



the startup act

A proposal for new legislation aimed at jump-starting
the U.S. economy through successful startups

KAUFFMAN

The Foundation of Entrepreneurship



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After administering a huge dose of conventional economic “medicine”—fiscal and monetary stimulus—the U.S. economy remains anemic. GDP growth has been disappointing, stuck at about 2 percent. This is not nearly good enough to bring down the unemployment rate, which has been hovering at around 9 percent, and is much higher for those without a college degree or for many minorities. Given the already large federal budget deficit and the huge amount of money pumped into the economy by the Federal Reserve, it is far from clear that applying even larger doses of the conventional macroeconomic remedies will restore the confidence and excitement that will strengthen the recovery and put the U.S. economy on a sustained path of higher growth.

There is another course, and it lies in understanding what has driven U.S. economic growth in output and jobs in the past, and is the key to doing so in the future. Through a series of studies published or funded by the Ewing Marion Kauffman Foundation, it is now well established that, until the financial crisis and the Great Recession, U.S. job and output growth was driven by the formation of *new firms*, or startups. All existing firms older than five years (and possibly those older than one year) *on net* generated no additional jobs. Roughly speaking, the additional workers hired by expanding firms were offset by job layoffs or voluntary departures of workers at firms whose employee numbers shrank.

Startups are responsible for more than job and output growth, however. With no vested interest in the status quo, entrepreneurs who launch firms have been disproportionately responsible for commercializing (and in some cases developing) the cutting-edge innovations that either have directly created or indirectly spawned the new firms and sometimes whole industries that characterize modern life here in the United States and elsewhere around the world: the automobile, the airplane, telephones, air conditioning, computing (hardware and software), gene-based therapies, and many new business models on the Internet. Existing firms provide important incremental innovations and,



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in many cases, refinements of the entrepreneurial breakthroughs. But without the latter, living standards in the United States and throughout the world would not be what they are today.

Since the recession began in 2008, Kauffman data indicate that more firms than ever are being formed each year. That's the good news. The bad news is that, as a new Kauffman study has documented, even before and continuing into and after the recession, the numbers of new firms *with employees* have been dropping. A strong, sustained recovery and a higher rate of growth require a reversal of this latter trend. *Simply put, the U.S. economy needs more "scale" or high-growth startups.*

Achieving this goal will require a continuous stream of new ideas capable of being commercialized, more bold entrepreneurs who can launch and build new twenty-first-century companies, fewer roadblocks to the launch and growth of these new enterprises, and low-cost capital available to finance them. A main function of government at all levels—local, state, and federal—is to facilitate these outcomes.

What better place to start than at the top, with a major federal government initiative embodied in what might be labeled a "Startup Act"? This bill could be narrowly targeted, but also comprehensive, legislation aimed at jump-starting the U.S. economy through more successful startups, focusing policymakers' and citizens' attention on the central role that entrepreneurial activities need to play to assure continued U.S. economic strength.

The possible components of a Startup Act, drawn from the public domain and embodied in some of our research, are briefly summarized below. Most of the ideas require neither additional budget expenditures nor a reduction of tax receipts. Of the few that do, the net cost should be reduced by the additional tax receipts that faster growth should

generate. Many of the ideas listed have elicited bipartisan support. Others are newer and need the added attention that a comprehensive startup bill could provide. And surely there are still other ideas, beyond those listed here, that could be included in such a bill. The Foundation hopes that by outlining this idea for comprehensive startup legislation, we will stimulate a long-overdue conversation in this country about how to maintain and reinvigorate the entrepreneurial energy that has made our economy the most innovative in the world.

Welcoming New Firm Founders to the United States

The obvious and easiest place to start is by welcoming entrepreneurs and other skilled individuals from abroad who want to come here to build companies. The data are clear. Immigrants found companies here at greater rates than native-born Americans do, and are disproportionately successful in starting high-growth, high-tech firms. Recent analysis of *Fortune* magazine's list of the 500 largest U.S. public companies similarly finds a disproportionate number of companies with immigrant or children of immigrant founders. Welcoming more job creators can only expand U.S. employment, boost weak demand for housing that is depressing real estate prices, and help renew the innovation engine that drives long-run growth in living standards for all Americans.

Two ideas would bring more entrepreneurs here who could build scale companies.

