Do Policies incentivising investment in early-stage start-ups really encourage investment?

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Abstract:

There is disagreement in the literature regarding the impact of policies incentivizing investors – and especially business angels – to invest in technology start-ups. We suggest that a policy that incentivizes investments in young technology start-ups effectively communicates a message of low legitimacy of these early-stage firms, thereby signalling the customers of the policy – business angels – that the investment is risky. We employ a quasi-experiment, using census data on about 2,500 Israeli start-ups in seven high-tech industries with over 4,700 business angels, we find that following the implementation of a policy known as the Angels' Act, the number of angels investing in seed stage start-ups decreased. Our findings indicate that the policy, originally designed to increase investments in early-stage firms, effectively boomeranged. We contribute to the literature by revealing that similar to policies that target consumers, policies that target investors as customers may signal negative aspects and have unintended consequences.

Keywords: policy, technology start-ups, business angels

Track: Public Sector and Non-Profit Marketing

1. Introduction

Business angels are high net worth individuals who invest their own money directly in businesses in which they do not have a family connection (Gaston, 1989; Madill, Haines and Riding, 2005; Mason and Harrison, 2000; Sohl, 2012). Business angels as investors are the main source of financing for small and medium enterprises (SMEs), especially during early stages of firms (Ou and Haynes, 2006). Business angels provide not only financial support but also entrepreneurial experience, business and management experience, skills, industrial knowledge, mentoring, and personal networks (Harrison and Mason, 1992; Landström, 1993; Politis, 2008).

Policy makers understand the importance of entrepreneurship for economic growth, employment. Moreover, policy makers know that innovation encourages sustainable growth (Decker et al., 2014; Lerner, 2008; Van den Bijgaart, 2017; Wilson, 2015). Furthermore, governments and policy makers are increasingly conscious of the importance of incentives in stimulating the development of innovation (Van den Bijgaart, 2017). Subsequently, policy makers design policies that focus on supporting the funding of entrepreneurial ventures. These policies use a variety of methods to encourage investors to channel more funding into start-ups. Fiscal incentives, such as reducing taxes on investors' profits, are one of the most frequently used policies to encourage investing in young firms, (OECD, 2011; Smith, 1990). Policy makers use fiscal incentives to attract investors and incentivize private investors to invest in the early stages of businesses (Mason, 2009; Van Parys and James, 2010).

Despite policy makers' good intentions, scholars are not unanimous regarding the effectiveness of tax incentives in promoting innovation. Tax incentives may bear costs – not only financial costs, such as foregone revenue and administrative costs, but, if not carefully designed, also welfare costs through inefficient allocation of capital. Moreover, it is unclear as to what extent tax incentives are effective in attracting investment. For example, there is evidence that tax incentives in Canada were ineffective (Carpentier and Suret, 2005). In Finland, tax benefits to angels hardly increase welfare once taking into account application and alternative costs (Takalo and Toivanen, 2018). Investors in Scotland reported that the fiscal stimulus does not motivate them to increase their investment (Paul, Whitmann and Johnston 2003).

This paper examines the implementation of a policy and its effect on the number of investors – specifically business angels – in technology start-ups. We examine a specific policy

known as the Angels' Act, designed to incentivize investment in seed stage start-ups, implemented in Israel from 2011 to 2015. We attempt to determine whether the number of business angels increased or decreased as a result of these policy. Specifically, we aim to answer the following research question: Do policy incentives increase the number of business angels in start-up firms in their seed stage? To answer this question, we use data on over 4,700 business angels, and over 2,500 start-up firms active between January 2007 and October 2014. We examine the effect of the Angels' Act – a tax policy incentivizing investment in seed-stage start-ups – implemented in Israel in 2011.

We argue that policy incentives may signal to potential investors that investment in seed stage start-up firms is risky, thereby discouraging investment. As a result, following the implementation of the Angels' Act, the number of business angels investing in technology start-ups at the seed stage decreased. Our research provides a potential reason for the controversy in the literature and popular media regarding the effectiveness of such policies: we claim that under certain circumstances, these policies might decrease the number of business angels investing in early stage (seed) firms, in addition to implications for firm performance.

2. Theoretical framework

2.1 Characteristics of business angels

The availability of financing sources is a major factor in the growth and success of small firms (Ou and Haynes, 2006). The formal external way for small firms to obtain financial support is through financial intermediaries such as financial institutions, banks, and securities markets (Chittenden, Hall and Hutchinson, 1996). In addition, one can use informal inside sources such as the owner-manager's personal savings, or informal outside sources, including financial support from family and friends, trade credit, venture capital (VC), and angel financiers (Abouzeedan, 2003; He and Baker, 2007; Wu, Song and Zeng, 2008).

