ISSUE BRIEF:

TAX-CREDIT AUCTIONS FOR VENTURE CAPITAL

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New Jersey's overall position with respect to venture capital – money invested in startup firms with anticipated high-growth potential – has weakened as of late. According to the National Venture Capital Association, while ranking 13th in the nation in terms of investments, the state has experienced a steady decline in recent years, from $716 million invested in 2008 to $322.2 million in 2013, the lowest amount since 1995. Of the top-15 states, New Jersey has suffered the steepest drop when measuring 2008 against 2013, a 55-percent fall. The state places 17th in the nation in terms of the number of deals executed, an area that has witnessed a reduction from 92 in 2008 to 43 in 2013, the fewest since 1994. This 53-percent decrease represents the most significant found in the top-17 states.[1]

The trend should raise concerns, particularly when accounting for such documented benefits as job creation. Nationally,

Key Points

- New Jersey has experienced a 55-percent decline in overall venture-capital investment, falling from $716 million in 2008 to $322 million in 2013, the lowest amount since 1995. The state also has witnessed a 53-percent decrease in the number of deals, from 92 in 2008 to 43 in 2013, the fewest since 1994.
- A dip in venture capital likely links to a loss of related benefits, notably job creation, as companies supported by venture capital generated 11-percent of private-sector positions over the last four decades.
- In response to the national trend in venture-capital retrenchment, Maryland and Pennsylvania recently initiated insurance tax-credit auctions, with each state targeting the $80 raised for investment in high-growth sectors.

over the last four decades, companies supported by venture capital generated 11-percent of private-sector positions.[2]

The recession and its aftermath have induced venture-capital retrenchment in many states,[3] with a number having responded with efforts to finance activity intended to incubate high-growth sectors and, by extension, spur employment expansion. As Russell Nichols writes in *Governing*, "Governments began to realize they could fill the gap by providing seed money to new startups in all sorts of emerging industries, from biotech and health care to nanotechnology and solar power."[4] In one innovative model, Maryland and – following its lead – Pennsylvania each held auctions for premium insurance tax credits, with the funds designated for investment in potentially burgeoning segments of their economies.

In May 2011, Governor Martin O'Malley signed into law InvestMaryland, a partnership between the state and private firms. Housed within the Maryland Venture Fund, InvestMaryland focuses on growth companies with an emphasis on such industries as software, life sciences, healthcare information technology and communications. InvestMaryland raised $84 million through a 2012 online auction of tax credits to 11 insurance companies with operations in the state.[5] Overseen by the Grant Street Group, the initiative exceeded its goal of $70 million, having set a floor of $0.70 on the dollar for the credits, which companies can claim as of 2015. Private venture firms – selected by Altius Associates – manage two-thirds of the capital on the condition to return 100 percent of the principal and 80 percent of the profit to the state. The Maryland Venture Fund invests the remaining one-third of the capital.[6]

In July 2013, Pennsylvania Governor Tom Corbett signed into law Innovate in PA, designed after InvestMaryland. Innovate in PA set the goal of raising around $85 million in investment capital for the technology industry through a similar insurance tax-credit auction. The funds will be managed by Ben Franklin Technology Development Partners, Life Sciences Greenhouses and the PA Venture Capital Investment Program.[7]

The tax-credit mechanism, in particular, and government involvement in venture capital, in general, do attract criticism, with the former targeted for drawing on future revenue[8] and the latter for introducing unnecessary and possibly limiting elements into the market. As James A. Brander, Qianqian Du and Thomas Hellmann observe, "Critics doubt whether governments can improve upon private sector VC activity and many fear that government activity in VC markets might be associated with problems arising from political pressures, rent-seeking, and general bureaucratic inefficiency."[9] In their study, though, the three authors ultimately uncover the advantages to enterprises supported by both government venture capital (GVC) and private venture capital (PVC). "When GVC finance and PVC finance are both present (mixed funding)," Brander, Du and Hellmann conclude, "total investment is higher and exit outcomes are better than with PVC finance alone or with GVC finance alone."[10]

As noted, the conditions that inspired Maryland and Pennsylvania to travel creative avenues to stimulate investment have struck New Jersey with notable force. The downward trajectory could owe to receding venture activity nationwide, as well as exogenous factors, such as the consolidation of the pharmaceutical industry in the state.[11]