Entrepreneurs' Visas: One approach, embodied in the revised version of the Kerry-Lugar Startup Visa Act, *would permit entrepreneurs from other countries entry into the United States.* Initially, entrants would be screened for a temporary visa based on either the outside capital they had attracted or revenues from U.S. sales they already had recorded. Permanent



work visas (green cards) would be granted once these entrepreneurs had hired a minimum number of U.S. workers. Although the Kerry-Lugar provisions limit the number of these startup visas,¹ given the jobs each entrant would create here in the United States—without “taking a job” from any other U.S. workers—*there is a strong case for having a high limit, or even none at all, on these visas.*

A startup visa program without caps would enable many potential founders of scale companies *already* here to realize their dreams in the United States and, in the process, strengthen our economy. These include some portion of the roughly 1 million skilled immigrants here on temporary H1-B visas, as well as the 60,000-plus foreign students who graduate each year with undergraduate or graduate degrees in science, technology, engineering, and math (STEM) from U.S. universities.

Green Cards with Diplomas for STEM

Degrees: A second, mutually reinforcing idea would grant green cards to foreign students when they receive their STEM degrees from U.S. universities. Although a case can be made to extend this idea to all foreign graduates receiving degrees of any type, it makes sense to start with STEM graduates because they have the skills that develop the technological advances that drive improvements in productivity and living standards. Admittedly, most STEM graduates who are given visas will compete with U.S. workers for jobs. However, there is and likely will continue to be a strong demand by U.S. firms for workers with this kind of education. Our economy can only profit from having more skilled talent. And, in the long run, given the greater propensity of immigrants to found businesses, it’s likely many of the STEM graduates permitted entry now eventually will go on to form scale businesses that hire American workers.

This startup agenda has started out by concentrating on importing more job creators and innovators because this reform well may be the most cost-effective policy measure the federal government can take immediately to stimulate more scale startups. However, there is also an urgent need to stimulate scale entrepreneurship among native-born Americans. The other possible components of comprehensive startup legislation outlined in the sections that follow would facilitate scale firm formation and growth in this country by all founders, regardless of where they were born.

Financing Scale Firms and Their Growth

All companies, especially those capable of scaling, require capital. Some can be financed internally by their founders and the earnings they generate. The huge decline in computing and telecommunications costs—perhaps best symbolized by the rise of “cloud computing” that makes it possible to rent computing services much like buying electricity—clearly has reduced many firms’ need for capital and thereby made it easier to start and grow them.

Nonetheless, at some point new, growing firms often require outside capital, in the form of both equity and debt. This is especially true for firms in capital-intensive businesses, such as alternative energy or aspects of life sciences (such as new medical devices, therapies, and pharmaceuticals).

Putting aside the current fad with social networking startups, the Great Recession has made it more difficult for new companies requiring substantial capital investment to attract it, for two reasons. The deep drop in equity and real estate prices, even with the recovery in stock prices since the initial crisis, hit early stage investors—wealthy individuals and institutional investors who have funded startups in the past—especially hard. Moreover, continuing economic troubles and uncertainty, as well as memories of the Internet bubble, have reduced many early stage investors’ appetites for risk.

In addition, with some notable exceptions, the market for initial public offerings has been depressed since the bursting of the Internet bubble and the legislative reaction to the financial scandals embodied in the Sarbanes-Oxley Act of 2002 (SOX). Although such “initial public offerings” (IPOs) have staged a modest comeback in 2011, especially with a new round of public offerings of stock in Web-based companies, the annual numbers of IPOs since the bursting of the Internet bubble in 2000 have remained well below their prior peak, which, in fact, was reached in 1996, when more than 600 companies went public. In contrast, in the decade spanning 2000 to 2010, the annual number of IPOs fell roughly in the fifty to 150 range. Investors will be a lot more willing to finance early stage companies and their growth when those companies have at least the option of going public after they have scaled, rather than simply selling out to the best available large firm, which often can squeeze out the entrepreneurial energy and spirit that helped found the company in the first place.

1. Usually, less than half of the 9,940 EB-5 visas currently allowed each year are taken. The Kerry-Lugar provisions transfer some of the unused allotment for EB-5 visas into this to be created EB-6 category. The exact number to be transferred is to be determined.



