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‘VC: An American History’ Review: The Seed Spreaders

In America, government policy has directly supported a robust venture-capital industry. Is this a good way to encourage risk-taking?

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By Marc Levinson

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In June 2000, in a transaction long forgotten, an online pet-supply retailer called Pets.com, famed for commercials featuring a sock-puppet dog, acquired a competitor, Petstore.com. Pets.com was backed by Hummer Winblad, a venture-capital firm in San Francisco; a young Seattle company called Amazon.com also held a substantial stake. The merger with Petstore.com fixed nothing. Five months later, Pets.com was defunct (although its domain name is still in use). In a history of the turn-of-the-century dot-com boom, its brief life and unmourned death would barely merit a mention—save for the fact that government policy supported its creation.

The question of whether the venture-capital industry creates any social benefit looms over Tom Nicholas’s “VC: An American History.” Mr. Nicholas, a professor at Harvard Business School, is evidently a fan of American-style venture capital. “The fact that so many innovations have been launched in this way says a lot about the economic benefits of a vibrant and unconstrained venture capital industry,” he contends. But his book doesn’t demonstrate that venture capital as promoted in the U.S. is the best way, or even a good way, to support risk-taking.

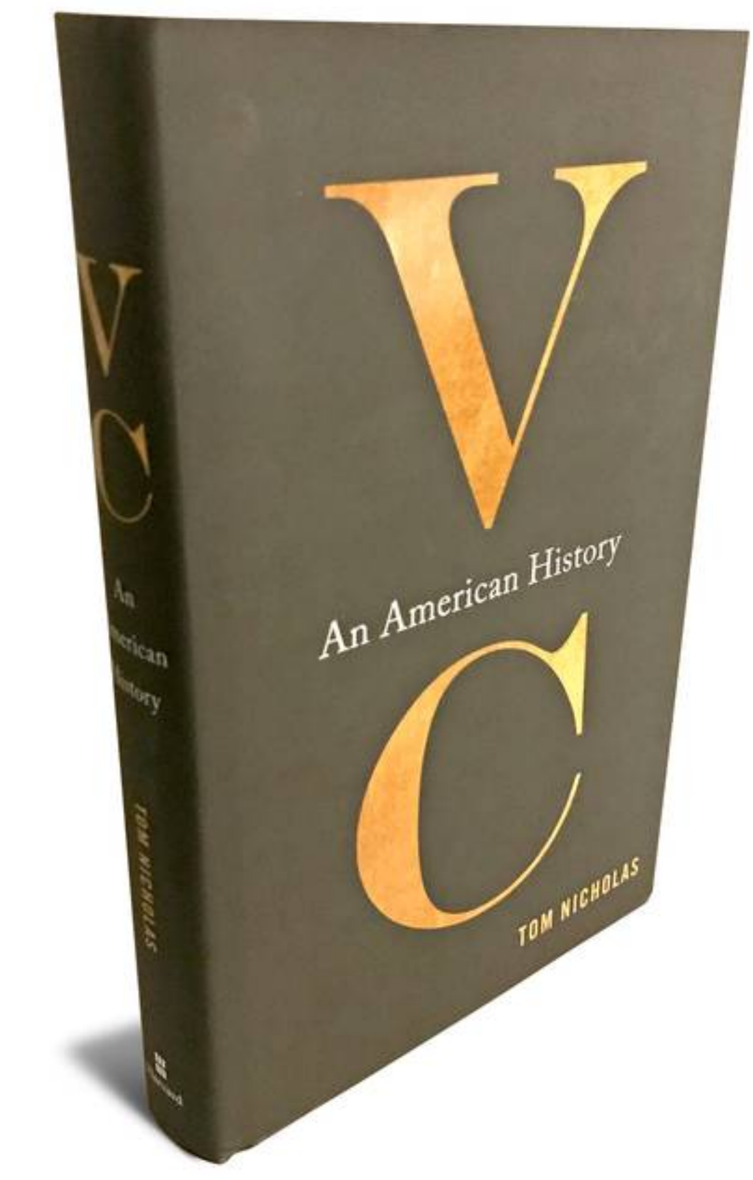

PHOTO: WSJ

Mr. Nicholas begins his story with the 19th-century whaling industry in New England. Whaling voyages were typically sponsored by partnerships, in which individual investors took shares as small as 1/64th. The partners included an agent—a sort of managing partner—who was responsible for choosing a ship and a captain; determining what whales the ship should target and where it should hunt; and monitoring performance insofar as possible across thousands of miles of ocean. The captain and crew were hired under contracts giving them incentives

