow to process incoming patents.

More than thirty years ago, Congress enacted the Bayh-Dole Act, granting recipients of federal research monies intellectual property rights in innovations discovered with the use of those funds. Since Bayh-Dole was enacted, faculty members typically have been required under their university contracts to use the university’s own technology licensing office (TLO) as the exclusive agent for licensing the rights to faculty-developed innovations either to the inventors themselves or third parties. In effect, university TLOs have become monopoly licensing agents and gatekeepers, preventing innovative faculty from using their own attorneys or other third parties, or even other university TLOs, to license and commercialize their innovations. The federal government can and should remedy this odd situation. One simple way to do so is to mandate that all federal research grants to universities be conditioned on universities’ affording their faculty members the ability to choose their own licensing agents. A university’s own TLO could compete in this new environment or, at minimum, provide informational services and mentoring to university faculty members. Licensing freedom for faculty inventors and true competition in innovation licensing would speed up the commercialization of faculty innovations, benefiting the innovators, their universities and our society.

Removing regulatory barriers to entrepreneurship. Because of their size, small and new businesses bear an especially heavy burden when complying with the multitude of local, state and federal rules that govern business behavior. To help alleviate this burden, the Startup Act contains two proposals for systemic reform of the federal regulatory process. The first is a simple requirement that all major rules (those with estimated costs of at least $100 million) sunset automatically after ten years. Rules then would be allowed to lapse unless and until re-proposed and implemented (under new standards outlined next). This would regularly cleanse the books of inefficient and costly rules and, thus, barriers to business formation and growth for all businesses, including startups. The second proposal is for all major rules to be subject to a uniform regulatory review process. Under this screening procedure, no major rules would be implemented or maintained (after a sunset review) unless agencies can determine that the rules’ benefits outweigh their costs. Furthermore, the form of these rules should be such that the option chosen is the most cost-effective of the alternatives available.

In addition, the Startup Act offers a new mechanism for monitoring and thereby potentially curbing regulatory abuses and excessive costs at the state and local levels. Although the federal government should not step on the toes of local and state governments, it can facilitate healthy competition among these jurisdictions

for favorable startup environments. Just as the World Bank has assessed the favorability of the legal environment toward business in different countries through its annual *Doing Business* reports, there should be some recognized entity that does the same (with a special emphasis on policies and practices affecting the formation and growth of new businesses) for each of the fifty states and all cities above a certain size. The *Doing Business* rankings have proven to be an important spur to regulatory reform around the world. A similar *Doing Business* project for jurisdictions inside the United States could have the same result. Both the government and private sector have roles in this effort. Because the underlying data are likely to be costly and difficult to gather, it could be useful and important to charge and fund one government agency with collecting the raw data that could be made available to the public, which would permit either nonprofit or for-profit rating systems to develop.

The proposals contained in the Startup Act represent a kind of “greatest hits” collection picked from a far broader set of promising reform ideas. Some of these other ideas can be found in a book published this year by the Kauffman Foundation entitled *Rules for Growth: Promoting Innovation and Growth through Legal Reform*. That book was the product of an ongoing Kauffman Foundation initiative – the Project on Law, Innovation and Growth – that we hope will make further major contributions to our understanding of how to improve our legal and regulatory system to make it more conducive to entrepreneurial dynamism.

Much work remains to be done, but in the current crisis, first steps are urgently needed. We believe the proposals put forward in the Startup Act would make excellent first steps toward reviving firm formation, innovation and prosperity.

Thank you.

Brink Lindsey Biography

Brink Lindsey is a senior scholar in Research and Policy for the Ewing Marion Kauffman Foundation, where he uses his expertise in international trade, immigration, globalization and economic development to identify the structural reforms needed to revive entrepreneurial innovation, firm formation and job creation in the wake of the Great Recession.

Lindsey joined the Kauffman Foundation from the Cato Institute, where he served as vice president for research. While at Cato, he helped oversee the Institute's research agenda, developed new research programs and was the senior editor of *Cato Unbound*, a monthly web magazine, which he founded in 2005. From 1998 to 2004, he was director of Cato's Center for Trade Policy Studies, helping to make it a leading voice for free trade. An attorney with extensive experience in international trade regulation, Lindsey was formerly director of regulatory studies at Cato and senior editor of *Regulation* magazine.

An accomplished author, Lindsey has written several books, including *The Age of Abundance: How Prosperity Transformed America's Politics and Culture*; *Against the Dead Hand: The Uncertain Struggle for Global Capitalism;* and, with Daniel Ikenson, *Antidumping Exposed: The Devilish Details of Unfair Trade Law*. He also is a contributing editor at *Reason* magazine. In addition, Lindsey's writings have been published widely in major newspapers and the leading policy magazines, and he has appeared frequently on television and radio.

Lindsey earned an AB from Princeton University and a JD from Harvard Law School.

About the Kauffman Foundation

The Ewing Marion Kauffman Foundation is a private nonpartisan foundation that works to harness the power of entrepreneurship and innovation to grow economies and improve human welfare. Through its research and other initiatives, the Kauffman Foundation aims to open young people's eyes to the possibility of entrepreneurship, promote entrepreneurship education, raise awareness of entrepreneurship-friendly policies, and find alternative pathways for the commercialization of new knowledge and technologies. In addition, the Foundation focuses on initiatives in the Kansas City region to advance students' math and science skills, and improve the educational achievement of urban students, including the Ewing Marion Kauffman School, a college preparatory charter school for middle and high school students set to open in 2011. Founded by late entrepreneur and philanthropist Ewing Marion Kauffman, the Foundation is based in Kansas City, Mo. and has approximately $2 billion in assets. For more information, visit www.kauffman.org, and follow the Foundation on www.twitter.com/kauffmanfdn and www.facebook.com/kauffmanfdn.

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