NACIE also has suggested a 100 percent exclusion on corporate taxable income earned by qualified small businesses ... on the first year of taxable profit, followed by a 50 percent exclusion in the subsequent two years.

The provisions summarized below would facilitate the formation and growth of scale companies by providing incentives for seed-capital investments and by removing barriers to going public. The first two ideas are tax incentives and, as such, would add to the federal deficit in the short run. We are extremely mindful of the need to reduce the federal deficit in the long run in a steady, continuous fashion, which is necessary not only to provide a stable economic environment for new businesses, but also to maintain confidence of domestic and foreign investors in U.S. Treasury debt and, indeed, in the U.S. economy more generally.

We are not claiming that the following incentives will entirely “pay for themselves” in the long run. However, there seems little doubt, given the past role of startups in creating jobs and introducing hugely beneficial innovations, that by inducing additional startup activity, some of which will lead to new scale businesses, the following incentives will generate increased economic activity and, thus, more tax revenue over time. Accordingly, the long-run budgetary costs of these incentives singly or in combination should be less, perhaps substantially less, than any short-run costs.

Facilitating Early Stage Financing

Two ideas for facilitating early stage financing of startups, especially in capital-intensive lines of business where promising firms often can die in the “valley of death” (sometime after startup but before the commercial potential of an idea has been proven), seem especially promising:

Capital Gains Tax Exemptions for Long-Held Startup Investments: Currently, the tax rate on capital gains is 15 percent. Absent Congressional action to extend current law, the rate will return to its pre-2003 level of 20 percent in 2013. In addition, beginning in 2013, an additional 3.8 percent will be added to the capital gains rate (and on taxes

applicable to dividends and interest), as part of Affordable Care Act of 2010.

Whether or not Congress permits this significant increase in the capital gains tax rate to take place or to revise the law and keep it at 15 percent for all investments, there is a strong case, given the job creation and innovation benefits of startups, for exempting from any capital gains tax *patient investments in early stage companies*. The Administration has proposed to make permanent the exemption put into law by the Small Business Jobs Act of 2010 but set to expire at the beginning of 2012 for investments in “qualified small businesses” (those with less than a \$50 million valuation at the time of investment) held for at least five years. The National Advisory Council on Innovation and Entrepreneurship (NACIE) created by the Department of Commerce, likewise, has recommended a permanent exemption for these critical initial investments in startups. It is appropriate for this idea to be included in any comprehensive startup legislation.

Tax Incentives for Startup Operating Capital:

Even if they have been successful in attracting outside capital or have sufficient capital from their founders, startups typically have cash flow difficulties in their early years. This is especially true for companies in capital-intensive lines of activity.

To ease this burden, NACIE also has suggested a 100 percent exclusion on corporate taxable income earned by qualified small businesses (again, using the same test as for the proposed capital tax exemption) on the first year of taxable profit, followed by a 50 percent exclusion in the subsequent two years. Here, too, the precise terms of this idea would depend on its estimated short-run cost and room under any larger budget deal for this initiative. If any budget deal limits the ability to provide this incentive on a permanent basis, Congress could enact this additional incentive for startups for a limited period and consider extension thereafter.



Facilitating Access to Public Capital Markets

In 2002, following a series of financial reporting scandals, Congress enacted SOX, which significantly affected the cost of going public. Although a recent Securities and Exchange Commission staff study indicates that annual SOX compliance costs for its most onerous provisions—verification of internal controls embodied in Section 404 of the Act—reportedly have come down, they are still surely well above the \$90,000 that Congress initially projected at the time the Act was passed.

For large companies, such costs do not represent a significant burden, and well may be justified by the benefits of enhanced transparency. But for smaller, growing companies, after-tax compliance costs up to and exceeding \$1 million can prove to be substantial hurdles to going public. Here's why: The typical new public company stock sells at about twenty times earnings. If new companies are required to bear after-tax costs of as much as \$1 million, that translates into a loss in valuation of roughly \$20 million. Even annual costs of \$500,000 would haircut market valuations by \$10 million. These are large amounts relative to typical initial valuations of \$100 million or less when companies may go public.