Angels are a highly-selective group of wealthy individuals with long business experience who invest directly in firms with which they have had no previous relationship (Madill, Haines and Riding, 2005). Because business angels' interest is in high yields, they invest in seed-stage firms, despite the high level of risk (Lipper and Sommer, 2002; Mason, 2006). In fact, EBAN (2016) reported that compared to other stages, firms receive higher investments by business angels during their seed stage. Business angels tend to be more attentive to the needs of small firm owner-managers, due to their desire to leverage their investment. They also prefer to invest in their local economies (Harrison and Mason, 1992). Apart from their financial role, business

angels can contribute to management functions, business strategy, general administration, networking, and marketing, etc. (Kelly and Hay (2003); Mason and Harrison, 1996). However, business angels as a source of financing have a limitation too – lower willingness to invest additional money into a firm to enable it to grow and become a real competitor in its market. Mostly, they have neither the skill nor the interest in investing in a firm after it has access to other external sources of finance (e.g., Wall, 2007).

Our dependent variable is the number of business angels. We focus on the number of business angels because more than other investors, these investors are known to provide added value to the start-ups they fund; that is, they provide 'smart money' (Kerr, Lerner and Schoar, 2014; Sapp and Tiwari, 2004). 'Smart money' refers to investments made by sophisticated investors who have an understanding of the financial and technological markets and can often spot trends before others. 'Smart money' basically means money that is invested by people in a firm, but the people who invest that money also invest their time and advice into the firm, and are experienced, well-informed, and/or 'in-the-know'. These actions and qualities relate to 'smart money', because it is not just about the money ('dumb money'), but also the wisdom that is added by the investors (Frazzini and Lamont, 2008). Thus, in many cases the number of investors is more important than the amount of money they invest. Research shows that 'smart money' contributes to performance far more than 'non-smart money' (Sørensen, 2007).

2.2 Legitimacy theory

Legitimacy is defined as the process, resource, and outcome of conformation to institutionally- or socially-defined norms, values, and expectations (Oliver, 1996). Legitimacy of a business is determined by how well a firm is accepted by its investors and/or potential investors. Legitimacy is different than reputation, the latter relating to a number of unique features highlighting a distinct positioning compared to other competitors (Czinkota, Kaufmann and Basile, 2014). In other words, the social acceptance called legitimacy is a firm's "pre-condition to compete" (Pfeffer and Salancik, 1978) or "license to operate" in the market (Chiu and Sharfman, 2011).

Entrepreneurs' endeavours to develop their legitimacy is extremely difficult, because similar new ventures often fail (Rao, Chandy and Prabhu, 2008). New ventures suffer from lack of legitimacy in the eyes of the stakeholders', such as consumers, venture capitalists, and even business angels (DiMaggio, 1988). In fact, not all firms are able to overcome a lack of legitimacy. Zajac and Westphal (2004) found that actions, both substantive and symbolic, on the part of new ventures can help overcome this lack of legitimacy. Legitimacy improves the ability

of the founders to create social connections with external stakeholders (Delmar and Shane, 2004).

Small firms in general and in firms during their seed stage in particular is considered to have low legitimacy, because these firms often have no stocks traded and are not subject to high information-reporting requirements (Watson, Everett and Newby, 2000). In addition, firms at an early stage are assumed to be more risky and less likely to provide a positive outcome (Wiltbank, 2005).

For these reasons, government support in early stage start-ups may lead to the opposite result, because it increases the perception of the risk of an investment. In other words, by providing tax incentives, the government may emphasize the risks associated with investing in new ventures, thereby bolstering the de-legitimacy of seed-stage start-ups. We therefore predict that a policy incentivizing investment in seed-stage start-ups is negatively associated with the number of business angels investing in them compared with the number of business angels investing in advanced-stage start-ups.

3. Method

3.1 Research context

We focus on the high-tech industry arena in Israel. Israel has a substantial number of high-tech entrepreneurs and firms (Dutta, Lopez-Claros and Mia, 2008), and the Israeli start-up ecosystem is considered first in the world in terms of number of start-ups with respect to population size and it also attracts foreign business angels (Greenberg, 2015).

We utilize a policy incentivizing business angels to invest in start-ups that was implemented in Israel in 2011, known as the Angels' Act. The aim of the Angels' Act was to encourage angels to invest *specifically in seed-stage start-ups*. The seed stage is the stage in which a firm is first organized around an initial idea. It was hoped that these investments would help these firms establish stability, and if they succeeded they could contribute to the economy. The Angels' Act applied to investments made by the end of 2015; the business angels were entitled to receive their tax benefit three years after the date of investment.

