Testimony of:

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Before the

Securities and Exchange Commission
Washington, D.C.

October 22, 2012

In the Matter of:

Proposed Rules for the 'Jumpstart Our Business Startups Act'

STATEMENT IN FAVOR OF PROPOSED RULES WITH EXCEPTIONS

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To: **Honorable Mary L. Schapiro**
Chairwoman
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Madame Chairwoman, the following is my testimony in regards to the Commission's proposed rules on the 'Jumpstart Our Business Startups Act' which I ask that you submit to your fellow Commissioners and the staff for their consideration.

Alabama has an acute dearth of venture capital and a shortage of investment banking and venture capital firms in which to raise such funds for aspiring entrepreneurs. To address this problem, the Speaker of the Alabama House of Representatives, Honorable Mike Hubbard, has proposed legislation that will provide \$25,000 capital to 200 state entrepreneurs. The 'Jumpstart Our Business Startups Act' which proposes to lift restrictions on raising up to \$1,000,000 in a one year period for ventures would be the perfect complement to Speaker Hubbard's proposals. The initial state funds could make it possible for entrepreneurs with good, workable ideas to pay for auditing and other start-up costs for ventures to create sorely needed jobs.

I hereby request your permission to include in testimony, on said proposed rules, my attached White Paper and suggestions which illustrate the dire need for venture capital in Alabama and by implication, the profound, favorable impact the 'Jumpstart Our Business Startups Act' will have on our state if the rules are flexible enough for entrepreneurs with few start-up resources.

Crowdfunding can solve the venture capital firm shortage problem in Alabama. But none of the major crowdfunding companies have publicly stated they will apply to become intermediaries. The new rules must accommodate crowdfunding while minimizing unnecessary risk for the investor.

I suggest $100 investment limits for crowdfunding investors who certify electronically that they made $50,000 in the previous year, even if not an accredited investor, and further certify that they can afford to lose the entire investment. This strikes a rational balance between the competing interests of needing to jumpstart the economy and of prohibiting unbearable fraud, while allowing small investors to profit from socially useful ideas.

WHITE PAPER

JOBS FOR ALABAMA

SUMMARY

Alabamians are faced with hard times, and we need new, courageous and innovative ways to deal with them. Many politicians and most national economists are not telling the public the whole truth. The economy is in worse shape than they are being told. **When the whole world goes into recession simultaneously** as it did in 2005-2008 as the result of a world-wide financial crisis, **economic history teaches that the average recession that follows**, or the following, rapidly recurring string of recessions or sub-trend growth, **lasts an average of 14 years** [e.g. See the recent work of University of Maryland economist Carmen Reinhart]. This Great Recession will have a long tail with many benefits and costs yet to be paid, creating much greater government debt in the form of TARP and stimulus monies, costs of war, welfare, food stamps, medicaid, worker retraining, and unemployment compensation, etc.

A free, market-driven economy should be tampered with only reluctantly and then only when the losses, in terms of human capital, are great and prolonged. Such a time is now. However, even now, prudence dictates that the "'Rule of the 'Three Ts'"should prevail. The remedy in such circumstances must be "Timely," "Targeted" and "Temporary."

This WHITE PAPER proposes, as a solution to bringing down Alabama's 8% plus unemployment rate: (1) a **venture capital corporation** seeded with state funds and supplemented by other sources, and (2) an **investment tax credit** applied against state taxes to complement the venture capital effort and to spur growth in the state's other goods producing sectors. New ideas and innovative products account for fully half of real economic growth, and new ideas and innovation come to fruition through venture capital.

To achieve this goal will take a co-operative effort among business, labor and education factions that hold in their hands the fate of thousands of Alabamians who desperately need jobs. This proposal is designed to stimulate vigorous growth in the business economy without goring the ox of the education or labor interests. It is a carefully crafted solution that richly deserves the support of all factions on both sides of the aisle.

The Problem

Alabama finds itself a very real part of the Great Recession, with approximately an 8% plus unemployment rate. The aggregate numbers belie the bifurcated nature of a true picture of the state's economy. For example, over 50% of 16 to 20 year olds in the state do not have a job. Twenty seven percent of our construction workers seek work [*See:* Footnote 1 for further examples].

The devastating results of the Great Recession on Alabama's economy is a declining Gross State Product with an accompanying decline in median household income adjusted for inflation, in sales taxes and in ad valorem taxes and a rapid increase in foreclosures and bankruptcies. Real estate values have fallen, and as the Alabamian's net worth declines, so does his or her propensity to consume. The volume of tax lien sales by county revenue commissioners are up and redemptions are down.

