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What Start-ups Don't Need Is Money

Making the federal government a venture capitalist won't fix America's technology woes, says author.

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Policymakers are talking about making the federal government a venture capitalist. That, they say, will cure the country's economic woes. Not likely

Clinton's key advisers and House of Representatives Democrats mistakenly believe that making the government a venture capitalist will help spur investment in start-up companies and "critical technologies," putting this country on the path to long-term economic growth. That's Washington's latest fix for America's technology woes.

But the venture-capital industry does not need the government's help, and the government certainly does not have what it takes to be a venture capitalist.

Proponents of the government as venture capitalist say that private venture capitalists aren't investing enough in start-ups. Early last year the blue-ribbon Competitiveness Policy Council recommended that government agencies such as the Advanced Research Projects Agency, the Department of Commerce, and the National Institutes of Health be allowed to make investments in business start-ups both directly and through a proposed technology bank. The National Competitiveness Act of 1993, currently being considered by the House, would create new government agencies and programs to invest in start-up companies and in venture-capital funds as well.

There is, however, little evidence that we are underinvesting in venture capital. First, the United States raises and invests far more venture capital than Japan or Germany. Even during the so-called lean years of 1990 and 1991, venture capitalists invested a total of more than $3.25 billion in more than 2,000 entrepreneurial companies. And venture-capital investment was up markedly in 1992 as the country began to pull out of the recession.

Second, venture capitalists are just one of many sources of capital for new enterprises. In fact, venture capitalists finance just 10% of high-technology start-ups and less than 1% of all business start-ups. The majority of capital comes either from entrepreneurs themselves or from wealthy relatives and friends and other "angel" investors.

Meanwhile, global corporations are pumping more of their capital into start-ups. Two of the hottest new companies in multimedia technology -- Kaleida Labs and General Magic -- were financed almost entirely by large U.S. and Japanese electronics companies. Such alliances offer a promising mechanism for combining the innovative capabilities of entrepreneurial start-ups with the manufacturing and marketing muscle of large corporations.

Proposals to make the government a venture capitalist come as the market is beginning to recover from the overfunding of the late 1980s, when there was too much money chasing too few good ideas. The incredible influx of new capital brought a slew of inexperienced venture capitalists into the business. Many lacked the savvy or the contacts or the judgment to identify good deals. A herd mentality developed as venture capitalists copied one another's investments. That follow-the-leader syndrome meant more start-ups than could hope to survive were being funded in industries from computer disk drives and notebook PCs to biotechnology. Devastating shakeouts and huge losses were the result.

The venture-capital industry responded the way financial markets are supposed to -- it corrected itself. Profits on venture-capital investments went into a virtual free-fall, and investors redeployed their capital. According to industry sources, the internal rate of return on venture capital, which hovered in the range of 25% to 35% in the mid-1970s and 15% to 25% in the early '80s, plummeted to less than 5% by the mid to late '80s. Investors began pulling their money out of venture capital and investing it elsewhere. The venture-capital market fell off sharply in 1990 and 1991 before rebounding to more than $2.3 billion in 1992, spurred by record markets for initial public offerings and the general economic recovery.

The government has tried getting involved in venture capital before -- and its track record has not been good. The Small Business Investment Co. (SBIC) program of the late 1950s, which proponents of the government as venture capitalist often tout as their model, was littered with mismanagement, failure, and abuse. Less than 10 years after the program's inception, dozens of SBICs went bankrupt. During the '80s state governments got into venture capital as part of a failed strategy to develop high-technology enclaves. Within a few years those states saw most of their locally subsidized venture capital get exported to Silicon Valley, Route 128, or other places with promising high-tech start-ups; either that, or they saw their money go to local companies that failed to generate any profits. Now many of the states are reducing their commitment to venture capital or are pulling out altogether.

The government is ill equipped to deal in the high-risk, high-return world of venture capital. In the first place, tremendous profits from one or two home runs typically accompany 9 or 10 strike-outs. In addition, venture capitalists do more than just pick winners and losers; they are involved in hands-on monitoring and management of start-up enterprises. That is not something government agencies and bureaucrats can do well, in particular because government administrators face political pressure to invest in pet projects or key congressional districts. It's just plain silly for the government to even consider the costly business of direct financing. There are more powerful ways for it to affect the flow of capital, such as by manipulating the tax rate on capital gains or easing restrictions on private investors.

Worst of all, Washington's penchant for quick-fix solutions like government venture capital shows that it does not even begin to comprehend our underlying competitiveness problem. Our federal government -- which spends tens of billions of dollars annually on new technology, more than our major competitors do, combined -- evidently believes that what the economy needs are still more subsidies to critical technologies and incentives for breakthrough innovations. Such beliefs make it easier to ignore the real problem: our growing inability to take the breakthroughs we make and turn them into high-quality commercial products that consumers around the world want to buy. Making the government a venture capitalist is not going to help.

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