



Policy Agenda to Revitalize American Entrepreneurship

Recent research has demonstrated that new businesses – “startups” – are disproportionately responsible for the innovations that drive economic growth, and account for virtually all net new job creation.¹ Alarmingly, recent research has also demonstrated that rates of entrepreneurship in America have fallen near a 40-year low, *and that this decline is occurring in all 50 states, in all but a handful of 360 metro areas examined, and across a broad range of industry sectors, including high-technology.*²

Given the importance of thriving entrepreneurship to innovation, economic growth, job creation, rising wages, and expanding opportunity, such circumstances amount to nothing less than a national emergency. Reversing the decline in American entrepreneurship requires changes in public policy.

CAE’s recommended policy agenda is structured in response to a straightforward question: What do entrepreneurs need to thrive? The simplest answer is:

- Great new ideas;
- Access to capital;
- Access to skilled talent; and,
- Relief from distractions like regulatory and tax burden, complexity, and uncertainty.

New Ideas

New ideas are the basic craft and contribution of entrepreneurs. Whether a new product or service, “building a better mousetrap,” or new methods of producing, distributing, or delivering products and services, new ideas are the essence of innovation, which drives productivity gains and economic growth, and creates jobs, wealth, and opportunity. New ideas can come from the mind and imagination of entrepreneurs or as the result of scientific inquiry and discovery.

¹ John Haltiwanger, Ron Jarmin, and Javier Miranda, “Business Dynamics Statistics Briefing: Jobs Created from Business Start-Ups in the United States,” Ewing Marion Kauffman Foundation, 2009.

² “Declining Business Dynamism in the United States: A Look at States and Metros,” Robert Litan and Ian Hathaway, The Brookings Institution, May 5, 2014.

Restore the Research and Development (R&D) Tax Credit to the Most Favorable in the World

The Research and Experimentation Tax Credit – commonly known as the research and development (R&D) tax credit – was created as part of the Economic Recovery and Tax Act of 1981 to incentivize technological progress and innovation by allowing businesses to deduct a portion of the cost of research and product development from their taxable earnings. The United States was one of the first countries to incentivize R&D by way of the tax code and claimed the world’s most generous tax treatment of R&D into the early 1990s.

Since its introduction, the R&D tax credit has been shown to be a powerful driver of innovation and economic growth. A large and growing body of research indicates that R&D investment is associated with future gains in profitability and market value at the firm level, and with increased productivity at the firm, industry, and broader economy levels. R&D also has significant “spillover” benefits, as research conducted by one firm can lead to progress that increases the productivity, profitability, and market value of other firms in related fields. A recent analysis of the R&D expenditures of 15 OECD countries over the period 1990 to 2013 concludes that a 1 percent increase in R&D spending accelerates economic growth by 0.61 percent. Research also shows that R&D investment has become increasingly mobile, with businesses and corporations locating more of their investment outside their home countries. Investment location decisions are determined by many factors, including the growth of foreign markets, production costs, talent and skills availability – and tax and other incentives offered by governments.

The United States no longer claims the most favorable tax treatment of corporate R&D. Today, 26 of the 34 OECD nations offer R&D tax incentives, and other non-OECD nations like Brazil, India, Russia, Singapore, South Africa, and China do as well. A recent analysis by the Information Technology and Innovation Foundation has shown that the United States now ranks 27th of 42 nations studied in terms of R&D tax treatment. More favorable tax treatment of R&D means that foreign companies are able to invest more heavily in relative terms, with potentially profound implications for innovative advantage over the longer term. Moreover, as global companies – including American companies – look for places to invest in R&D, many other countries are now substantially more attractive than the United States.

Restoring America’s preeminence in incentivizing R&D will not be cheap. But losing the innovation advantage our nation has enjoyed for 70 years would be much more costly. Moreover, academic research regarding the stimulative effect of R&D investment on the rate of economic growth and job creation, as well as the significant “spillover” impact of such investment, strongly suggests that any short-term loss in tax revenue will be substantially or even entirely recovered through faster economic growth and job creation over the longer run.

Enhance the Tax Provisions of the PATH Act

The R&D tax credit would be particularly relevant for startups, which often incur substantial losses in their early years due to development of new products, services, methodologies, and techniques – and for whom preservation of cash flow and operating capital is crucial to survival. And yet, until recently, startups were largely shut out of any benefit associated with the credit because it can only be applied against taxable earnings, which many startups don’t have for years, and sometimes many years.

The Protecting Americans from Tax Hikes (“PATH”) Act of 2015 made a number of improvements to the application of the R&D tax credit, perhaps most notably finally making the credit permanent after numerous extensions and expirations since its creation in 1981. Now certain of the credit’s availability, businesses can make investment decisions more effectively and efficiently. In addition, the PATH Act addressed the disconnect between the policy intention of the R&D credit and startups by allowing new businesses to apply the credit against payroll taxes, rather than income taxes, up to \$250,000 annually. To qualify, companies must have had gross receipts for five years or less and gross receipts of less than \$5 million for the tax year the credit is applied.

CAE recommends enhancing the PATH Act’s tax provisions for startups by expanding eligibility to include companies with gross assets of less than \$100 million – matching CAE’s recommend change in the definition of “Qualified Small Business” (see recommendation regarding Section 1202 of the tax code below) – and by raising the payroll tax deduction limit to \$1 million annually.

Restore Government R&D to its Historical High

In addition to enhancing the tax treatment of private R&D, CAE urges policymakers to restore U.S. government funding of R&D to the historical high of 2.2 percent of GDP. To do so, funding would need to increase from the current \$145 billion annually to about \$400 billion.

