

NURTURING ENTREPRENEURIAL GROWTH IN STATE ECONOMIES

By
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Since their initial meeting in 1908 to discuss interstate water problems, the Governors have worked through the National Governors' Association to deal collectively with issues of public policy and governance. The association's ongoing mission is to support the work of the Governors by providing a bipartisan forum to help shape and implement national policy and to solve state problems.

The members of the National Governors' Association (NGA) are the Governors of the fifty states, the territories of American Samoa, Guam, and the Virgin Islands, and the commonwealths of the Northern Mariana Islands and Puerto Rico. The association has a nine-member Executive Committee and three standing committees—on Economic Development and Commerce, Human Resources, and Natural Resources. Through NGA's committees, the Governors examine and develop policy and address key state and national issues. Special task forces often are created to focus gubernatorial attention on federal legislation or on state-level issues.

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The Center for Best Practices is a vehicle for sharing knowledge about innovative state activities, exploring the impact of federal initiatives on state government, and providing technical assistance to states. The center works in a number of policy fields, including agriculture and rural development, economic development, education, energy and environment, health, social services, technology, trade, transportation, and workforce development.

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FOREWORD

SUMMARY

The new economy is being propelled by growth in small, high-growth companies, commonly called "gazelles." Typically created and driven by entrepreneurs, gazelles account for nearly 70 percent of current economic growth. New and growing firms are a major source of new jobs in the current economy. Although Fortune 500 companies have lost more than 5 million jobs since 1980, more than 34 million new jobs have been added to the economy in the same period. Entrepreneurs and small businesses created the majority of these jobs

The United States has one of the highest levels of entrepreneurial activity in the world, and as much as one-third of the differences in national economic growth may be due to differences in entrepreneurial activity. There are fourteen to sixteen startups for every 100 existing businesses, and perhaps another 2 million businesses start each year as self-employment ventures or businesses without employees. As many as eight out of every 100 American adults are currently trying to start a business of their own.

While most entrepreneurs start by forming small businesses, not all small businesses are entrepreneurial. Typically, entrepreneurs are more focused on assembling resources and creating new innovative products or services that will lead to further investment and growth. They do not stay small businesses for long—though they may rely on small business assistance in their early stages. Every state has programs to assist small businesses, yet the needs of small businesses and entrepreneurs quickly diverge as a result of rapid entrepreneurial growth.

States are beginning to understand the unique role entrepreneurs play in the new economy, but program and policy responses are not consistent across program areas or among states. Unlike the more familiar industry segments of the "old economy," entrepreneurs transverse economic activities and represent a broad range of businesses. However, they do share certain identifiable characteristics in their development and growth that can be indicators for states to use to develop and maintaining essential resources for entrepreneurial growth.

States that wish to improve their economic competitiveness in advanced technology, biotechnology, information technology, and telecommunications should develop policies that nurture entrepreneurs. In these areas, entrepreneurial development plays a prominent role. Strategies to achieve this goal include:

- improving access to capital;
- providing technical assistance;
- streamlining securities regulation;
- improving state regulatory and licensing environments;
- implementing regulatory reform;
- building intellectual capacity at state universities;
- creating industry clusters;
- improving state tax environments;
- improving entrepreneurship education;
- reaching out to entrepreneurs; and
- recognizing entrepreneurial achievement.

By focusing on the characteristics important to entrepreneurial growth, states can begin to develop policy and program responses in a more targeted manner to nurture entrepreneurship. Often policies and programs that affect entrepreneurs are scattered throughout state government and do not fall completely within the purview of economic development. Governors can lead the way to a comprehensive state economic development policy by encouraging cross-agency cooperation and program development that fosters entrepreneurship.

THE EMERGING ROLE OF ENTREPRENEURS IN STATE ECONOMIES

Capitalizing on advances in technology, global communications, and the Internet, the new economy is being propelled by small, high-growth companies, commonly called “gazelles.” A gazelle is as a firm with sales or revenue growth that exceeds 20 percent per year over a four-year period. These companies are created and driven by entrepreneurs. Entrepreneurs are essential change agents in the new economy, providing a mechanism for the reallocation of resources to their most productive use.

According to a report from the Global Entrepreneurship Monitor (GEM), nearly 70 percent of economic growth is attributable to entrepreneurial activity.¹ The United States has one of the highest levels of entrepreneurial activity in the world, and as much as one-third of the differences in national economic growth may be due to differences in entrepreneurial activity. There are fourteen to sixteen startups for every 100 existing businesses, and perhaps another two million businesses are begun each year as self-employment ventures or businesses without employees. As many as 8.4 out of every 100 adults are currently trying to start businesses of their own.²

New and growing firms are a major source of new jobs in the current economy. Although Fortune 500 companies have lost more than 5 million jobs since 1980, the United States economy has added more than 34 million new jobs. In 1996 small businesses produced an estimated 64 percent—or 1.6 million—of the 2.5 million new jobs created.³

WHAT IS AN ENTREPRENEUR?