In 2010, Congress implicitly took this kind of calculation into account when granting a permanent exemption from the Section 404 audit requirements for public companies with market capitalizations of less than \$75 million. Any comprehensive startup legislation should go further, for a very simple reason: The best judges of whether the benefits of the SOX requirements outweigh their costs are *shareholders* of the companies for whose benefit the law was enacted in the first place. Accordingly, rather than simply raising the market cap threshold for exempting smaller public companies from SOX's requirements (which still is a second-best solution), the most logical SOX reform is to allow shareholders of public companies with market valuations below \$1 billion to opt in to at least Section 404 compliance, if not to all of the SOX requirements. Companies whose shareholders do not elect to comply with SOX should have special designations in their exchange listings to denote this fact so that all shareholders, current and potential, are put on notice.

The market prices for these companies will then determine whether capital is more efficiently deployed for investors in complying with check-the-box auditing requirements or in developing and commercializing new products and services. We strongly believe that many companies' shareholders

will vote their own monetary interests, and that of their firms, by not opting in to the SOX requirements, which would lower current barriers to going public.

Accelerating the Formation and Commercialization of New Ideas

Founders of new companies and existing businesses alike must constantly innovate to stay abreast of the competition, which is increasingly global in character. Innovation, in turn, drives improvements in living standards.

Innovators get their ideas from many sources. One important source is from foreign countries, which is why continued and ideally expanded openness to goods, services, and capital from other countries is so important. Companies and countries that succumb to the "not-invented-here" syndrome—the failure to recognize that geographical origins of new ideas are unimportant—inevitably will fall behind.

U.S. law, embodied in our Constitution and various implementing acts, encourages innovation by granting limited legal protection to new ideas through patents. In recent decisions, the Supreme Court has been bringing greater clarity to the substantive standards for granting patents, helping ensure that truly novel ideas gain protection but that obvious ideas do not.

At this writing, Congress is debating patent reform legislation with various provisions (except for the topic addressed below) whose likely impacts on innovation and startups are not clear. The likely impact of the following two ideas, however, is more certain to be positive.

Differential Patent Fees to Reduce the Patent Backlog: To obtain patent protection for new ideas, inventors first must receive a patent from the U.S. Patent and Trademark Office (USPTO). In recent years, however, USPTO examiners have been unable to keep up with the pace of new applications, to the point where there is now a backlog of over 700,000 patent applications at the office.

There is an old saying that "justice delayed is justice denied," and the same certainly applies to a patent regime that is too slow to process incoming patents. The USPTO has asked for greater appropriations to fund the hiring of more examiners, but in the current budget environment, it is not clear that its request will be met. And, even if it were, more examiners are likely to make only a dent in the backlog, at best.



There is no principled reason why university faculty members should be forced to deal with only one licensing agent, especially considering that their research activities are being funded by taxpayers.

The patent reform legislation passed by both the Senate and House has a better structural solution that borrows principles from the private sector, where the price system—namely higher fees for faster or better service—is widely used to deal with excess demand. Both bills would authorize the USPTO to charge higher fees to patent applicants for expedited consideration, while providing a 50 percent discount for small business, individual inventor, and nonprofit applicants. The PTO has supported a similar scheme on its own, but at this writing, has not yet implemented it. We believe the PTO should adopt the idea and, if not, that it should be included in any patent reform bill enacted by Congress.

Licensing Freedom for Academic Innovators:

New products, services, and production methods also come from new ideas developed in academia, often through research funded by the federal government. Indeed, of the more than \$50 billion the U.S. government now spends annually on basic R&D, more than \$30 billion goes to universities. University research in recent decades has accounted for multiple innovation breakthroughs, and this trend surely will continue. But we can do better. Taxpayers deserve it.

More than thirty years ago, Congress enacted the Bayh-Dole Act, granting recipients of federal research monies intellectual property rights in innovations discovered with the use of those funds. In June, the Supreme Court clarified in *Stanford v. Roche* that universities themselves do not gain those rights unless faculty members expressly assign them as part of their contracts with their university employers. Universities are likely to respond to the decision by making clear in all future faculty contracts, if they haven't already, that this is the case.

If this is all that universities do in response, it will be a missed opportunity for them and for the nation. Since Bayh-Dole was enacted, faculty members typically have been required under their university contracts not only to report their innovations to the

university's own technology licensing office (TLO) (so that the TLO can be aware of the university's intellectual property rights), but also to use the TLO as the *exclusive agent for licensing the rights to faculty-developed innovations* either to the inventors themselves or third parties. In effect, university TLOs have become monopoly licensing agents and gatekeepers, preventing innovative faculty from using their own attorneys or other third parties, or even other university TLOs, to license and, hence, commercialize their innovations.