The U.S. government’s commitment to R&D has waned dramatically in recent decades. After growing at an inflation-adjusted average annual rate of 7 percent between 1950 and 1990, growth in government outlays for R&D fell to an annual average of just 1.4 percent between 1990 and 2012. Meanwhile, other nations have dramatically expanded government support of R&D. Over the period 1992 to 2009, Australia increased government R&D spending at an average annual rate of 9 percent, South Korea by 11 percent, Singapore by 14 percent, and China by nearly 20 percent. China’s performance is especially impressive given that its GDP grew at an annual rate of nearly 10 percent over the period. China is expected to overtake the United States in total R&D spending *this year*, according to the National Science Board.³

Perhaps most alarming, the federal government’s share of basic research funding has plunged in recent years – from 70 percent through the 1960s and 1970s, 60 percent as recently as 2004, below 50 percent in 2013 for the first time in the post-World War II era, and to just 44 percent in 2015. Basic or “pure” research is conducted to gather general information and to build on existing knowledge and understanding – it is the basis for applied research, establishing the context of knowledge and understanding within which additional progress can be made regarding specific inquiries. Government funding of basic research has played a critical role in driving many technological breakthroughs that have helped U.S. industry become a global technology leader. Google, Sun Microsystems, Pfizer, Genentech, and Cisco are examples of companies whose origins can be traced directly back to basic research funded by the government.

³ National Science Board Statement on Global Research and Development (R&D) Investments NSB-2018-9: https://www.nsf.gov/nsb/news/news_summ.jsp?cntn_id=244465

U.S. government-funded R&D peaked at 2.2 percent of GDP in 1964, then steadily declined to a low of 0.7 percent of GDP in 2000 and has remained at or below 1 percent of GDP ever since. If America is to retain its status as the world's innovation leader, the multi-decade decline in the commitment of federal dollars to scientific research must be reversed. Tripling government R&D funding is a significant challenge given current fiscal circumstances, but there is little doubt that America's economic future depends on such a commitment.

Streamline Technology Transfer and Commercialization of Government-Funded Innovation

Promising innovations stemming from federally-funded research too often face a slow, cumbersome, and uncertain path to commercial viability. Discoveries with significant social and economic benefit often take years to reach the commercial marketplace, while other innovations never leave the research lab. It is not hyperbole to assert that more streamlined and efficient commercialization of federally-funded innovation may have greater impact on the U.S. economy and quality of life of American citizens than any other research and development strategy. On July 30, 2018, CAE submitted a comment letter to the National Institute of Standards and Technology (NIST) regarding reform of federal technology transfer authorities and processes. That letter is attached to this document.

Expand I-Corps

The National Science Foundation's (NSF) Innovation Corps ("I-Corps") program was created in 2011 to accelerate the translation of scientific and engineering discoveries into technologies, products, processes, and services that enhance the nation's competitiveness, benefit society, and promote economic growth. Developed by famed Silicon Valley entrepreneur Steve Blank and based on his "Lean Startup" model, I-Corps provides education, training, and mentoring to scientists and engineers to identify and explore the commercial potential of NSF-funded research. The goals of the I-Corps program are to: 1) spur translation of fundamental research to the marketplace; 2) encourage collaboration between academia and industry; 3) train NSF-funded faculty, students, and other researchers in innovation and entrepreneurship; and, 4) maximize the potential of NSF's investments in basic research through creation of a National Innovation Network (NIN) comprising I-Corps "Nodes" (or central training sites) and sites (universities) that work cooperatively to build, utilize, and sustain the national innovation ecosystem.

The American Innovation and Competitiveness Act (AICA) was signed into law in January of 2017 (P.L. 114-329), and Section 601 of AICA directs NSF to further develop and expand the I-Corps program. Since its launch in 2011, the I-Corps program has been adopted by several other federal research agencies including the National Institutes of Health, the Department of Energy, the Department of Health and Human Services, and the National Security Agency, and has delivered remarkable results – to date, the program has trained over 1,200 teams of scientists and engineers, resulting in 583 startups and \$300 million in follow-on funding. The FY 2019 funding request for I-Corps is just \$30 million. CAE recommends that I-Corps' resources be significantly increased and that the program be expanded to include all research agencies, including through widespread integration into other relevant R&D programs such as the Small Business Innovation Research (SBIR) program.

Access to Capital

Starting a new business requires money. In the initial days of a startup, capital needs may be limited to the bare essentials – money to purchase supplies, computers, and other office equipment. Falling costs for computers, software, and other office technologies in recent years, together with the establishment of the Internet and its distributional and promotional power, have dramatically lowered the cost of getting a new business off the ground.

But that's just the beginning. As new businesses begin to grow, capital needs multiply. Entrepreneurs need money to pay bills, move out of the garage or dining room into office space, and, hopefully, begin paying initial employees. Most importantly, entrepreneurs need capital to further develop their product or service idea, research the marketplace, and develop and implement a strategy for identifying and targeting customers.

Because such costs typically arrive long before the first dollar of revenue, capital and credit are the lifeblood of any new business. Difficulties in accessing sufficient capital and credit at reasonable terms can delay or prevent the launch of a new business, disrupt the further growth and development of an existing business, or even kill an otherwise healthy and viable business.

Make the SBA More Responsive to Startups

Congress should instruct the Small Business Administration to initiate an ongoing dialogue with lending institutions and startups regarding how SBA programs, products, and procedures can more clearly distinguish between existing small businesses and new, high-growth startups. The SBA should also be instructed to determine how SBA-backed lending can be tailored and more responsive to the unique nature and needs of startups (e.g., less complex, less reliant on cash-flow and physical asset collateral).