There is some confusion about the definition of entrepreneurship, particularly as it relates to small business. In its report *State Entrepreneurship Policies and Programs*, the Ewing Marion Kauffman Foundation's Center for Entrepreneurial Leadership defines entrepreneurship as:

The ability to amass the necessary resources to capitalize on new business opportunities. The term is frequently used to refer to the rapid growth of new and innovative businesses and is associated with individuals who create or seize business opportunities and pursue them without regard for resources under their control. They build something from practically nothing and usually reinvest earnings to expand their enterprise or to create new enterprises. Other words that characterize entrepreneurship include innovative, creative, dynamic, risk, flexible and growth oriented.⁴

Though not all-encompassing, this definition describes several characteristics that can help state policymakers develop a strategy to cultivate entrepreneurship. The primary difference between entrepreneurship and small business lies in purpose. Small business owners create companies to generate wealth and a level of income for themselves as operators of those businesses;

entrepreneurs assemble resources and create new innovative products or services that may lead to further investment and growth.

As entrepreneurs become more visible in state and local economies, a general profile is evolving.

- Entrepreneurs develop innovative products and services that improve quality of life.
- Entrepreneurs create more dynamic and flexible new industries and firms to replace those no longer viable in a rapidly changing global economy.
- Entrepreneurs provide most new employment opportunities.
- Entrepreneurs create wealth that is reinvested in new enterprises and, through demonstrated philanthropic activity, in communities.

Entrepreneurs bring new wealth into a community; small businesses capture a share of existing wealth. While most state policies for small business benefit entrepreneurs, there are important aspects of entrepreneurship that can be nurtured by effective state policies targeted to their specific needs.

HOW CAN STATES CREATE AN ENTREPRENEURIAL ENVIRONMENT?

There has been dramatic growth of entrepreneurial activity in the overall economy, but what role is it playing within state economies? Do states address this growth in their economic development strategies? Do they segregate it when developing programs to assist entrepreneurs?

A survey developed by the NGA Center for Best Practices and the Kauffman Center for Entrepreneurial Leadership was sent to all fifty states asking Governors and state policymakers about policies of significance to entrepreneurs. Governors were also asked to identify the most important initiatives they have undertaken and those they are currently developing to promote entrepreneurship. The survey was designed to assess state policymakers' understanding of the needs of entrepreneurs and state efforts to promote entrepreneurship, and to gather information on innovative practices. The survey results are summarized in *State Entrepreneurship Policies and Programs*, a report published by the Kauffman Center for Entrepreneurial Leadership.⁵

One way policymakers can promote entrepreneurship is to include specific strategies and goals in overall development strategies. Nearly all states have adopted an economic development strategy. Typically, these strategies lay out broad principles that guide all economic development policy-related activities in a state.

Entrepreneurial behavior is an important component in many of the emerging growth industries. Several states have included entrepreneurship as a primary economic development goal or as one of several goals contained in larger strategies to develop the technology-based industries of the new economy.

The Kentucky Science and Technology Corporation. The Kentucky Science and Technology Corporation is a private, nonprofit organization committed to the advancement of science, technology and innovative economic development, recently developed a strategic plan to promote technology development in the state. The strategy is driven by one overarching goal: To

create an innovation-driven entrepreneurial economy that makes Kentucky an international leader in the development of knowledge and its applications to people, firms, and products. The plan focuses on building an entrepreneurial economy by developing:

- schools that infuse innovation throughout the learning enterprise, stress science and mathematics, help create an environment that views entrepreneurship as a viable employment option and an alternative to simply "getting a job";
- universities that promote the development of new knowledge, ideas, products, and firms;
- a range of capital resources to support new ideas and startup and growing enterprises;
- public policies that encourage entrepreneurship, innovation, and business expansion;
- the scientific and technological capacity to support the startup and growth of innovative companies;
- communities with dynamic local and regional support systems; and
- a culture that supports and rewards high-speed innovation and entrepreneurship.

Many aspects of this strategy are contained in Governor Paul E. Patton's Knowledge-Based Economy Initiative. The initiative created the Kentucky Innovations Commission, a statewide strategic planning board chaired by Governor Patton. Other board members include the leaders of both houses of the legislature, the department of economic development, council on postsecondary education, and representatives from the private sector. The commission will elevate the policy discussion of the knowledge-based economy and ensure collaboration between the state's economic development efforts and its higher education community.

The North Carolina Economic Development Board. The North Carolina Economic Development Board has six primary goals. Goal Four addresses entrepreneurship.

- Create an economic climate conducive to the birth, attraction and retention of innovative entrepreneurial firms that create new products and services and expand into new markets.

Adoption of this goal led to Governor James B. Hunt Jr.'s establishment of the North Carolina Alliance for Competitive Technologies and the Center for Entrepreneurship and Technology within the North Carolina Department of Commerce.

HOW CAN STATE STRATEGIES ADDRESS ENTREPRENEURIAL NEEDS?

The transition to the new economy has prompted states to reexamine their economic development policies. Several states have adopted development strategies to improve their economic competitiveness in advanced technology, biotechnology, information technology, and telecommunications. Entrepreneurial development plays a prominent role in several of these new strategies.

According to the National Commission on Entrepreneurship and the Kauffman Center for Entrepreneurial Leadership, there are discernable differences between the needs of entrepreneurs and those of small businesses. While reshaping state policies and programs will be beneficial to both, these efforts will create an environment that encourages entrepreneurial growth:

- improving access to capital,
- providing technical assistance,
- streamlining securities regulation,
- improving state regulatory licensing environments,
- implementing regulatory reform,
- building intellectual capacity at state universities,
- creating industry clusters,
- improving state tax environments,
- improving entrepreneurship education,
- reaching out to entrepreneurs, and
- recognizing entrepreneurial achievement.