Apart from the present crisis, Alabama has suffered from a chronic shortage of long range capital for plant and equipment for scores of years since the devastation of the economy by the Civil War. Businesses, except the very largest, are mostly inadequately limited to short-term bank financing and out-of-state sources difficult to access. IPOs (Initial Public Offerings) are almost non-existent intrastate, and the state is bereft of investment banking institutions, save the public utility bond market. A hydroponics scam several decades ago resulted in highly restrictive state securities regulations, and the market originating public issues largely by-passes Alabama, particularly from out-of-state investors.

Venture capital (*i.e.* capital for new business ventures) is extremely hard to find within Alabama. [*See:* the chart at Footnote 2 for the great comparative disadvantage Alabama has in the formation of venture capital].

Venture capital generally goes to fund start-ups, and start-ups are usually small to medium sized businesses, and these types of businesses generate 45 to 80% of all new jobs created.

The writer originally designed the Alabama Development Office (ADO) and the Alabama Department of Economic and Community Affairs (ADECA) to attract the capital of foreign (non-Alabama) corporations to be supplemented by state capital and various federal programs such as the Economic Development Administration (EDA), the Appalachian Regional Commission (ARC), the U.S. Department of Agriculture (USDA) and the Small Business Administration (SBA), etc. The real problem with ADO at this time is that the basic source of foreign-corporation capital is diminutive, during an economic contraction, and wholly inadequate to maintain a balanced state economy in such an economically distorted period. Alabama needs 13,500 new jobs per month just to keep the unemployment rate from rising.

The Solution

A two (2) step solution is proposed to ameliorate the Alabama economic crisis and create jobs :

(1) The **Alabama Development Corporation**; and

(2) A two (2) part **Investment Tax Credit**.

(1) The Alabama Development Corporation

The Alabama Development Corporation (ADC) is to be a public-sponsored corporation, a venture capital firm, seeded with state and/or federal funds. The purpose of the venture capital firm is to finance the start-up of mostly small and medium sized firms. But the venture capital can be used by an existing firm when warranted, and the funds can be supplemented by the now existing Alabama CapCo, other venture capital sources, individual investors, banks, insurance companies, public offerings, bond issues, etc.

The purpose of the venture capital firm is to create good-paying jobs; therefore, the firm's board [*See:* Footnote 3] gives preference to companies making a product since they are more prone to hiring highly paid workers as they grow than are strictly service oriented companies.

The Creation of New Goods and Services

It is not sufficient in a **depressed economy** just to produce more of the same goods you have already been producing. More of the same goods is the remedy for an **inflated economy** where too much money is chasing too few goods. On the other hand, a depressed economy calls out for real new growth through new, different and innovative products that create a "pull demand," pulling dollars out from under mattresses, so to speak, and back into circulation, creating jobs with such new demand.

Economist Paul Romer of Stanford University has produced studies that show that about half of an economy's real growth comes from innovation, invention and new ideas, the strong suit of venture capital. [*See:* Footnote 4]. Venture capital will unleash new ideas and creative products and services. It is just what the doctor ordered for a sick economy.

The Deal Offered to Entrepreneurs

The financial instrument that the Alabama Development Corporation is to be empowered to issue by law is unique. It is a "grant/loan" to prospective businesses.

The Alabama Development Corporation may grant up to 97% of the needed capital, and the entrepreneurial firm and its backer(s) must contribute a minimum of 3% and endorse the entire amount, to have "skin in the game." It covers "gap" financing that banking and other sources presently cannot or will not cover.

In ten years the grant amortizes and becomes a loan with interest due *ab initio* with terms negotiated by the President of the Alabama Development Corporation. After the 10th year, the entrepreneurial firm, its successors or assigns, must pay the state an excise tax of 10% of net profit for the following 10 years. If said firm is sold within such period, 10% of profit from the sale shall be due upon payment, in excise taxes to the state.

Qualifications

Major qualifications for the grant/loans are at Footnote 5.

(2) The Investment Tax Credit

The Investment Tax Credit (ITC) is designed to complement the Alabama Development Corporation, and a second part thereof is structured to stimulate existing state producers and industry. [*See:* Footnote 6 for ITC details and percentages by year].