Increase the SBA Guarantee to SBICs

On June 6, 2018, the Senate passed the Small Business Investment Opportunity Act (SBIOA) to modify the SBA's Small Business Investment Company (SBIC) program and increase the amount of capital SBICs can invest in qualifying small businesses. SBICs are privately-owned and managed investment funds that use their own capital – plus funds borrowed with an SBA guaranty – to invest in new and small businesses. Since Congress created the program in 1958, SBICs have channeled more than \$67 billion of capital to 166,000 American businesses across a variety of industries. Some of America's most iconic companies have received investment capital from SBICs, including Apple, Tesla, Whole Foods, Staples, Intel, FedEx, and Costco. Until recently, the SBA was authorized to guarantee up to \$150 million for each SBIC investment fund. The SBIOA increased the cap to \$175 million. While certainly a step in the right direction, CAE is of the view that an increase of \$25 million is insufficient – especially since the cap was last raised in 2009. CAE urges policymakers to increase the cap on the SBA guarantee to SBICs to \$250 million.

Re-structure and Re-launch the SBA's Early Stage Innovation Fund (ESIF) Initiative

In January 2013, the Small Business Administration (SBA) launched the Early Stage Innovation Fund initiative (ESIF) – an offshoot of the SBA's Small Business Investment Company (SBIC) program (see recommendation above). Whereas licensed SBIC's invest primarily in the growth of existing small businesses, ESIF licensed firms were required to invest at least half their funds in early- and seed-stage startups. By guaranteeing up to \$50 million in additional capital per licensed fund, the ESIF initiative was intended to help leverage private capital already raised by active funds, providing additional investment capacity to venture capital funds beyond the venture capital centers of Silicon Valley, New York, and Boston, which attract three-quarters of all venture capital. In announcing the program, the SBA said it planned to guarantee up to \$1 billion in additional startup capital over five years at no cost to the American taxpayer.

On September 19, 2016, the SBA proposed changes to the ESIF program because as of June of 2016, the SBA had licensed only five venture capital funds. On June 11, 2018, the SBA announced that it was withdrawing its proposed rule and ending the ESIF program. According to the SBA, the initiative failed because the SBA-backed portion of ESIF-affiliated investments were structured as subordinated debt that paid quarterly interest back to the government equivalent to the rate of a 10-year Treasury bill plus 1.5 percentage points and “debentures are not well-suited to an early stage investing strategy sine many early-stage investments do not provide ongoing cash flows needed to pay the current interest an annual charges associated with SBA guaranteed debentures.”⁴ Given the importance of early- and seed-stage risk capital to startups, together with the relative scarcity of venture capital in heartland states, CAE recommends that the SBA work with the venture capital community to determine a financing structure consistent with the earnings and repayment realities unique to startup and relaunch the Early Stage Innovation Fund initiative as soon as possible.

In conducting its reassessment, the SBA should look to more successful models that help fill the early stage funding gap. Between 2010 and 2015, Treasury's State Small Business Credit Initiative (SSBCI) provided nearly \$450 million in funding for states to allocate to venture capital markets, catalyzing significant private investment in the process. Recognizing the important early stage funding gap, states allocated nearly two-thirds of these funds – which carried no federal payback requirement – to seed and early stage investments.

The Administration should also examine the experience and successful approach of the Israel Innovation Authority (formerly the Office of the Chief Scientist), which was created in 1974 and charged with fostering the development of Israel's industrial R&D and venture capital industries. The authority has taken a multi-pronged approach – not only co-investing public money to help launch new venture capital funds, but also lending money directly to promising but risky new ventures that otherwise struggle to find private investment. The lending program, which has played a critical role in the growth of successful Israeli firms such as Waze, receives payback through sales royalties in lieu of equity.

⁴ <https://www.federalregister.gov/documents/2018/06/11/2018-12030/small-business-investment-companies-sbic-early-stage-initiative>

Pass the HALOS Act

CAE supports enactment of JOBS Act reforms passed by the House in 2017, including S. 588, “Helping Our Angels Lead Our Startups (HALOS) Act”: The bill, received by the Senate on January 11, 2017 after passing the House with broad bipartisan support (H.R. 79), would clarify that promotional events organized by entrepreneurs known as demo days, venture fairs, or pitch days (“demo days”) are exempted from general solicitation restrictions. Uncertainty regarding demo days and general solicitation restrictions has created confusion among investors and potential legal liability for entrepreneurs, reducing the value of demo days and capital availability for startups.

Raise the Cap on the Reg A Exemption (or “Mini-IPO”)

The JOBS Act of 2012 sought to revive the Regulation A exemption – sometimes called a “mini-IPO” – which allows public companies to raise capital through general solicitation without the full burden of disclosures typically required of a conventional IPO. The Act increased the amount of capital that could be raised under the exemption from \$5 million to \$50 million and instructed the SEC to reevaluate that cap every two years. As of year-end 2017, 185 qualified offerings have raised a total of \$670 million under the new Reg A – only limited progress. Companies seeking more than \$50 million in capital, say \$75 million or \$100 million – still small amounts by any standard – must resort to the conventional IPO process and the burden of standard disclosures. Given the significant decline in the number of IPOs in recent years – and especially the more than 90 percent plunge in sub-\$100 million listings since 2001 – CAE urges the SEC to raise the Reg A exemption cap to \$100 million.

Raise the Cap on 3(c)(1) Investment Funds

On May 24, 2018, the “Economic Growth, Regulatory Relief, and Consumer Protection Act” was signed into law by President Trump. Title V of the legislation addresses capital formation – including a provision, “Supporting America’s Innovators,” Section 504, that had previously passed the House (H.R. 1219) and Senate (S. 444) by wide margins. The section amends section 3(c)(1) of the Investment Company Act of 1940, by raising the permitted number of investors from 100 to 250 for investment funds not making a public offering of securities that are exempt from registration as an investment company with the Securities and Exchange Commissions and from the filing of costly disclosure requirements associated with registration – provided the fund size does not exceed \$10 million.