IMPROVING ACCESS TO CAPITAL

Entrepreneurial firms generally have more potential to achieve high rates of growth than small businesses. Consequently the financing needs of these companies are different. A generally accepted definition of a “gazelle” is a firm with sales or revenue growth that exceeds 20 percent per year over a four-year period on a revenue base of approximately \$100,000. There are other distinguishing characteristics.

- Entrepreneurs import cash; retail businesses recycle existing dollars.
- Entrepreneurs often are precompetitive in business maturity; many small businesses are well established and have little need or desire for public assistance.
- Entrepreneurs often need more technical assistance than small businesses—especially accessing federal research dollars.

Capital formation can be a significant impediment to aspiring entrepreneurs. There is a significant gap in capital access for businesses in startup and early growth stages. One characteristic that separates entrepreneurs from other business entities is their potential for high growth. With new products and innovations being introduced rapidly, businesses seeking to compete in a global marketplace need massive infusions of capital to survive. The size of the investments and the risk inherent in these ventures limit their ability to raise the necessary capital, resulting in a “capital gap.” Estimates of the gap vary, but it is generally believed to be between \$250,000 and \$2 million. This amount typically is beyond the means of traditional lenders and most state small business loan programs. It is usually provided by early-stage “angel” and venture capitalists.

The lack of seed and early-stage financing, including angel and venture funding, is the other main impediment to obtaining adequate financing for entrepreneurs. The most common approaches states can use to fill this void are through direct investments in venture-oriented limited partnerships and by capitalizing new funds dedicated to directing investments within their states. Many state technology development corporations also partner with private venture firms to finance promising technology firms.

Direct Investment by State Agencies

Under this model, a state makes both debt and equity investments, usually by direct purchase of common or preferred stock with a long-term loan. Typically, these investments are part of a joint venture with private-sector investors.

Massachusetts Technology Development Corporation. One of the oldest and most successful examples of direct investing by a state agency is the Massachusetts Technology Development Corporation (MTDC) investment program. MTDC usually expects a return on its equity investment in five to seven years. Private investors partnering in these investments usually provide two to five times the amount of capital provided by MTDC. Through its management assistance program, MTDC provides technical assistance to first-time entrepreneurs in high-technology business. MTDC reviews and critiques initial business plans, advises on strategies to attract private financing, and refers entrepreneurs to private sources of capital.

The success of MTDC can be difficult for other states to emulate. For example, it is particularly difficult for a state to recruit and retain talented fund managers in the public sector, where compensation is far lower than the private sector.

State Investments in Venture Capital Limited Partnerships

State investments in venture capital partnerships encourage firms to focus on investment opportunities within the state. Public retirement funds have used this practice for years. Under this model, states make direct investments in venture capital funds. States have two options to invest: invest in one fund or invest in a portfolio of funds. Investment in a portfolio of funds may provide the state with the greatest diversification and lower the risks of investing in a single partnership.

Connecticut Innovations, Inc. Connecticut Innovations is a venture capital corporation capitalized with funding from the state. Total fund equity for the firm now totals \$103 million. Typical investments range between \$50,000 and \$1 million, and the company must raise matching funds. Unlike more traditional financing sources, Connecticut Innovations may accept a proprietary technology as collateral. Connecticut Innovations typically makes equity agreements and seeks a return on investment commensurate with the risk involved. The firm offers several programs to assist Connecticut businesses.

- Access Connecticut is a venture capital fund formed in August 1996 with a \$4 million investment from Connecticut Innovations. It is managed by an affiliate of Prince Ventures, a seventeen-year-old investment firm in Westport, Connecticut. Prince Ventures manages more than \$100 million and has extensive experience assessing products of high-technology research and establishing successful new businesses.
- The Connecticut Innovations Resource Center is a high-technology information clearinghouse and a gateway to resources available from Connecticut Innovations. The center maintains a complete listing of educational programs and services and state and federal resources to help convert ideas into products.
- The Critical Technologies Program provides royalty-based, market-driven funding to the University of Connecticut for collaborative high-technology research and development that

leads to marketable products or processes. The program encourages collaboration between the University and business for the development and commercialization of products or processes with a high potential to contribute to long-term, sustainable economic growth in the state.

New Hampshire Capital Consortium. Established in November 1994, the New Hampshire Capital Consortium (NHCC) is a venture capital partnership organized by the New Hampshire Business Development Corporation (NHBDC) to fund early-stage, high-potential growth companies in New Hampshire. NHCC is funded by NHBDC, the state, CFX Bank, Energy North, First NH Bank, Fleet Bank, the New Hampshire Charitable Foundation, Public Service of New Hampshire, and Shawmut Bank. NHCC makes investments between \$250,000 and \$2 million in high-potential companies with five-year sales forecasts of \$20 million to \$50 million. Investment is made in equity with appropriate risk-adjusted return.

Tax Credits

Targeted tax credits are another mechanism states use to increase the availability of investment capital. Tax credits can be offered to individuals who invest directly in a business venture or to individuals who make investments in certified seed and venture capital pools.

Kansas Tax Credit for Investment in Venture Capital. Taxpayers who make cash investments prior to January 1, 2000, in a certified technology-based venture capital company or in a certified local seed pool are eligible for a tax credit equal to a maximum of 25 percent of the investment. Unused credits may be carried forward until they are depleted. Funds invested in a local seed pool to provide funding for Kansas small businesses to develop a prototype product or process; to undergo a marketing study of the feasibility of a new product or process; or to create a business plan for the development and production of a new product or process.

