Ladies and Gentlemen of the Committee: Thank you for the opportunity to testify before you today. Spurring startup activity in the US is central for promoting economic growth more broadly and I am grateful for the opportunity to speak before you on this important topic.

Although economic policy in the United States tends to focus on small businesses, the best available economic data indicate that young businesses, not small ones, are responsible for the lion's share of economic growth in our country.[1] The confusion is understandable: almost all young businesses are by their very nature small, but most small businesses are not young. While small businesses are undoubtedly an essential part of the fabric of American life, most are not important engines of job creation. (If they were, they would not continue to stay small.) Young businesses are a different story: most fail, but the ones that succeed create jobs and increase our country's economic dynamism.

In this regard, the early-stage SBIC initiative is laudable both in terms of its objective and in terms of its creativity. I would like, however, to draw your attention to three facts about early stage business activity that, taken together, should temper our expectations of policies that attempt to stimulate early-stage business activity by extending leverage to equity investors in this market.

First, my work with Alicia Robb of the Kauffman Foundation shows that debt, not equity, is the primary source of capital for new businesses.[2] While we have long understood that credit markets

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[1] See John Haltiwanger, Ron Jarmin and Javier Miranda (2010) "Who Creates Jobs? Small vs. Large vs. Young," NBER Working Paper 16300, or Ronnie Chatterji "Why Washington Has it Wrong on Small Business," Wall Street Journal, November 12, 2012.

[2] Alicia Robb and David T. Robinson (2013) "The Capital Structure Decisions of Startup Firms," Review of Financial Studies.

were important for small business, it is surprising that NEW businesses rely so heavily on the banking sector for access to capital.[3] This is true for a wide range of startups: even high-tech, Venture Capital-backed firms rely heavily on access to bank debt through credit lines, personal and business bank loans.

Because home equity is such an important source of collateral for most individuals at the prime age for starting new businesses, this means that the collapse of the housing market was as much a crisis in entrepreneurship as it was a crisis for the banking system.[4]

The second fact is that early stage investing is extremely risky. Failure occurs often. Successes are rare, but are highly rewarded. For every Google or Apple, there are thousands of bad ideas that never make it out of the inventor's garage. There is an understandable need to create curbs inhibiting excessive risk-taking and discouraging bad investment performance, such as the provisions that are included in the early-stage SBIC guidelines. We must nevertheless be aware of the fact that these provisions are likely to discourage some of the most desirable investments from being undertaken: these are the speculative investments that are sometimes associated with the most disruptive technological innovations.

The third fact that bears consideration is that the gestation periods for many early stage investments are prohibitively lengthy for many investors. Increasing the flow of capital into the sector will not change the waiting time between the first investment and the

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[3] See also Alan Berger and Greg Udell (1998) "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle." *Journal of Banking and Finance* 22:613–73.

[4] Evidence connecting home equity to startup activity can be found in Manuel Adelino, Antoinette Schoar and Felipe Severino (2013) "Housing Prices, Collateral and Self-Employment," working paper, Duke University.

acquisition or IPO that will provide the return to the early-stage investor. The primary remedy here is increased liquidity in later-stage investment markets. Some of the most interesting features of the JOBS Act passed last spring are those features that stimulate the development of intermediate liquidity opportunities for early stage investors.

These three facts conspire to make your job a difficult one. To put it simply, we are swimming against the current when we attempt to stimulate early stage investment activity by leveraging existing equity in the sector.

Given these facts, what is the underlying economic mechanism that will likely be responsible for the successes that we do see?

In my view, it is this:

Investors without sufficiently deep pockets are often discouraged from making speculative early-stage investments because they are worried that their early investments will become diluted by later-stage investors. It's not that they need capital to make more investments now; they need more capital later to be used when follow-on investments occur. In my view, the key to this program's success will lie in its ability to amplify the amount of "dry powder" that early stage investors have on hand to participate in later-stage funding rounds as successful investments grow to fruition. Giving early-stage investors the confidence that they will have access to sufficient capital to take their investments across the finish line will be the hallmark of this program's success.

Thank you.