The increase in the number of permitted investors is a welcome change that will facilitate the formation of angel investor funds and smaller venture capital funds that will fuel new generations of startups. However, the fact that the cap on qualifying funds was not raised will limit the value and impact of the increase in permitted investors. Moreover, because institutional investors prefer larger funds of at least \$30 or \$40 million, the \$10 million limit means that fund managers are generally unable to attract institutional investors to smaller funds. With these realities in mind, CAE recommends that the cap on funds exempted from registration as an investment company be raised to at least \$50 million – and potentially to \$100 million, which would be consistent with the recommendation above regarding capital raises under the Reg A exemption.

Eliminate Volcker Rule Barriers to Bank Participation in Venture Capital Funds

Prior to the passage of the Dodd-Frank Act in July of 2010, many banks across the country – including many community and regional banks – participated in venture capital funds as limited partners. Banks’ participation in such funds was beneficial to both banks and new businesses – banks served as an important source of early-stage capital for promising young companies in their towns and regions, while earning healthy returns and helping to develop the next generation of business customers.

Following enactment of Dodd-Frank, however – and, in particular, following the promulgation by regulators of rules to enforce Volcker rule restrictions – bank participation in such funds was prohibited.⁵ In drafting rules to implement Volcker prohibitions, regulators cast a wide net – banning any trading or covered fund investment activities that might possibly be considered proprietary, regardless of their value to banks, their customers, or the broader economy – rather than specifically targeting those activities that were clearly the object and intent of the Volcker rule’s systemic risk concerns.

As a result, rather than reducing systemic risk, Volcker rule regulations have in many ways impeded the efficient operation of the financial system, driving banks away from providing services valued by their customers, reducing competition, and undermining economic growth. A vivid example of the negative impact on banks of all sizes – including the nation’s community and mid-size banks to which the Volcker rule was not intended to apply – is the prohibition of banks’ participation in covered funds, including venture capital funds. The unfortunate effect has been to stifle investment in emerging growth companies, which, research shows, contribute disproportionately to innovation, productivity gains, economic growth, and job creation.

CAE strongly supported S. 2155 – the Economic Growth, Regulatory Relief and Consumer Protection Act – bipartisan legislation signed into law in April of this year, which exempts banks with total assets of less than \$10 billion from compliance with the Volcker rule, and, therefore, lifts current regulatory restrictions on smaller banks participating in venture capital funds. But banks with total assets above \$10 billion are still be subject to Volcker restrictions.

Because the damage caused by the Volcker rule stems principally from its implementing regulations and not the underlying statute, CAE is strongly of the view – along with other organizations like the National Venture Capital Association and the American Bankers Association⁶ – that financial regulators have the authority and latitude to revise covered fund restrictions in ways that would remove unwarranted obstacles to economic growth and focus more sharply on the specific activity that the statute seeks to prohibit – namely, engaging primarily in stand-alone, short-term proprietary trading.

⁵ The five federal financial agencies charged with implementing and administering the Volcker Rule are the Federal Reserve, Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC).

⁶ See ABA Letter to the OCC (Sept. 21, 2017) (responding to OCC RFI on Volcker Rule reform proposals) (available at <https://www.aba.com/Advocacy/commentletters/Documents/cl-Revising-Volcker2017.pdf>); Department of the Treasury, Office of the Comptroller of the Currency, Proprietary Trading and Certain Interests in and Relationships with Covered Funds (Volcker Rule); Request for Input, 82 Fed. Reg. 36,692 (2017).

Mobilize More Angel Investors

In recent years, “angel” investors – wealthy individuals who invest in young promising companies – have become a major source of startup capital in the United States. Like venture capitalists, angels invest in new, high potential companies in exchange for an equity stake in the business. Many angel investors – particularly those who are current or former entrepreneurs – also provide advice, mentoring, and other support to the management team of the new businesses in which they invest. As with venture capital, angel capital is recovered and returns realized when financed firms either go public or are bought by another company.

Angel investors also differ from venture capitalists in significant ways. For example, unlike VCs, who invest institutional capital in amounts of \$1 million or more, angels invest their own money, typically in amounts between \$25,000 and \$500,000. Despite smaller individual investments, aggregate angel capital rivals that of venture capital. Each year, angels invest about \$25 billion in more than 70,000 new companies. For every new company that receives venture capital, nearly 20 others receive angel capital. Amazon, Home Depot, and Uber are just a few of the thousands of companies launched with angel capital.

Perhaps most importantly, whereas venture capital is typically invested during a later growth phase after initial financing has helped create a viable company, angel investors have emerged as the principal source of outside “seed” or early-stage funding critical to the formation, survival, and growth of new businesses – providing 90 percent of such capital once entrepreneurs have exhausted their own resources and those of family and friends.

According to the Center for Venture Research (CVR), which has analyzed the angel market since 1980, there are currently about 300,000 active angel investors in the United States. According to the Securities and Exchange Commission, *another 9 million American households* meet accredited investor criteria.⁷ Most are likely unaware of what angel investing is and of the opportunity to potentially participate in financing the next generation of great American companies. To be sure, angel investing is risky and, therefore, not a viable or appropriate investing strategy for every accredited investor. But if only 3 percent of the 9 million additional potential angels chose to allocate a portion of their financial portfolios to promising new companies launched in their cities and towns, the number of active angel investors would double to 600,000 – and, presumably, the amount of capital invested would double to \$50 billion annually.