Delaware Investor Tax Credits. Personal income tax credits are available to individuals who invest in approved Delaware small businesses. The tax credit is equal to 15 percent and applicable to no more than \$100,000 of investment per investor in any one company. Tax credits can be spread over five years. Designated companies must have annual sales of no more than \$5 million in the last twelve months preceding investment

Certified Capital Companies. The concept of Certified Capital Companies (CAPCos) was developed in Louisiana in the early 1980s to increase the pool of money for seed and venture capital investments. Several states are using CAPCos. Typically, certified capital companies are partnerships, corporations, or limited liability companies that are formed to make investments in early-stage companies in the state and have annual revenues below a given threshold. To encourage institutional investors to provide capital to these companies, states provide tax credits, generally taken against insurance tax liability. In Louisiana and Missouri, the credit is greater than 100 percent of the amount invested in the certified company.

These tax credits are a controversial mechanism for raising capital due to their cost. Opponents argue that safeguards are needed to ensure that most of the investment capital freed up by the tax credit is invested within the state. They also assert that many of the investments are not

true venture investments, but are relatively risk-free investments that should not be supported by tax dollars.

The Kansas legislation has attempted to build safeguards into the enacting legislation. The Kansas credit is not limited to the insurance industry, but is available to individual investors and other institutional investors. Investment can only be made in companies with no more than fifty employees, half of whom must live in the state. The amount of credits available is limited to between \$5 million and \$50 million over a ten-year period. To ensure all investments comply with the stated intention of the act, the state securities commissioner conducts annual audits of all CAPCos. Procedures are spelled out for the revocation of a company's certified status, including the recapture of tax credits by the state.

Due to the relatively early stage of the programs, many states say it is too soon to evaluate the success of CAPCos in increasing the pool of seed and early stage venture capital.

PROVIDING TECHNICAL ASSISTANCE

Many of today's entrepreneurs are technologists and are not trained in finance and marketing—skills required to build an entrepreneurial firm. Would-be entrepreneurs must understand how the venture industry operates, what investors look for when reviewing a business plan, and the general terms and conditions required by firms to take a stake in a growing company. In the investor's mind, this lack of a managerial track record increases the risk of investing in the fledgling enterprise.

States provide technical assistance to businesses through different venues, including small business development centers, state economic development agencies, and technology development corporations. Many state-sponsored seed and early stage capital funds also provide financial and management assistance for entrepreneurs. State science and technology corporations provide some degree of assistance to technology-based entrepreneurs.

Missouri Business Assistance Center. The Missouri Business Assistance Center (MBAC) provides these business services:

- customized business startup packet;
- copy of *Starting a New Business in Missouri*—a simple-to-use guide for new startups and seasoned business owners;
- information on state-level licenses, fees, permits, and regulations affecting business with copies of many state forms;
- assistance in obtaining a sales tax identification number;
- help in communicating and resolving problems with state government agencies;
- information on financing sources;
- referral to local, state, and federal agencies, and professional associations and local organizations that provide business education and counseling;
- information on writing a business plan;
- help in locating a Missouri supplier or manufacturer of specific products and services;
- information on importing and exporting products; and

- referrals for services such as financial analysis, loan packaging, and business management counseling.

STREAMLINING SECURITIES REGULATION

Entrepreneurs looking to raise capital publicly must ensure that they do not run afoul of federal and state securities laws. Since 1996, issuers looking to raise less than \$5 million have been largely exempt from federal registration requirements, but they must still comply with relevant state laws. Complying with nonuniform state securities laws can be a daunting task for most entrepreneurs and requires the expertise of legal counsel. The North American Securities Administrators' Association (NASAA) has developed model regulations and legislation that can be adopted by states to simplify the registration requirements for issuers looking to raise capital in multiple states.

States have made progress in promoting uniformity in state securities registration requirements, simplifying the process of registering securities in multiple states. Most states have adopted at least some of the NASAA model regulations intended to promote uniformity among state securities laws. Some states have adopted the Small Corporate Offering Registration (SCOR) and participate in regional review programs that evaluate SCOR offerings in multiple jurisdictions. Many states also participate in a coordinated equity review program to review certain multistate initial public offerings and participate in the Small Business Administration's ACE-Net, a program that brings together entrepreneurs and angel investors over a secured network on the Internet. The proliferation of small firms looking to raise capital in new and innovative ways presents numerous problems for state securities regulators trying to balance protection of investors from fraudulent securities offerings with improving the ability of legitimate businesses to raise capital in their states.

Small Corporate Offering Registration. The Small Corporate Offering Registration (SCOR) helps small businesses raise capital with a minimum of red tape, while simultaneously disclosing the offering's risks to investors. SCOR offerings are limited to less than \$1 million and are not listed on stock exchanges. The issuer acts as its own transfer agent.

NASAA also has developed a regional review program for multistate SCOR offerings. Entrepreneurs soliciting funds in multiple states can file a SCOR registration form in each state where they are trying to raise capital. Once the application is filed, any comments on the initial application and responses by the entrepreneur are communicated to the designated "lead state." In addition, each of the member states has agreed to apply a common standard in reviewing applications. Currently, thirty-one states participate in one of the regional review programs in the New England, Mid-Atlantic, Midwest, and Western regions. Several states are promoting the use of SCOR as an alternative to state-supported financing for small businesses and entrepreneurs looking to raise capital.