New Jersey, for a number of years, has engaged in venture-capital transactions. The New Jersey Economic Development Authority (NJEDA) has invested as a limited partner in firms with portfolios concentrating on early-stage entities with less than $3 million in annual revenue. The Edison Innovation Fund, dedicated to life sciences and technology, houses venture-capital vehicles, including the Edison Innovation Angel Growth Fund, the Edison Innovation VC Growth Fund and Edison Innovation Growth Stars Fund. As of 2013, the NJEDA reports to have invested over $40 million in 12 venture funds, with an estimated return of 62-times to the state's businesses.[12]

Additionally, Governor Chris Christie signed into law in 2013 the Angel Investor Tax Credit Act, which offers a 10-percent tax credit on corporation business and gross income tax for investments in certain emerging technology companies domiciled in the state. As of 2013, the NJEDA reports having approved 30 investments that have qualified for the Angel Investor Tax Credit, resulting in $14.7 million of capital for the state.[13]

The tax auctions engineered by Pennsylvania and Maryland could present another alternative for New Jersey, especially when weighing the projected impact in one state and a reported surge in the other. Governor Corbett's office estimates Innovate in PA will produce 1,850 technology jobs and almost 3,500 indirect positions, while doubling the state's investment. Coincident with InvestMaryland's initial funding, venture capital in the state increased by over 60 percent, from $408 million in 2012 to $665 million in 2013. The number of deals rose from 57 to 71.[14]

The attribution of Maryland's latest success with venture capital solely to InvestMaryland likely appears too strong, as several components may have contributed to the progress; however, the upswing could speak to the positive relationship between public and private investment. Brander, Du and Hellmann write, "Markets that receive more GVC funding also receive more funding overall and, strikingly, receive more PVC finance."[15] This public-private dynamism should enter into New Jersey's consideration of more aggressive venture-capital strategies, including the tax credit auction.

Notes

[1] National Venture Capital Association, *2014 National Venture Capital Association Yearbook*, by Thomson Reuters (Arlington, VA: National Venture Capital Association, 2014).

[2] Christopher DiGiorgio and Jeanne G. Harris, "If Venture Capital Falters, Will Job Creation Fade?" (Chicago, IL: Accenture Institute for High Performance, 2013).

[3] National Venture Capital Association.

[4] Russell Nichols, "State Governments: The Latest Venture Capitalists," *Governing*, March 2011, http://www.governing.com/topics/economic-dev/State-Governments-Latest-Venture-Capitalists.html.

[5] Gus G. Sentementes, "Maryland raises $84 million to invest in tech startups," *The Baltimore Sun*, March 15, 2012, http://articles.baltimoresun.com/2012-03-15/news/bs-bz-invest-maryland-funding-20120315_1_tax-credits-investmaryland-christian-s-johansson.

[6] Lindsey Robbins, "InvestMaryland taps first venture capital firm," Gazette.net, December 7, 2012, http://www.gazette.net/apps/pbcs.dll/article?AID=/20121207/NEWS/712079626/1033/investmaryland-taps-first-venture-capital-firm&&template=PrinterFriendlygaz.

[7] Deborah M. Todd, "Pennsylvania to sell $100M in tax credits for tech investment," *Pittsburgh Post-Gazette*, July 5, 2013, http://www.post-gazette.com/business/businessnews/2013/07/05/Pennsylvania-to-sell-100M-in-tax-credits-for-tech-investment/stories/201307050154.

[8] Zack Seward, "How PA. startups are getting $75M more in state funding," Newsworks.org, October 3, 2013, http://www.newsworks.org/index.php/local/onward/60510-how-pa-startups-are-getting-75m-more-in-state-funding-innovate-in-pa.

[9] James A. Brander, Qianqian Du and Thomas F. Hellmann, "The Effects of Government Sponsored Venture Capital: International Evidence" (Cambridge, MA: National Bureau of Economic Research, 2010), 2.

[10] Ibid., 4.

[11] BioNJ, *Life Sciences in New Jersey: Looking Beyond Biotech* (Trenton, NJ: BioNJ, 2014).

[12] New Jersey Economic Development Authority, *2013 Annual Report* (Trenton, NJ: New Jersey Economic Development Authority, 2014), 22.

[13] Ibid., 20.

[14] National Venture Capital Association.

[15] Brander, Qianqian and Hellmann, 5.