With this in mind, CAE recommends that sufficient funds be allocated, either through legislation or Presidential directive, to launch a nationwide initiative – in collaboration with the more than 400 angel investing groups across the country and online angel platforms – to engage, educate, and mobilize potential angel investors.

⁷ Report on the Review of the Definition of “Accredited Investor,” Securities and Exchange Commission, December 18, 2015.

Reexamine the Definition of “Accredited Investor”

The Dodd-Frank Act requires the SEC to review the definition of accredited investor every four years. The current definition requires an individual to have annual income of \$200,000 (\$300,000 for a couple) or net worth of \$1 million, excluding the value of a primary residence. These parameters limit the number of accredited investors to just 10 percent of the U.S. population.⁸ Excluding 90 percent of American investors from important and potentially profitable investment opportunities is overly cautious and restrictive. Moreover, an accreditation framework based on income and financial assets is an arbitrary standard of financial sophistication and unjustly favors investors residing in coastal cities like San Francisco, Seattle, and New York with high costs of living and high property values over investors residing in lower cost areas. The SEC should examine the definition of accredited investor with the aim of more rationally and fairly expanding investment opportunities for more Americans.

Allow Loans to Entrepreneurs in Opportunity Zones to Count Toward Banks’ CRA Obligations

The Community Reinvestment Act (CRA) was enacted in 1977 to require commercial banks and savings associations to help rebuild and revitalize the communities in which they conduct business by meeting the credit needs of all segments of those communities, including low- and moderate-income neighborhoods, in a manner consistent with their safe and sound operation.

Research has revealed that new businesses – “startups” – are disproportionately responsible for the innovations that drive economic growth, and account for virtually all net new job creation. As such, startups are a powerful mechanism of economic development and revitalization – and an important pathway to economic participation and empowerment. Access to the capital necessary to launch a new business is a perennial challenge for entrepreneurs, particularly in economically distressed or rural areas overlooked by other sources of capital such as venture or angel capital. More than 50 million Americans live in economically distressed communities.⁹

Commercial banks are an important – often the only – source of startup capital for entrepreneurs in such areas, and yet securing capital and credit from banks can be difficult or even impossible for startups, as new businesses are risky and typically lack many of the characteristics that banks look for in creditworthy clients – e.g., credit history, reliable earnings and cash flow, or inventory. The resulting disconnect between startups and commercial banks is a major obstacle to entrepreneurship and the new businesses, jobs, and expanded opportunity that it creates.

To bridge the gap between banks and startups in distressed or rural areas, Congress should amend the Community Reinvestment Act to allow banks to count loans and credit extended entrepreneurs in such areas as part of their annual CRA obligations. Doing so would be consistent with CRA’s original goal of economic revitalization by helping to unlock bank credit for the new businesses that drive growth and job creation. Distressed areas eligible for such CRA treatment could be the “Opportunity Zones” (low-income community census tracts) designated by Governors under the recently enacted Investing in Opportunity Act.

⁸ SEC, “Report on the Review of the Definition of ‘Accredited Investor,’” p. 48 (Dec. 18, 2015): <https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf>.

⁹ 2017 Distressed Community Index, Economic Innovation Group.

Access to Talent

A wide and worsening disconnect between the skill needs of 21st century employers, including startups, and the skills of graduates from American high schools, colleges, and universities – often referred to as the “skills gap” – is arguably the most significant obstacle to the full productive capacity of the U.S. economy and to our nation’s ability to fulfill its sacred promise of providing opportunity for all American citizens. Roundtables with entrepreneurs conducted regularly across the country by CAE staff reveal that finding job applicants with appropriate skills is one of the most difficult challenges confronted by American startups. “We have the jobs, and need to fill them to survive and grow,” they tell us. “But we can’t find enough people with the skills we need.”

Create the “U.S. Business-Education Workforce Dialogue”

The President should direct the Department of Commerce and the Department of Education to immediately co-establish the U.S. Business-Education Workforce Dialogue – a framework of ongoing discussion and collaboration between business and education leaders to regularly examine kindergarten through grade 12, community college, and university curricula to ensure that the nation’s education system serves the broader educational needs of American students, as well as the skill requirements of 21st century businesses.

The Dialogue should include educators at K-12 schools, community and vocational colleges, and universities, as well as leaders of multinational corporations, regionally active firms, small businesses, and young startups. Dialogue participants should meet on a regular basis – at least semi-annually – in pursuit of a robust and specific agenda, facilitated by a dedicated staff.

Importantly, the Departments should neither set the agenda for the Dialogue nor seek to pre-determine its outcomes. Rather, the Administration’s role should be to establish, facilitate, and encourage the Dialogue, allowing business and education leaders to identify the relevant issues and, working together, develop and implement effective solutions, with the help of policymakers.

A particular focus of the Dialogue should be to better leverage the value of the nation’s 1,200 community colleges. Whether serving as an educational “on-ramp” for first generation college-goers or low-wage/low-skill adults, offering cutting-edge occupational training, or working with businesses to provide continuing education and training for their employees, community colleges are the natural backbone of the nation’s workforce development efforts.

At its best, the Dialogue should seek to make employers fully integrated partners with American schools, colleges, and universities in producing both a highly educated and appropriately trained, “ready-on-day-one” workforce. Employers should not only communicate their skill needs to educators, but also provide business community input into curricula determinations, help set aptitude standards, develop apprenticeship programs and work/study arrangements, and encourage active business professionals and other practitioners to serve as teachers, instructors, assistants, advisers, and mentors.

This kind of active collaboration would likely produce substantial savings for businesses – U.S. employers spend more than \$415 billion each year on informal on-the-job training and an additional \$175 billion each year on formal education and training, according to Georgetown University’s Center on Education and the Workforce.