Coordinated Equity Review. The Coordinated Equity Review (CER) Program provides greater ease of multistate offerings between \$5 million and \$20 million. These offerings must be registered with the Securities and Exchange Commission (SEC) and are usually publicly traded on the New York and major stock exchanges. To issue a multistate offering using CER, an issuer

sends registration materials to states where it intends to offer its securities along with a one-page application form. Pennsylvania serves as the program administrator for the program. Within three days of receiving the application, Pennsylvania designates two lead states: one merit review state and one full disclosure review state. The nonlead states have ten days to comment on applications. The lead states collect the comments from states where the offering is made and incorporate them into one letter that is sent to the issuer. Outstanding issues are resolved with the lead states. Once the lead states clear the application, all other participating states agree to clear it as well.

California Securities Reform Efforts. Through sponsorship of small business capital formation forums around the state, California identified the need to reform its securities laws, which had not been updated since 1968. The laws were seen as the major impediment to capital formation. Through regulations, California's Department of Corporations has adopted the following provisions.

- A "testing-the-water" provision permits general announcements of proposed privately placed offerings to be published by written document only. A recent commissioner's opinion indicates that text transmitted electronically via the Internet would satisfy the requirement of a written document. This provision has served as a model for the NASAA "testing-the-waters" regulation.
- The SCOR program allows small businesses to raise up to \$1 million by issuing shares of stock in a limited public offering. The California Trade and Commerce agency, supported by a number of private sponsors, markets and promotes the use of this and other programs as an alternative to government financing of small businesses.
- In 1996 the department of corporations lowered the suitability standards for small business stock offerings of \$5 million or less.⁶

As a result of the small business capital forums, a bipartisan effort produced the Capital Formation and Securities Fraud Enforcement Act of 1996. The bill was designed to replace the merit review process in California with a full disclosure system similar to the one used by the SEC. Through its small business capital forums, California determined that merit review was a primary impediment to capital formation. Merit review, used by approximately forty states, involves a substantial review of an issuer and the proposed offering by state securities regulators. The sheer volume of offerings in California places great pressure on the securities staff to certify offerings in a timely manner. Officials felt that movement to the federal system of full disclosure—which requires issuers to make available all relevant material information about a firm and the current offering—would greatly improve the securities registration process and increase the number of limited public offerings in the state. Although this legislation has not yet passed both houses of the legislature, it has created a great awareness among policymakers to reform the securities laws to provide for better protection for investors and a more efficient capital formation process for small businesses.

OhioAngels.com. OhioAngels.com, a for-profit initiative sponsored by the Ohio Department of Development, is a new and secure portal for private investing and venture funding in the state.

OhioAngels.com uses the Internet to bring together thousands of angel investors, entrepreneurs, venture capital firms, professional service providers, and economic development professionals to form a secure portal that:

- allows angel investors to see a large number of qualified business plans that meet their personalized investment criteria while retaining privacy and anonymity; and
- provides entrepreneurs with a forum to present their business plans confidentially to thousands of investors across the state.

IMPROVING STATE REGULATORY AND LICENSING ENVIRONMENTS

Like most businesses, entrepreneurs looking to start a business must register with the state and, depending on the nature of the business, file several license and registration applications with various state agencies. States are streamlining procedures for licensing and registration, and steps are being taken to streamline the overall regulatory burden on businesses. One way states can simplify this process is through the establishment of one-stop business registration and licensing centers. These centers are located in convenient areas across a state and serve as a point of contact for the entrepreneur and state regulatory agencies. Many of the services provided by a one-stop also are offered via the Internet.

One-stops not only provide benefits to entrepreneurs and small business, but also provide administrative cost savings for the state. Most states are establishing one-stops physically, through the Internet, or both. At this point, most of these offices simply provide referrals for businesspersons seeking information about state registration and regulatory requirements. However, several states have taken the concept one step further and are providing context-sensitive search capabilities and customized packets of information based on information provided by the prospective businessperson.

Washington's Unified Business Identifier (UBI) and Master License Service (MLS).

Individuals looking to register or license their business in Washington State simply visit one of the UBI service locations around the state, complete a single master application, and receive a UBI number that will be used by state agencies involved in business regulation, taxation, and registration.

Businesses that require licensing will also receive a personalized business licensing packet that provides a licensing fact sheet, a booklet *Operating a Business in Washington State: A Business Resource Guide*, a master application, with a registration and license description sheet that describes the registrations and licenses available through the MLS, and a list of UBI locations that can process the master application and assign a UBI number. From the state's web site, <www.accesswashington.gov>, prospective businesses can view the License Information Management System (LIMS), an online licensing library that provides information on federal, state, county, and city licensing.

IMPLEMENTING REGULATORY REFORM

Cost and degree of difficulty in complying with state regulatory schemes are substantial considerations for startup companies. States can help by streamlining their regulatory environment through one-stop business information and licensing initiatives, appointing small business advocates and ombudsmen, and developing small business assistance programs within their environmental agencies to help entrepreneurs navigate the environmental permitting process. Other initiatives include:

- revising state administrative procedure statutes,
- streamlining environmental regulations,
- deregulating electric utilities,
- paperwork reduction acts,
- allowing small business input into the regulatory process,
- tort reform legislation, and
- electronic records and signature legislation.

New York Governor's Office of Regulatory Reform (GORR). An executive order by the Governor provides the framework to develop regulations and specify criteria to evaluate new regulations. Newly proposed and existing regulations are subject to the discipline of cost-benefit analysis, risk assessment, and peer review. GORR assures the regulated community and its citizens that government regulatory policy is predicated on sound scientific and economic principles and is focused on outcomes.