3.2 Data and measures

We used a comprehensive database on the Israeli VC industry that virtually represents the entire population of technology start-ups in Israel. Specifically, we obtained data from January 2007 to October 2014, collected by the research firm IVC. The data include 2,542 start-up firms in seven high-tech industries, with 7,668 investors of which 4,774 are business angels.

Our dependent variable is the *number of business angels* than invested in each of the firms. Our main independent variables is *seed stage*, taking the value of 1 if the firm is in the seed stage and 0 if otherwise. We control for the following other *firm stages*: R&D stage, initial revenue stage, and revenue growth stage.[1]

Following previous studies (Davila et al., 2003; Paik, 2014), we controlled for the following legitimacy variables: (1) *central location* is a dummy variable that takes the value of 1 if the start-up firm is the centre of Israel, and 0 if otherwise (peripherals and Jerusalem); (2) *firm age*; (3) *Prior entrepreneurship experience* takes the value of 1 if at least one of the entrepreneurs has prior experience in entrepreneurship, and 0 if otherwise; we also control for (4) the *total number of entrepreneurs* and (5) *total number of managers.*

We also included the following individual- and firm-level variables: *academic status* takes the value of 1 if at least one of the start-up's entrepreneurs has a PhD or MD academic degree, and 0 if otherwise; *firm status* is a dummy variable representing one of four status modes in which the firm can be defined – failure (for a firm that failed and closed its operations down); initial public offerings (IPO) – for a firm that went public; mergers and acquisitions (M&A) – for a firm that was acquired by another firm; or active – for a firm that was still independently active at the time the data were harvested. *Number of rounds* is the total number of financing rounds a start-up firm has had. *Industry* is a set of dummy variables for the seven industries represented in our census: information technology (IT) & enterprise software, communications, life sciences, semiconductors, cleantech, internet, and miscellaneous technologies.

4. Results

4.1 Descriptive results

Table 1 shows the characteristics of firms by variables indicating legitimacy before and following the implementation the Angels' Act. It demonstrates that the firms' characteristics are similar before and following the implemention the Angels' Act.

Firms with:	Firms established from 2007-2010	Firms established from 2011-2014
Central location	1,805	2,090
Firm age (average)	1.865	2.268
Prior entrepreneurship experience (average)	.419	.394
Number of entrepreneurs (average)	1.970	1.933
Number of managers (average)	1.034	.574

[1] R&D is the product development (Benjamin and Margulis, 2001). The *initial revenue stage* is when a patent is first issued and profits are generated for the first time, either directly or through selling products (Sullivan, 1994). The *revenue growth stage* is defined as the stage during which customers remain loyal, and new opportunities arise to generate increased revenues (Edvardsson et al., 2000).

Table 1. Firms' legitimacy variables observed before vs. after the Angels' Act

Figure 1 offers model-free evidence regarding the percentage of firms that angels invested in before vs. after the Angels' Act.

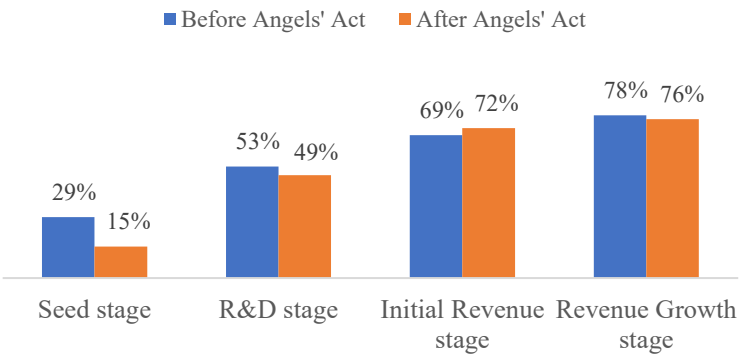

Figure 1. Percentage of firms that angels invested in before vs. after the Angels' Act

4.2 Modelling

Because start-ups established before the Angels' Act and the start-ups established after the Angels' act could have different characteristics, we use propensity score matching (PSM). Details regarding the specific estimation approach are in our full paper. Table 2 shows estimation of a negative binomial regression model.

Results suggest that following the implementation of the Angels' Act, firms at their seed stage are negatively and significantly associated with the number of business angels compared with the number of business angels in revenue growth stage start-ups. Legitimacy variables are also positively and significantly associated with the number of business angels (central location, firm age, prior entrepreneurship experience, number of entrepreneurs, and number of managers.