VC: AN AMERICAN HISTORY

By Tom Nicholas
Harvard, 382 pages, $35

to work in the best interest of the investors. The financial results, Mr. Nicholas shows, were strikingly similar to those of modern venture-capital funds: A handful of top agents repeatedly oversaw highly successful voyages that brought extraordinary returns for investors, but most agents produced mediocre returns or lost money.

Similarly, America’s industrialization was shaped by contracts that were carefully crafted to protect investors while giving managers incentives to act to the investors’ benefit. Clauses in Samuel Slater’s 1790 agreement with industrialists William Almy and Smith Brown to operate a Rhode Island cotton mill tied Slater’s fortunes to the venture’s long-term success. Slater agreed to “devote his whole time and service” to the enterprise and to allow the investors to bring in apprentices, even though they would presumably break Slater’s hold on the knowledge required to run the mill. The arrangement allowed Slater to grow wealthy, but only if his venture-capital investors prospered as well.

As Mr. Nicholas makes clear, the venture-capital industry in its modern incarnation is a creation of the U.S. government. The Small Business Investment Act of 1958 led to the creation of hundreds of venture-investment companies, which were entitled to federal loans and extremely favorable tax treatment. Although some were frauds, others seeded such consequential startups as Intel. A 1979 law allowed pension funds to invest in venture capital. And reductions of tax rates on capital gains since the 1970s have allowed venture capitalists to collect their pay mainly through capital gains rather than more highly taxed wages, minimizing their tax bills. At the same time, the federal government has been a major customer of VC-funded startups in computing, software and semiconductors. As Mr. Nicholas puts it: “Government policy had powerful supply- and demand-side effects.”

How successful have these policies been? If investors’ returns are an indication of whether money has been spent well, venture-capital investing is not a particularly beneficial activity. While venture funds outperformed public equities in the 1990s, in both the 1980s and the early 2000s investors would have been better off putting their money into an index fund. Venrock Associates, which managed the investments of pioneer venture capitalist Laurance Rockefeller, turned an initial $288,000 investment in Apple into a storied $116.6 million gain in 31/2 years. But excluding Apple, its portfolio showed an annual return of 3.4% on investments made between 1969 and

1978. Rockefeller’s “stunning success with Apple . . . was close to accidental,” Mr. Nicholas observes, but it made up for money-losing investments in a number of long-forgotten companies.

It is an article of faith that ready access to venture capital makes an economy more dynamic. Mr. Nicholas frames the case historically, contending that “the spillovers into the real economy generated by venture investing during the 1990s were powerful and pervasive.” But he focuses entirely on the U.S. and offers no information about how high-risk startups are funded in other countries.

By some measures, other countries may have more dynamic economies than the U.S. The Bloomberg Innovation Index has ranked the U.S. eighth among the most innovative countries in 2019 after leaving it out of the top-10 last year; the leaders for this year are South Korea and Germany, which don’t provide venture capital the American way. Startups are flourishing in countries such as Israel, Estonia and even Norway, according to European Union statistics, while data from the U.S. Census Bureau puts the number of new American businesses expecting to hire employees at less than half the level of 2004. And the World Intellectual Property Organization reports that South Korea, China and Japan, among other countries, outpace the U.S. in patent filings per $100 billion of gross domestic product.

So perhaps the history of U.S. venture-capital investing is not quite the triumph that Mr. Nicholas would have us believe. It might be the case that, by gracing venture-capital partnerships with favorable tax rates, we encourage investors to put resources into dogs like Pets.com.

Mr. Levinson’s books include “The Box: How the Shipping Container Made the World Smaller and the World Economy Bigger.”

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