A regular and robust dialogue between U.S. business and education leaders offers tremendous and highly tangible potential benefits to the nation and its citizens. Economists at Harvard University have estimated that if the math proficiency of U.S. students were raised to levels currently observed in Canada and South Korea, U.S. economic output could be expanded by “nothing less than 75 trillion” over the next 80 years – roughly \$1 trillion annually.

Create an “Entrepreneur Visa”

Foreign-born entrepreneurs have been an important part of America’s economic landscape for many decades. A study released by CAE in December of 2017 found that 43 percent of Fortune 500 companies – and 57 percent of the top 35 companies – were founded by immigrants or a child of immigrants. These companies are headquartered in 68 metro areas across 33 states and employ millions of Americans.

And yet the United States is one of only a few industrialized nations that do not have a visa category for foreign-born entrepreneurs. In recent years, many nations – including China, Germany, France, New Zealand, Australia, and Chile, and most recently Canada and the UK – have created new visas to attract foreign-born entrepreneurs, including American entrepreneurs.

It should also be pointed out that many of the well-documented abuses of the existing H-1B visa process are attributable to the current lack of a clearly defined and lawful pathway for foreign-born entrepreneurs who want to build their new companies in America. Problems associated with the H-1B visa include the fact that such visas are arbitrarily capped at 85,000 per year, the demand far outstrips the supply, large companies benefit disproportionately while smaller businesses are virtually shut out, and recipients must be sponsored by a U.S. company to whom they become indentured servants.

With these realities in mind, CAE proposes the creation of a new visa category – an “entrepreneur visa” – specifically designated for foreign-born entrepreneurs who want to launch new businesses in the United States. To qualify, applicants would have to meet national security requirements and would have to have raised at least \$100,000 in initial funding to validate themselves as entrepreneurs and to authenticate the validity of their business idea.

Under the terms of the entrepreneur visa, foreign-born entrepreneurs would be admitted on a temporary basis, say two years. If by the end of that period their business has been successfully launched, is producing verifiable revenue, and has produced jobs for at least two nonfamily members, the temporary visa would be extended – say, for an additional three years. If the new business continues to be successful and has created jobs for at least five nonfamily members by the end of the initial five-year period, the foreign-born entrepreneur would be granted permanent residency in order to continue building their business and creating American jobs. A 2013 study by the Kauffman Foundation concluded that an entrepreneur visa would create between 500,000 and 1.6 million new American jobs within 10 years.

Award “Graduation Green Cards”

A permanent residency card – “green card” – should be awarded to any foreign-born student meeting national security requirements who completes an undergraduate or postgraduate degree from an American college or university and wants to remain in the United States following graduation. Research has repeatedly demonstrated that immigrants are twice as likely as native-born Americans to start a new business. More than 1 million foreign-born students – the largest foreign-born student population in the world – study at American colleges and universities each year. Current policy requires most to leave the country after graduation, taking their U.S.-acquired education and training with them.

Preserve the “Guarantee” in the Affordable Care Act

Prior to the passage of the Affordable Care Act, employees had a strong incentive to remain at established firms that provide health insurance without regard to their health status, rather than leaving to launch a new business. By prohibiting insurance companies from taking preexisting conditions into account when setting rates, the ACA provides for the employee mobility necessary for new business formation. Should Congress modify the Act, it should keep the provision protecting those with preexisting conditions, and should also keep – or find a workable alternative to – the individual mandate, which expands insurance populations to cover the higher costs of those with preexisting conditions.

Limit Non-Compete Agreements to One Year

Non-compete agreements should be limited to no more than one year. Such agreements impede talent mobility and deter the launch of new firms. Policymakers should seek to strike an appropriate balance between firms’ legitimate desire to protect trade secrets and proprietary knowledge, and the entrepreneurial economy’s need for new ideas and talent.

Further Progress on Reducing Regulatory Burden

Regulation is essential to market economies. It establishes the rules of competition, ensures a level playing field, governs participants’ behavior, and protects consumers, public health and safety, private property, and environmental resources. Without question, innovation, economic growth, and wealth creation depend on the promulgation and enforcement of regulation.

But regulation isn’t free, or without consequence. Regulation imposes costs – costs borne by businesses. A wave of new, inconsistent or outdated regulations, or complex and confusing regulations can distract business owners’ focus and time away from their product line and the marketplace. They can impose costs that consume resources that could otherwise be invested back into businesses. Regulation can also create economic distortions, entrenched interests, and powerful constituencies, and lead to cronyism and dependency. Perhaps most insidiously, regulation and its costs operate like an invisible and, therefore, easily overlooked, tax.

The stifling effect of regulatory burden and complexity is particularly acute for startups. New businesses lack the resources and scale of larger firms over which to absorb and amortize the costs of compliance. Moreover, their very survival, especially during the initial years, depends on the energy, focus, and flexibility of their leaders.

The Trump Administration has made regulatory reform a central feature of its economic agenda and has made significant progress in its first 18 months. CAE is of the view that even more fundamental reform is possible that would significantly improve the prospects of startups and the U.S. economy more broadly.

Create a Regulatory On-Ramp for Startups

The Congressional Budget Office (CBO) and Office of Management and Budget (OMB) should be directed, by Congress and the Administration, to co-develop a reduced, “light touch” regulatory framework (i.e., a “regulatory on-ramp”) to which new businesses would be subject for the critical first five years after formation. The framework should be comprised of only the most essential product safety, environmental, and worker protection regulations as co-determined by CBO and OMB. Co-development of the framework by CBO and OMB is important since regulation is the implementation of Congressional intent by Executive branch agencies.

To minimize regulatory uncertainty, the new-business framework should also protect new businesses from new regulations for the critical first five years. To be sure, the startup regulatory framework would need to be updated, improved, and refined from time to time by CBO and OMB. But any changes would apply only to new firms the following year and not to young firms already operating within the five-year window of regulatory certainty.

