Can America Get Its Entrepreneurial Groove Back?

Private Capital at the Political Forefront

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With discussion of private capital and the role of investors in job creation at the forefront of the political debate thanks to Republican presidential candidate Mitt Romney’s role at Bain Capital decades ago and President Obama’s discussion of tax fairness for investors, as well as Warren Buffett’s foray into tax policy, the Brookings Institution and the Private Capital Research Institute recently co-hosted a day-long discussion featuring Small Business Administrator Karen Mills, business leaders, policymakers and academics on the role of the industry in the economy. The event examined: the state of private capital and its future potential for stimulating economic growth; the impact of regulation and government intervention on the economy; an update on private capital research; and the drivers of innovation and the role of private equity in stimulating growth. The following summarizes the discussion’s key points.

Economic Paralysis: Dealing with the Financial Crisis Legacy

The financial crisis caused a severe shock to the financial system, global trade, and most importantly, to consumer confidence. As described by Michael Klein, the former Chairman of Citi Institutional Clients Group, this has caused both consumers and corporate executives to view the current economic situation through a lens of instability and fear, often referred to as a “financial crisis window.” Aaron Chatterji of the Fuqua School of Business at Duke University indicated that widespread uncertainty among executives explains, in part, the unprecedented $1.9 trillion of cash being held on corporate balance sheets. While a portion of the cash stockpiling may be due to prevailing low interest rates which enable corporations to borrow large sums of capital, the broader question remains: what is holding back reinvestment in innovation and other expansion initiatives that could create jobs? One possible explanation that has been suggested is regulatory uncertainty caused by new legislation such as Dodd-Frank and the Affordable Care Act. Another cause for inaction: uncertainty regarding the prospects for sustained consumer demand. Executives are skeptical about the long-term appetite for new products, and therefore are reluctant to invest in costly product development projects. As a result, financial institutions and the financial markets have less confidence, hindering a robust economic recovery.

New York Times Columnist David Brooks argued that despite feeling the ongoing reverberations precipitated by the financial crisis, the U.S. has maintained its fundamental strengths of flexibility and dynamism. Crime, domestic violence, teenage pregnancy and teenage suicide rates are declining. America is still a country with low-corruption and competitive industries. Most importantly, America maintains its strong social networks built on extremely high levels of trust that enable what sociologists call “spontaneous sociability.” This spontaneous sociability, as described by Brooks, is what enables Americans to build rich networks that serve as the foundation for creativity and innovation. Given the strength of the nation’s fundamentals, the challenge for policy makers and stewards of private capital is how to best capitalize on these strengths and become part of the solution. In other words, how can the public and private capital sectors work together to accelerate innovation to create more jobs and stimulate growth?
Government and Its Impact

As outlined by Brooks, the American political system was formed to cultivate the formation and movement of capital and encourage fluid capitalism. During the financial crisis however, the government’s role was transformed with its decision to aggressively provide capital to support failing private institutions. Post-financial crisis, which today is still a new and uncertain environment, it remains appropriate to consider the appropriate role of government in a free economy. Brooks asked whether the government today should be “cooking the meal” or “setting the table”?

In the scenario where the policymakers cook the dinner, they take an activist role in the economy including providing venture capital or low cost loans to stimulate growth to certain sectors or industries. However, this model faces significant challenges due to the large budget deficit and questions whether the government is the appropriate organization to pick “winners and losers.” A more viable option would be to have the government “set the table” as HBS Professor Josh Lerner described it, thus creating the systems to establish a favorable environment for entrepreneurs. For example, strengthening intellectual property laws, lowering tax rates and implementing effective immigration policies that entice a highly-skilled labor force are all examples of concrete government-sponsored table-setting initiatives.

Carl Shapiro of the President’s Council on Economic Advisers suggested the correct role of government is to provide the proper “ambiance for the meal.” Government, according to Shapiro, can ensure that small and growing businesses have the access to capital and the tools necessary to thrive. He described three areas to improve this ambiance which the government is currently pursuing. First, in order to provide small, high-growth firms with access to capital, the Securities and Exchange Commission ("SEC") allows for special treatment of seed capital. For example, government officials are proposing “crowd funding,” which would provide a limited exemption from SEC registration requirements for companies capable of raising one million dollars. Second, government officials are working to expand the limit of Regulation A, which provides an exemption from SEC registration requirements as well as simplified financial disclosure for public offerings not exceeding $5 million. Policy makers are proposing to raise this statute to include public offerings below $50 million from $5 million, enabling companies to get access to financial capital more easily and quickly. Third, officials are designing procedures to streamline compliance with cumbersome Sarbanes-Oxley requirements for growing companies, making them proportional and commensurate with the age and size of the company. While the government may be doing more than simply setting the table, the question remains, what can be done from the demand side to stimulate sustainable growth?

The Impact of Regulation and Policy

The question of how policy makers can structure regulation to set the table for expansion and innovation was a major area of focus. According to Shapiro, research from institutions like the Kauffman Foundation, which seeks a further understanding of the economic impact of entrepreneurship and to improve the environment in which entrepreneurs start and grow businesses, play a crucial role in identifying effective policies and analyzing their economic impact. The research from these “think tanks” shows that among the broad set of small
businesses, it is the subset of young, high-growth firms that stimulate innovation and growth. It is the entrepreneur who does not have an existing vested stake in maintaining the status quo, and who is most often the driving force behind disruptive innovation.