This state of affairs is clearly at odds with the way faculty research is treated: There is no "research clearance office" at universities that first decides where (if at all) a faculty member's research should be submitted for publication. Likewise, competition, and not monopoly, is the governing principle of the rest of the U.S. economy. There is no principled reason why university faculty members should be forced to deal with only one licensing agent, especially considering that their research activities are being funded by taxpayers.

The federal government can and should remedy this odd situation. One simple way to do so is to mandate that all federal research grants to universities be conditioned on universities affording their faculty members the ability to choose their own licensing agents. A university's own TLO could compete in this new environment or, at minimum, provide informational services and mentoring to university faculty members. Licensing freedom for faculty inventors and true competition in innovation licensing would speed up the commercialization of faculty innovations, benefiting the innovators, their universities, and our society.

Alternatively, if a free-agency condition for federal grant monies proves to be too controversial, Congress could direct federal R&D grantmaking to be conditioned on a university having a streamlined process for licensing faculty innovators' intellectual

property to their own startups (much as the Universities of North Carolina and Washington have done). In addition, Congress should consider authorizing, or even requiring, at least some federal R&D grants to have a minimum amount (say 1 percent) of their total funds set aside for commercialization education of or commercialization activities by the principal investigators.

Removing Barriers to Formation and Growth of Scale Businesses

Finally, because of their size, small and new businesses bear an especially heavy burden when complying with the multitude of local, state, and federal rules that govern business behavior. There are features of existing law that require federal agencies to take impacts on small business into account when setting rules, which the Office of Advocacy within the Small Business Administration and the Office of Management and Budget do their best to monitor. But small and new business still face disadvantages relative to larger firms that the law cannot fully remove.

Meanwhile, although a few regulatory statutes require agencies to balance costs against benefits when setting rules, there is no across-the-board requirement to this effect for all agencies and for all rules. This means that at the time a rule was promulgated, it was possible the costs outweighed the benefits or the remedy chosen was not the most effective. Even if a rule initially passed a cost-benefit test, later changes in technology, costs, and behavior could have raised costs above any benefits. In either case, these costly rules remain on the books forever. Under a series of Executive Orders dating from the Carter Administration, the White House (formally through the Office of Management and Budget since the Reagan Administration), encourages all Executive branch agencies to conduct cost-benefit and remedy assessments of all major rules before issuing them. But, unless they are instructed by law to take these analyses into account in *actually setting the rules*, agencies need not do so (and in some cases even are prohibited by the governing statute from doing so).

Furthermore, states and localities maintain and continue to issue many rules that affect the cost of starting and growing a business. There is no uniformity in the extent to which these requirements must be subject to a cost-benefit test or a requirement that the chosen course of action is the most cost-effective.

Successive Administrations and many states and localities have attempted over the years to rationalize the growing compilation of rules without much clear success. The three proposals below, if enacted, could do much to improve matters without compromising the purposes of regulatory statutes, which are to correct market failures that pose harm to consumers and firms alike.

Automatic Ten-Year Sunsets for all

Major Rules: To its credit, the Administration has commenced a one-time review of major rules—those that have long been defined to impose costs on the private sector of at least \$100 million—to determine whether any should be modified or eliminated. This should not be an isolated exercise, but an ongoing and permanent requirement for all major rules by all agencies. The best way to accomplish this would be for Congress to enact a simple law requiring all major rules (those with estimated costs of at least \$100 million) to sunset automatically after ten years. Rules then would be allowed to lapse unless and until re-proposed and implemented (under new common-sense standards outlined next). This would regularly cleanse the books of inefficient and costly rules and, thus, barriers to business formation and growth for all businesses, including startups.

New Common-Sense Standards for

Regulations: The U.S. regulatory system has developed under a patchwork of different governing statutes with different mandates. Having different objectives is fine and appropriate; likewise, it is appropriate that, as elected officials see new market failures that can be corrected by appropriate government regulation, new governing statutes with new objectives should be enacted.

At least two aspects of rulemaking should be common among all rules, but, as noted above, this is not currently the case. First, all major rules should not be implemented or maintained (after a sunset review) unless agencies can determine that the rules' benefits outweigh their costs. Second, the form of these rules should be such that the option chosen is the most cost-effective of the alternatives available.