GORR action has resulted in significant cost savings for the business community and the state. Through May 1999, one-time annual savings of more than \$1.9 billion has been realized, and there has been a 50-percent decline in the adoption of new regulations. The strict application of regulation review criteria and the process set forth in the executive order has been credited for much of the decline.⁷

GORR is organized into teams that work with regulated parties and state government agency staff to research and recommend reforms to the acting director. The jurisdiction of each team includes multiple agencies. The teams are criminal justice, health and human services; environment, building codes, and transportation; labor/workers' compensation; and permit assistance. Each team has a team leader, an attorney, and a research analyst. Teams include staff with professional credentials in business, health, engineering, law, and other pertinent areas.

To assist small businesspersons and entrepreneurs in complying with federal and state environmental regulations, states have established business assistance centers. Ombudsmen serve as technical advisors to businesses seeking environmental permits. The Environmental Council of the States (ECOS) has identified thirty-five states that have established ombudsman offices within their state environmental protection agencies.⁸

Maryland Environmental Permit Assistance Center. Created within the department of the environment, the Maryland Environmental Permit Assistance Center:

- answers questions in person or by telephone about environmental permitting;
- operates an Internet-accessible database that tracks most major permit applications;
- coordinates services for customers who need multiple permits;
- distributes fact sheets on topics such as general permits and on how to make permitting easier;
- provides pollution prevention information that explains how businesses can save money and reduce environmental liabilities by changing their operations;
- assists permit applicants who have questions or concerns about the services they are receiving from the department; and
- collects feedback and suggestions from permitting customers and uses this information to improve permitting services.

The center also operates the small business assistance program, which helps small businesses understand and comply with environmental programs.

BUILDING INTELLECTUAL CAPACITY AT STATE UNIVERSITIES

Successful entrepreneurial “hot spots” such as Silicon Valley; Route 128 in Massachusetts; and Austin, Texas, share a common element—the presence of top-flight research universities. The success of technology transfer policies adopted at these universities is a model states are attempting to replicate to develop industry clusters around their own major research universities.

The core of this success is a university’s capacity to build “intellectual infrastructure” to recruit and retain top-flight faculty. Most states are encouraging greater collaborative partnerships between their universities and the private sector—especially in technology transfer. Entrepreneurs are frequently involved in the commercialization of these technologies. States can attract research faculty by increasing funding for research activities at centers of excellence, centers for advanced technology, and other research centers. The presence of a national laboratory also provides impetus to commercialize technologies developed in the laboratories. States foster an entrepreneurial environment by addressing changes in faculty policies about intellectual property rights—including increasing the faculty share of royalties and licensing revenues generated through university-generated patents.

States recognize that universities are more than an asset for producing a skilled workforce—they also are an important economic development tool. States have always provided generous funding support for university-based research and development activities, and this continues to be important to maintaining the quality of the university system. However, the shift towards research commercialization and industry-sponsored research has important implications for higher education policy that has not been fully recognized.

Two initiatives demonstrate the approach some states are taking to attract top-flight faculty and promote collaboration among universities, government, and the private sector in commercializing technologies developed in a university setting.

Georgia Research Alliance. One of the more ambitious strategies to improve the intellectual capacity at a state university is the Georgia Research Alliance (GRA). GRA is a public-private

partnership among the state, six public and private universities, and the business community. To build the state's knowledge base, Georgia has invested more than \$200 million in its Eminent Scholars Program; in research and development facilities in biotechnology, advanced telecommunications technology, and environmental technology; and in the Technology Development Program.

- The Eminent Scholars Program. This program actively recruits scholars from around the world to serve as endowed chairs in one of the state's member universities. To date, thirty scholars have been recruited in biotechnology, telecommunications technology, and environmental technology.
- Investments in Research and Development Facilities. Investment initiatives developed and managed through GRA are intended to establish new, leading-edge research programs, especially those involving collaboration between academic and industrial scientists and engineers. The alliance invests in two components of a major research initiative: facilities and equipment. Among the many centers is the Georgia Center for Advanced Telecommunications Technology (GCATT). Lucent Technologies cited the proximity to GCATT and Georgia Tech University as the primary reason for building an 11,000 square foot research facility in the region.
- Technology Development Partnership. The Technology Development Partnership (TDP) Program was developed to help capitalize on GRA's extensive investments in university research infrastructure. The program encourages research collaborations between Georgia industry and academia and assists in the development of technology with commercial promise. TDP invests in university-based research projects that have attracted matching support from an industrial firm and have successfully passed the program's review process. Projects are intended to help companies develop or improve products or processes.

Kentucky "Bucks for Brains" Program. The Kentucky Research Challenge Trust Fund, commonly called "Bucks for Brains," is a \$220-million program to support endowed chairs and professorships, additional faculty, and graduate students at Kentucky higher educational institutions. The program allows the University of Louisville and the University of Kentucky to build intellectual capacity through the recruitment of world-class researchers and research teams. State funds are matched equally with private funds.

Michigan's Innovation Forums. Michigan Governor John Engler hosted a yearlong series of meetings called Innovation Forums (www.innovationforum.org) that focused on finding new ways to bring cutting-edge technologies out of the university and into the industrial/commercial marketplace. The forums produced recommendations for developing, recruiting, and retaining high-technology talent at all levels. Some recommendations included:

- creating an image for Michigan;
- creating a lifelong learning environment;
- establishing an industry/education task force for current and anticipated worker education needs; and
- encouraging entrepreneurship.