To avoid abuse of the regulatory on-ramp – such as business owners simply renaming or reconstituting existing companies every five years – the Internal Revenue Service (IRS), working with the CBO and OMB, should develop appropriate definitions, characteristics, and limitations regarding the meaning of “new business.”

Require Third-Party Review of All Economically Significant Regulations

CBO and OMB should also be directed, by Congress and the Administration, to co-conduct third-party analysis of the economic costs and benefits of all proposed new regulations with an economic impact deemed greater than \$100 million. The third-party review should require analysis of the costs of the proposed regulation in relation to other federal regulations, as well as in relation to existing state and local regulations. In particular, the third-party review should focus on the impact of proposed new regulations on new and small businesses. Proposed regulations determined to have economic costs, or costs to new and small businesses, that exceed identifiable benefits should require Congressional approval for enactment.

Create a Regulatory Improvement Commission (RIC)

The federal government has a large, multi-faceted, and very effective apparatus for crafting and promulgating new regulations, but no regular mechanism for systematically addressing outdated, duplicative, ineffective, or unnecessarily burdensome regulations.

With this omission in mind, Congress should create a Regulatory Improvement Commission (RIC) as proposed by Michael Mandel, chief economist at the Progressive Policy Institute. Mandel has pointed out that the sheer accumulation of regulations over time can begin to suppress innovation and growth – even if every individual regulation, considered in isolation, is determined to be sound and reasonable.

The problem is that it's possible for every individual regulation to pass a cost-benefit test, while the total accumulation of regulation creates a heavy burden...The number of regulations matter, even if individually all are worthwhile. I call this the "pebble in the stream" effect. Throw one pebble in the stream, nothing happens. Throw two pebbles in the stream, nothing happens. Throw one hundred pebbles in the stream, and you've dammed up the stream. Which pebble did the damage? It's not any single pebble, it's the accumulation.

Modeled on the Base Closure and Realignment Commission (BRAC) – which provided independent, objective, nonpartisan review and analysis of U.S. military installations – the RIC's purpose would be to serve as a procedural mechanism for the regular evaluation, simplification, streamlining, consolidation, and elimination of selected existing regulations.

The RIC would be comprised of a bipartisan group of highly qualified stakeholder appointees and staffed by experts seconded from various regulatory agencies, Congress, and independent organizations. After selecting a portion of the regulatory code for review – a "scoop" of pebbles from the pile in the stream – the RIC would solicit input from individuals, businesses, other affected stakeholders, and outside experts, hold public hearings, and carefully and objectively examine the evidence in an open and transparent manner.

Upon completion of its analysis, the RIC would submit a package of recommended improvements to Congress for a "fast-tracked" up-or-down vote. Following Congressional approval, the package would be sent to the White House for the President's approval and signature, ensuring that the reforms carried the force of law.

A Regulatory Improvement Commission would provide a regular and politically feasible alternative to irregular and incoherent deregulation efforts, and would avoid the obvious flaws of regulatory agency self-review that have foiled most deregulatory efforts to date. Moreover, by considering the cumulative impact of regulations across agencies, the RIC would also escape the self-defeating trap of focusing on individual regulations that, considered in isolation, often appear perfectly sound and reasonable. And by requiring Congressional approval by way of a fast-tracked up-or-down vote, the RIC process would provide legislators with the necessary political cover to deliver authentic regulatory reform and simplification, safe from the conflict and interest group pressure that scrutiny of individual regulations often provokes.

Additional Tax Reform

The Administration and Congressional Republicans are currently discussing a second tax reform effort following the enactment of the Tax Cuts and Jobs Act of 2017. CAE urges that any additional tax reform should include a sharp focus on enhancing tax circumstances for American entrepreneurs and startups.

Allow Startups to Defer Income Tax Liability

Because capital is the lifeblood of any new business – and because holding onto as much capital as possible can be the difference between success or failure – CAE recommends that startups be permitted to defer any tax liability incurred during the critical first five years, and to apply that tax liability at any time over the ensuing 20 years. Because money has a time value – future tax payments are worth less than immediate payments – deferred tax payments should be assessed a reasonable rate of interest, perhaps a real rate of 2 percent.

Allow Startups to Carry Forward Operating Losses and R&D Credits

Most new businesses lose money in their initial years – sometimes for many years – before hopefully becoming profitable. Such losses are often due to substantial research and development (R&D) investments, salaries, and other expenses that exceed earnings. For many startups, R&D and salaries can be the primary expenses of the new company in its early years. Whatever the cause, startups, because they are new, have no previous income against which to apply current operating losses. Moreover, income against which losses can eventually be deducted might not materialize for years.

Even more problematic, two aspects of the current tax code that restrict loss and credit carry-forwards – Sections 382 and 383 – can have the effect of virtually eliminating any carry-forward tax benefit for startups. Sections 382 and 383 were written in the mid-1980s to prevent “loss trafficking” – companies acquiring failing firms with large losses solely to use the acquired company’s tax losses to offset other unrelated income. Section 383 pertains to tax credits, while Section 382 pertains to net operating losses. The rules can virtually eliminate the use of net operating losses and credits following transactions perceived as a change in ownership.

Startups often depend on outside investments – from venture capital firms or other sources – to finance R&D and other expenses, sometimes for many years. Such investments are critical for the survival and growth of new firms – but often trigger 382 and 383 change-of-ownership restrictions, potentially nullifying net operating loss carry-forward tax benefits, including for R&D investments. In other words, Section 382 and 383 carry-forward restrictions actually punish startups for incurring the very kinds of investments that federal tax policy explicitly encourages for older established firms. With this policy inconsistency in mind, CAE recommends that net operating losses and R&D credit carry-forwards for startups be exempt from the limitation rules of Sections 382 and 383.