These are common-sense standards that many individuals and firms try to live up to in their daily decisions, implicitly if not explicitly. Why not hold government regulators to the same standards?

This is not an idle question, because, by the most recent estimates, federal regulations alone (not counting the layer of state and local rules) impose large and growing costs on the private sector. When spending taxpayer money directly, Congress and the President often explicitly or implicitly debate



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whether programs are worth the expenditure. It is long overdue that the same be insisted of regulations, which are indirect forms of government spending: mandates that private firms (and sometimes individuals) spend their money to accomplish government-specified social objectives.

Assessments of State/Local Startup and Business Policies: The aphorism that all politics is local applies to new firm formation as well. Firms start in a *place*—a city, a suburb, a small town, or a rural location. Local and state policies toward new firm formation and growth can and do have an important impact on how many new firms launch and expand.

For much of recent history, local and state governments have spent far more time chasing *existing* firms, offering subsidies, tax breaks, and other benefits in efforts to induce businesses doing business in one place to move to another. Such “smokestack chasing” is a zero-sum game for the nation as a whole—though some places may gain, they do so at the expense of others. Moreover, even at the local level, the jobs “chased in” can and often do leave when a firm’s costs shift or they find a better deal, making it more attractive for them to move elsewhere.

Cities and states, and the nation as a whole, would be far better off if these governmental jurisdictions competed to provide the best environment for startups of scale businesses. These firms are a positive-sum game for the country, foregoing the waste and needless duplication of longstanding efforts to divert firms from their current locations.

One constructive way for cities and states to compete is through streamlined and sensible rules and processes for administering them. Recent research sponsored by the Kauffman Foundation (and published as a chapter in the Foundation’s *Rules for*

Growth) documents that rapid zoning decisions, in particular, can be especially important in facilitating the formation of firms.

Although the federal government does not and should not step on the toes of local and state governments, it can facilitate the healthy competition among these jurisdictions for favorable startup environments. Just as the World Bank has assessed the favorability of the legal environment toward business in different countries through its annual *Doing Business* reports, there should be some recognized entity that does the same (with a special emphasis on policies and practices affecting the formation and growth of *new businesses*) for each of the fifty states and all cities above a certain size. The *Doing Business* rankings have proven to be an important spur to regulatory reform around the world. A similar *Doing Business* project for jurisdictions *inside the United States* could have the same result.

Both the government and private sector have roles in this effort. Because the underlying data are likely to be costly and difficult to gather, it could be useful and important to charge and fund one government agency with collecting the raw data that could be made available to the public, which would permit either non-profit or for profit rating systems to develop. One logical agency to do this would be the Commerce Department, which now collects and distributes data about the weather, which is then analyzed and used by privately owned broadcasting stations and networks throughout the country. Collecting the “business climate weather” would be an obviously similar function for Commerce to carry out and then make available to the public.



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OVERVIEW AND FACTS

Achieving a strong, sustained U.S. recovery will require more high-growth companies, a continuing stream of new ideas capable of being commercialized, fewer roadblocks to launch and grow startups, and low-cost capital available to finance them. To facilitate these outcomes, the Kauffman Foundation proposes the Startup Act: a narrowly targeted, but comprehensive bill aimed at jump-starting the U.S. economy through more successful startups.

Welcome New Founders to the United States Who Could Build Scale Companies

- Entrepreneurs' visas
- Green cards with diplomas for STEM degrees

Finance Scale Firms and Their Growth

- Facilitate early stage financing of startups
 - Capital gains tax exemptions for long-held startup investments
 - Tax incentives for startup operating capital
- Facilitate access to public markets
- Shareholders of companies with market cap below \$1 billion opt-in under Sarbanes-Oxley Act

Accelerate the Formation and Commercialization of New Ideas

- Differential patent fees to reduce the patent backlog
- Licensing freedom for academic innovators

Remove Barriers to Formation and Growth of Scale Businesses

- Automatic ten-year sunsets for all major rules
- New common sense standards for regulations (cost-benefit test, and options chosen should be the most cost-effective of alternatives available)
- Assessments of state/local startup and business policies (Department of Commerce would provide data to permit others to conduct *Doing Business* type assessments of states/major cities)



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