To encourage entrepreneurship, the forums recommended that the state develop incentives to attract key executives to Michigan and research what has been successful in attracting people to the state. The forums also recommended that colleges and universities do more to encourage graduates to start companies in Michigan and establish statewide entrepreneurship competitions.

The Governor's Innovation Forum has led directly to the development of Michigan's Smart State Agenda, the state's current strategy to develop and capitalize on existing technological capacity.

CREATING INDUSTRY CLUSTERS

Firms in related industries tend to concentrate or "cluster" geographically.⁹ Due to the success of areas like Silicon Valley, a great deal of attention has focused on the genesis of clusters and how to replicate them. However, the clustering of regions has occurred for decades. One example is the automobile industry cluster in and around Detroit. This cluster consists not only of the "big three" automakers but also of parts manufacturers and suppliers.

Clustering is relevant to entrepreneurship for several reasons. Clustering allows firms to develop a high degree of specialization. This allows entrepreneurs to create startups that service a particular industry niche. The low level of vertical integration among firms in a cluster lowers the barrier to entry, which is conducive to increasing firm startups. Clustering may facilitate greater capital access because the geographic concentration of firms is attractive to angels and venture capitalists, many of whom have made their fortunes in these industries. The proximity of so many firms facilitates the flow of ideas and creates a kind of spillover effect from employees moving from firm to firm and beginning their own ventures.

IMPROVING STATE TAX ENVIRONMENTS

State tax burdens have fallen considerably, with tax reductions totaling \$26 billion since 1994.¹⁰ Reductions in personal income taxes also benefit entrepreneurs since many firms are established as "S" corporations or limited liability corporations. Unlike "C" corporations, "S" corporations are taxed under the personal income tax in most states. Most states provide assistance to entrepreneurs and small businesses in complying with tax registration and filing requirements. Other examples include state tax seminars, toll-free help desk numbers, maintaining information on state web sites, and providing compliance assistance at one-stop agencies.

Capital Gains Taxes

Equity is an important to all entrepreneurial firms. A venture capitalist is attracted to a particular investment because of its potential to achieve significant returns through equity appreciation. In addition, firms themselves are using stock options in lieu of cash salaries as compensation. Stock options provide employees with a stake in the success or failure of a venture and allow firms to attract workers who are willing to sacrifice immediate compensation for the prospect of greater wealth down the line if the firm is successful.

Most states conform to federal definitions of income for personal income taxation. They treat income from capital gains as any other income. Other states simply impose a tax based on certain percentage of federal tax liability. Reductions in federal capital gains taxes are automatically reflected in state liability. Arkansas, South Carolina, and Wisconsin exclude a certain percentage of capital gains income from state taxes. Massachusetts has reformed its capital gains taxes, imposing a different tax rate on this income depending on the period the taxpayer held the investments. Investments held for six years or longer are totally exempt from taxation.

Targeting Tax Breaks

Several states have enacted targeted tax breaks for entrepreneurs. In addition to tax credits to encourage capital formation, the most common exemption for technology-based businesses is the research and development tax credit.

Research and Development Tax Credits. According to a 1997 study by the State Science and Technology Institute, thirty-five states offer some form of research and development (R&D) tax credit.¹¹ States base their definition of R&D on the national research and experimentation credit at the federal level. The credit is usually equal to a certain percentage of R&D expenditures that exceed a base level (usually an average of R&D expenditures in the past three years). The requirement that expenditures exceed the base level is included to avoid subsidizing expenditures that a firm would have undertaken despite the presence of the credit.

Tax credits can have a limited impact for early-stage companies, since these firms do not have any federal or state tax liability at this point. However, Connecticut has recently amended its credit to allow firms to sell their unused credits back to the state, essentially making the R&D tax credit refundable. This may prove to be more effective in supporting research and development efforts among entrepreneurial firms than standard tax credits.

Miscellaneous Tax Credits. Compensation for workers in the new economy has taken many different forms. Stock options and royalties and licensing income from patents and copyrights are important features of compensation for today's high-technology entrepreneurs. Some states are using targeted tax credits in an attempt to attract high-technology businesses to their state.

- Hawaii has enacted income tax exclusions for royalties and other income from patents and copyrights associated with high-technology businesses and for employee stock options.
- Rhode Island has enacted specialized stock provisions for software developers to recruit software companies. Employees of qualified firms are exempt from paying personal income tax on profits from selling company stock and gains from stock options.
- New York's Governor George E. Pataki has proposed a capital asset exclusion. Gains realized by new companies and innovative entrepreneurs who invest capital in the state will be subject to a lower tax rate.

IMPROVING ENTREPRENEURSHIP EDUCATION

Entrepreneurial education teaches individuals the skills to succeed as entrepreneurs. An essential component—especially in secondary education—is providing students with the awareness that entrepreneurship can be one of many options students can pursue as a career choice. While still in very formative stages, states are increasing funding for a variety of education programs targeted at developing curriculum that includes entrepreneurship.

- Arizona spends approximately \$16 million on entrepreneurship programs.
- Montana spends \$650,000 on vocational education and marketing.
- New Jersey's Schools to Career program has a \$36 million grant to reform its school-to-work program, using community service, technology preparation, and standards as components.
- Massachusetts offers students interested in entrepreneurship the Youth Tech Entrepreneurs (YTE) program. The program prepares high school students for leadership and educational achievement by developing entrepreneurial and technical skills. The YTE program offers project-based curriculum and partners with participating schools to develop and implement academic and extracurricular programs that pay for themselves.