Allow Startups to Expense 100 Percent of Business Investment

The Small Business Tax Revision Act of 1958 created for the first time a special first-year depreciation allowance, whereby small businesses could deduct or “expense” from their taxable earnings a portion of the total cost of capital and equipment investment, pursuant to section 179 of the Internal Revenue Code. Expensing is the most accelerated form of depreciation, allowing businesses to write off the cost of business investment immediately rather than over time. Future deductions are not as valuable to businesses due to the time value of money and because deductions are not indexed for inflation. Expensing stimulates business investment by maximizing the tax benefit of depreciation, thereby effectively lowering the cost of the capital required to make the investment.

CAE recommends that startups be allowed 100 percent first-year expensing of all business-related capital, equipment, real estate, and research and development investment. According to an analysis by the Treasury Department, 100 percent expensing lowers the average cost of capital on new investments by more than 75 percent. Such savings are enormously significant, especially for new businesses for whom access to sufficient capital at reasonable terms remains a principal challenge. Together with the ability to carry forward losses, explained above, 100 percent expensing of all business-related investment – which would contribute to losses – would dramatically improve startups’ financial and tax-related circumstances.

Enhance the Payroll Tax Provisions of the PATH Act

The Research and Development tax credit is particularly relevant for startups, which often incur substantial losses in their early years due to research and development of new products and services, methodologies, and techniques – and for whom preservation of cash flow and operating capital is crucial to survival. And yet, until recently, startups were largely shut out of any benefit associated with the credit because startups often have no taxable earnings (for years) against which to apply the credit.

The Protecting Americans from Tax Hikes (“PATH”) Act of 2015 made a number of improvements to the application of the R&D tax credit, perhaps most notably finally making the credit permanent after numerous extensions and expirations since its creation in 1981. Now certain of the credit’s availability, businesses can make investment decisions more effectively and efficiently. In addition, the PATH Act addressed the disconnect between the policy intention of the R&D credit and startups by allowing new businesses to apply the credit against payroll taxes, rather than income taxes, up to \$250,000 annually. To qualify, companies must have had gross receipts for five years or less and gross receipts of less than \$5 million for the tax year the credit is applied.

CAE recommends enhancing the PATH Act’s tax provisions for startups by expanding eligibility to include companies with gross assets of less than \$100 million – matching CAE’s recommend change in the definition of “Qualified Small Business” (see recommendation regarding Section 1202 of the tax code below) – and by raising the payroll tax deduction limit to \$1 million annually.

Incentivize the Formation and Commitment of Angel Capital

Section 1202 of the tax code was enacted in 1993 to incentivize investment in “qualified small businesses” (QSBs) by excluding 50 percent of capital gains on investments held for at least five years from federal income tax. The PATH Act of 2015 made permanent a 100 percent exclusion from capital gains tax for any gains on long-term investments in qualified small businesses, up to \$10 million or ten times the original investment, whichever is greater. Previously, the American Recovery and Reinvestment or “Stimulus” Act of 2009 raised the excluded portion from 50 percent to 75 percent, and exempted any gains from the Alternative Minimum Tax (AMT). Subsequent legislation raised the exclusion to 100 percent and extended the AMT exclusion temporarily. CAE recommends that this full exclusion from federal income tax of any gains on angel investments in startups held for at least five years be retained in order to maximize the pay-off on any successful investments.

CAE also recommends that the Section 1202 gross asset definition for QSBs be raised from the current “less than \$50 million in gross assets” to “less than \$100 million in gross assets.” The current gross asset limit is too restrictive, as the high costs of innovative research, coupled with valuable intellectual property and successive rounds of financing, often push growing new companies over the \$50 million limit and, therefore, out of Section 1202’s favorable treatment of capital gains.

Finally, at present the Section 1202 exclusion only applies to investments in companies organized as C corporations. Because most new businesses are launched as S corporations, partnerships, or limited liability companies (LLCs) – “pass-throughs” – CAE also recommends that the 1202 exclusion be applied to any startup that converts to a C corporation within five years, and that the period of time spent as a pass-through count toward the five-year holding period required by Section 1202. In other words, angel investors would not have to hold the investment for five years beyond conversion to a C corporation, but only five years beyond the original investment in the company.

Improve Treatment of Startup Investment Losses

As a counterpart to the Section 1202 tax treatment of angel investment *gains*, Section 1244 of the tax code allows investors in qualified small businesses to deduct *losses* on such investments as an ordinary loss (deducted from ordinary income) rather than as a capital loss. Normally, the tax code treats equity investments as capital assets and, therefore, losses are deducted as capital losses to offset capital gains. If capital losses exceed gains in a particular year, remaining losses are deductible up to a limit of \$3,000 annually, with any additional remaining losses carried forward to subsequent years. By contrast, a loss on a Section 1244 investment is deductible from ordinary income up to \$50,000 for individuals and \$100,000 for couples filing jointly.

To qualify for Section 1244 treatment, the issuing company’s aggregate equity capital must not exceed \$1 million at the time of issuance, the company must have derived more than 50 percent of its income from business operations rather than passive investments for the previous five years, and the shareholder must have purchased the stock directly from the company and not received it as compensation. Startups generally don’t issue stock for years after launch, if ever –

nor have they been in existence for five years – and, therefore, currently don't meet the requirements of qualifying small businesses.

To further incentivize seed-stage investments in start-ups, CAE recommends expanding Section 1244 to permit losses sustained by angel investors on investments in new companies held for at least 5 years to be deductible from ordinary income up to \$250,000 annually.