Because the negative binomial model is not linear, it is difficult to interpret the interactions effects, and their scale and even sign can differ across observations (Hoetker, 2007; Wiersema and Bowen, 2009). We offer a graphic analysis of the interaction (Gruber, MacMillan and Thompson, 2013), based on a prediction of interaction values where we keep the other variables constrained to their means (Figure 2). The interaction effect is significant for firms at their seed stage, but not significant for firms in other stages.

		Main model	
The Angels' Act (yes/no)		.491	(.681)
Firm stage:	Seed stage	1.471*	(.514)
	Seed stage X the Angels' Act	**-1.798***	**(.701)**
	R&D stage	1.119	(.510)
	R&D stage X the Angels' Act	.140	(.687)
	Initial Revenues stage	1.475*	(.498)
	Initial Revenues stage X the Angels' Act	-.099	(.700)
	Revenue Growth		
	Revenue Growth X the Angels' Act		
Firm age		-.005	(.032)
Number of employees		.020**	(.003)
Number of managers		.053*	(.021)
Number of entrepreneurs		.050+	(.031)
Prior entrepreneurship experience (yes/no)		.226**	(.061)
Entrepreneurs with PhD or MD (yes/no)		-.248*	(.111)
Technological performance:	Number of patents	.035	(.240)
	Number of backward citations	.001+	(.001)
Number of financing rounds		.586**	(.035)
Industry:	Cleantech		
	Communications	1.607**	(.189)
	IT & Enterprise Software	1.778**	(.188)
	Internet	1.591**	(.182)
	Life Sciences	.845**	(.190)
	Semiconductors	1.500**	(.301)
	Miscellaneous Technologies	1.051*	(.326)
Geographic location:	Abroad		
	North	-.701**	(.073)
	South	-1.266**	(.183)
	Center	-.900**	(.129)
	Jerusalem & surroundings	-2.343**	(.266)
n		2,618	
R^2		.171	
Log likelihood		-3221.721	
Prob > chi2		.000	

**p<.001, * p<.05, +p<.10

Table 2. The effect of the Angels' Act and firm stage on the number of business angels (SE)

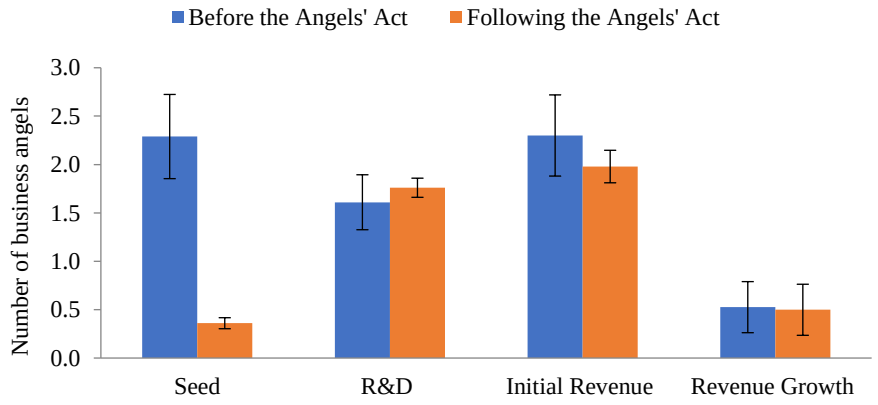

Figure 2. Impact of firm stage before vs. after the Angels' Act on number of angels

The full paper offers additional analyses and robustness checks.

5. Discussion

The present research indicates that a policy that was originally designed to increase investments in early stage firms, has effectively decreased the number of business angels investing in these

firms. Though the aim of the Israeli government was to encourage investing in seed stage firms (O'Donovan, 2002), we argue that the Act signalled angels that investment in these firms is indeed risky. We contribute to the literature by suggesting that just as policy measures targeting consumers can boomerang, so do policies designed to alter investor behaviour can have unintended consequences. Countries that want to encourage economic growth through start-up should take into account elements that may affect investors' decisions.

Similar to previous studies, the exact monetary amounts of the sums invested are largely lacking (Da Rin et al., 2013). We have no information on the amount of money business angels invested in the start-ups we examine. Thus, we look at 'smart money', measured by the number of business angels who contribute to firm success by sharing knowledge and advising the entrepreneurs and managers. Still, data on the amount of money business angels actually invest may have provided information that would have enabled us to measure the effect of 'smart money' above and beyond monetary value (Da Rin et al., 2013).

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