Unfortunately, the decline in new business formation and the decrease in number of jobs per new start-up since the financial crisis have contributed greatly to innovation stagnation. Small Business Association Administrator Karen Mills observed that small businesses account for approximately half of U.S. private sector payroll and they have been a major casualty of the financial crisis. Mills estimates that 62% of net job losses since March 2007 have occurred in small businesses. To combat this employment destruction, the government is actively channeling capital into the hands of small businesses through the SBA. As private-sector small business loans sharply in the wake of the 2008 crisis and credit standards tightened, the SBA increased its lending, reaching an all-time record high of $30 billion in 2011. Similarly, as venture capital (VC) funding fell over the same period, the SBA increased its commitments to the Small Business Investment Company (SBIC) program from an average of $0.8 billion from 2006 to 2009 to $1.8 billion in 2011, while decreasing the time it took for new funds to get licensed.

In addition, the SBA has identified three areas for new job growth. First, the SBA is working to provide more small-dollar loans and increase points of access for Main Street small businesses. Second, the SBA will provide support for high-growth businesses, which is the segment which has been shown to create nearly all net new jobs. To prevent a further decline in entrepreneurship rates, the SBA is increasing capital commitments through its SBIC funds and crowd-funding, offering mentoring and counseling to build an entrepreneurial culture, and enacting policy changes to stimulate innovation through patent reform and federal lab commercialization to streamline the grant process. Third, the SBA will further support and strengthen small businesses in supply chains through low-cost working capital lines of credit and revenue generation support systems. Thus, the government is working to design a policy to maximize existing resources to support entrepreneurs by leveraging public-private partnerships.

The Role of Private Capital

According to Klein, as of 2007 there was $7 trillion of capital raised annually around the world, which equates to approximately 20 percent of the relevant GDP in those markets at the time. This infusion of capital fueled global expansion, accounting for more than five percent of growth in 100 countries. The capital also helped to create great stability and a lower perception of risk within the marketplace.

Even in times of economic challenge, a recovery was spurred by the deployment of capital. Private capital enables managers to have visibility across the spectrum of investment opportunities to identify potential winners, and aligns fiduciary responsibilities with the organization’s goals. In addition to investing, growing and selling their investments, private equity managers are able to take a long-term view of their investments. They can add value, including providing strong management teams and financial advice to the ventures and have the flexibility to invest in new technologies, products, and geographies. Thus, private capital is part of the solution of encouraging and enabling economic growth in order to create more jobs.
However, is there enough capital in the system to weather the current economic downturn? According to Klein, there is a sufficient capital cushion in the system. This has resulted from increased capital raising since the crisis. In addition, the markets have recovered from the initial shock, instilling greater stability and making capital available at historically low nominal costs. However, the capital has not been distributed evenly, with the majority of fixed income raised attributable to government financing. In addition, according to Mark Wiseman, executive vice president of investments at the Canadian Pension Plan Investment Board, another issue is the trend towards “capital protectionism”: that is, government policies around the world that prevent the free flow of capital from one nation to the next. He explained that capital protectionism serves as an impediment to growth and must be addressed similar to trade protectionism.

As a result, firms must work with policymakers to ensure future growth and to promote further innovation. Ron Bloom, the former Assistant to the President for Manufacturing Policy, explained that despite the overhang of deleveraging and lack of aggregate demand, Americans have not lost the desire to start new companies. According to Richard Jaffe, Co-Chair of the Private Equity Group at Duane Morris LLP and a Board member of the Association for Corporate Growth, much of this innovation and growth will come from the middle market companies. The middle market private equity firms have the capital and can provide the guidance and discipline necessary to help their investments grow which will have a significant positive impact on the economy. However, per the suggestion of Heather Slavkin, the Senior Legal and Policy Advisor for the Office of Investment at the AFL-CIO, firms can ensure greater success by working closely with the labor unions and viewing the employees as assets in order to leverage the existing knowledge at these companies.

In addition to the middle market, disruptive innovation will also come from the edges of established industries and technologies, as explained by A.G. Lafley, the former CEO of Procter & Gamble and current Member of the President’s Council on Jobs and Competitiveness. The goal is to identify opportunities to build the associations, the connections and the collaboration that can unleash this disruptive innovation. As a result, it is crucial to expand the body of research to identify the winners within private capital and establish best practices for the industry to stimulate further investment, innovation, and growth.

**Key Takeaways**

Despite the current economic turbulence, the U.S. has managed to maintain its fundamental strengths of dynamism, flexibility and trust within the social fabric of the country. This coupled with the fact that capital is available due to companies’ decisions to stockpile cash has created opportunities for investment and growth. This growth will be spurred by small businesses, middle market firms, and innovation along the edges of existing and established industries. However, given the current economic situation, it will be critical for these companies to work closely with policymakers to identify the role of regulation in the economy -- whether it is in “table setting” or “cooking the meal.” As Bloom explained, government and business will likely be locked in a “constant dialogue about how they can serve each other and do better together.” This dialog will be crucial for creating the systems that will enable and encourage
innovation. In addition, it will be critical to have accurate data and research to assess the effectiveness of these systems, the impact of policy changes, and the performance of firms deploying private capital in order to establish industry-wide best practices.
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The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

PCRI's primary goal is to produce high quality academic research on the private capital industry based in large part on its comprehensive, centralized academic database of private capital transactions.