Conclusion

Most economists and most economic schools agree that an open, free and competitive economy is best for the human condition. When intervention is necessary, most agree the "Rule of 'Three Ts'" should be followed. Any intervention should be "Timely,""Targeted" and "Temporary." The proposed Investment Tax Credit fits all Three 'Ts.' It is phased out in three years. Also, the hope is that the ADC will spawn an expanded, viable venture capital industry in the state and will itself no longer be necessary.

A number of studies have shown that the ITC moves the allocation of capital up in time rapidly [*See:* Attached Survey of a NeoClassical Model Published by the Cleveland Federal Reserve]. A 3% ITC has been shown to favorably impact gross product 0.8%.

The rationale for the Alabama Development Corporation grows from illustrations above in **The Problem** section where the severe lack of venture capital in Alabama is demonstrated. Forty five to eighty percent of all new jobs are created by small and medium businesses, many of which are start-ups. The Alabama Development Corporation, an independent corporation, is designed to facilitate and greatly accelerate this process.

It would be logical to place its administration within the Alabama Development Office (now part of Commerce) which runs CapCo. This would produce administrative economy and avoid duplication of services and unnecessary redundancy of staff. It would obviate the need for creating a new agency.

The Alabama Development Corporation would complement CapCo and could provide "gap" financing for feasible CapCo projects that are otherwise having funding difficulties.

The State of Massachusetts started a venture capital fund, with similarities to the ADC, with $5,000,000.00, and a study by Earnst & Young found it produced approximately 4200 high-tech jobs in short order. That is an investment of less than $1200.00 per job, compared to the $100,000.00 plus investment per job Alabama made in Mercedes-Benz, Honda, Hyundai and Thyssen Krupp. An initial investment, similar to the size of Massachusetts' fund, by Alabama from the general fund in a pilot program would be prudent, with additional funding as rapidly as the pragmatic sanction warrants.

To put the future capital need in perspective, Alabama needs approximately 13,500 new jobs per month just to keep the unemployment rate from rising. According to the Alabama Department of Industrial Relations, Alabama is now producing about 13,000 new jobs per month.

To solve Alabama's job problem will require all factions putting their differences aside and making the state a true commonwealth where all work for the common good. We can do it with determination and right thinking. Nothing is as powerful as an idea whose time has come.

* * *

Footnotes

1. 30% unemployment among Black males without highschool diplomas, 27% unemployment among construction workers and 15.8% unemployment among single mothers. Many rural counties have unemployment exceeding 13% and underemployment has been variously estimated at 25%. (*Sources:* Wall Street Journal; NY Times; The Economist and The LAUS Service of the Alabama Department of Industrial Relations).

2.The following chart is a segment from one compiled by Price-Waterhouse for 2008, the most recent year available, and it shows why Alabama ranks 49th in venture capital formation.

State	*Per Capita Venture Capital*	*Year*
Alabama	$ 5.15	2008
Georgia	44.00	2008
Massachussetts	488.00	2008

3. See Attached Massachussetts General Law No. 40

4. *The Atlantic*, July 2010, p. 94.

5. Qualifications

I. The entrepreneurial firm must be an Alabama entity with an Alabama headquarters and its principal(s) must have good credit.

II. Seventy % of employees must be full time and based in Alabama for W-4 and W-2 purposes.

III. Alien owners must be qualified to do business in the USA.

IV. The President of the Board of the Alabama Development Corporation serves as CEO and must have 5 years experience with venture-capital-type investments.

V. 12 Board members in groups of three each are to be appointed to staggered terms by the Governor.

VI. The President sits as an ex officio member of the Board, but the Board selects its own Chairman with the President forced to abstain.

VII. A public official, employee or their immediate family are not eligible.

6. Part one (1) of the ITC gives the following percentages of tax credit for new plant and equipment purchased by a new entrepreneurial firm using the ADC, plus it is given to any firm or individual purchasing plant and equipment from such firms. It may be applied against state income tax and may be carried forward for a period of ten (10) years as follows:

-15% tax year 2013,

-10% tax year 2014,

-05% tax year 2015.

Part two (2) of the ITC is designed to stimulate existing state producers and industry. It gives the following percentages of tax credit for new plant and equipment purchased by a firm or individual purchasing plant and equipment product produced in Alabama other than that produced by an ADC entrepreneurial firm. It may be applied against state income tax and may be carried forward for a period of ten (10) years as follows:

-9% tax year 2013,

-6% tax year 2014,

-3% tax year 2015.

S. Douglas Smith