State colleges and universities also can promote entrepreneurship. Examples include entrepreneurship centers, programs, or endowed chairs in entrepreneurial education. Some examples of existing postsecondary efforts include:

- Indiana's Ball State University Entrepreneurial Studies Program;
- University of Louisville's Brown and Williamson Professor of Entrepreneurism; and
- University of Missouri at Kansas City's Ewing Kauffman and Bloch Chairs.

According to the NGA/Kauffman Center for Entrepreneurial Leadership survey, nearly half of the states maintain internships that give students hands-on experience in an entrepreneurial environment.¹²

REACHING OUT TO ENTREPRENEURS

States reach out to entrepreneurs in several ways. The most common are state economic development agencies and small business development centers. Many states use web sites to communicate with entrepreneurs. States also can provide resource information to entrepreneurs through other channels, including the Kauffman Center for Entrepreneurial Leadership's EntreWorld web site (www.entreworld.org), in a uniform way so entrepreneurs can access highly filtered information coded by stage of business development. Advertisements in trade publications and communications through local chambers of commerce are two other methods.

RECOGNIZING ENTREPRENEURIAL ACHIEVEMENT

Many states sponsor events or programs that recognize the contributions entrepreneurs make to state economies. Nearly half of the states recognize entrepreneurs through participation and sponsorship of the U.S. Small Business Administration's Small Business Awards.¹³ Other states present awards for business quality and excellence.

Several states have programs that recognize the achievements of entrepreneurs and promote networking opportunities between entrepreneurs and financiers. These include the sponsorship of venture capital fairs, “entrepreneur of the year” awards, “innovation fairs,” and “young entrepreneurs” conferences. States that participate in the NxLevel training network hold annual awards that recognize the best business plans developed by participants.¹⁴

SHOULD STATE POLICIES SUPPORT ENTREPRENEURS?

State policies that affect entrepreneurs are often scattered throughout state government and do not fall completely within the purview of economic development. State policymakers should ask these questions as they consider policies to promote entrepreneurship within their economies.

- What role can entrepreneurs play in the state’s current economy?
- What will entrepreneurs need to be successful contributors to a healthy state economy?
- What specific programs or policies address those needs?

In answering these questions, states should focus on these key policy areas:

- access to capital and financing mechanisms;
- securities regulations;
- promotion of state programs to entrepreneurs;
- recognition of entrepreneurial contributions to the state economy;
- building intellectual infrastructure;
- regulatory reform;
- business registration and licensing;
- tax policy and compliance; and
- entrepreneurial education.

The greatest area of state policy response to entrepreneurs favors technology companies. States have invested heavily in research and development efforts and have created programs to stimulate commercial activity around technology innovations. States are highly focused on ways to create investment capital, though their efforts may or may not be useful to all entrepreneurs. Where states have specifically created programs for entrepreneurs, they are targeted towards industry sectors. States must delineate between entrepreneurs and small business and develop policy responses to support the growth of entrepreneurship in their economies.

Entrepreneurs play a unique role in the new economy. The dynamic nature of entrepreneurship may never be well enough identified to create comprehensive state economic development programs that encompass all the areas important to entrepreneurial growth. However, states should focus on broader strategies that respond to the unique needs of entrepreneurial growth. Entrepreneurs are not a particular industry segment. They represent a wide range of businesses but share certain identifiable characteristics in their development and growth strategies. By facilitating this dynamic environment, states can position themselves to be attractive, competitive, and resourceful public-sector players in the new economy.

ENDNOTES

- ¹ Andrew Zacharakis, Paul D. Reynolds, William D. Bygrave, *Global Entrepreneurship Monitor: National Entrepreneurship Assessment—United States of America* (Kansas City, Mo.: Kauffman Center for Entrepreneurial Leadership, June 1999), 8.
- ² Ibid, 2.
- ³ Ibid, 5.
- ⁴ Jay Kayne, *State Entrepreneurship Policies and Programs* (Kansas City, Mo.: Kauffman Center for Entrepreneurial Leadership, November 1999), 3.
- ⁵ Kauffman Center for Entrepreneurial Leadership web site, <http://www.entreworld.org/Bookstore>, November 1999.
- ⁶ Suitability standards refer to conditions imposed on the issuer of securities that may restrict who the issuer may approach for financing (i.e., accredited investors).
- ⁷ New York State Governor's Office of Regulatory Reform, *Permit Reform in New York State: A report to Governor George E. Pataki*, available at http://www.gorr.state.ny.us/gorr/permit_rpt.html.
- ⁸ Environmental Council of the States web site, <http://www.sso.org/ecos/index.html>, April 2000.
- ⁹ Organization for Economic Cooperation and Development (OECD), *Fostering Entrepreneurship* (Washington, D.C.: OECD, 1998).
- ¹⁰ National Association of State Budget Officers (NASBO), *Fiscal Survey of the States* (Washington, D.C.: NASBO, June 1999).
- ¹¹ State Science and Technology Institute, *State Research and Development Tax Incentives* (Columbus, Ohio: State Science and Technology Institute, March 1997).
- ¹² NGA Center for Best Practices survey of Governors, May 1999.
- ¹³ NGA Center For Best Practices survey of Governors, May 1999.
- ¹⁴ NxLevel Training Network is a consortium of governmental, nonprofit, and for-profit institutions involved in promoting the development of small business. See also < <http://www.nxlevel.org/>>.