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**EXPLORING SEED
INVESTING IN ALABAMA:**
What is the Role of State Government?

*Exploring Seed Investing in Alabama:
What is the Role of State Government?*

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Executive Summary

The Alabama Innovation Commission seeks to build and enhance Alabama's technology sector. Would investor tax credit incentives encourage start-ups in high-growth, innovative business sectors?

Twenty-five states currently provide some form of investor business incentive tax credit programs, some of which provide refundable credits to out-of-state investors with no in-state tax liability. Alabama has no such incentive program that directly benefits out-of-state investors. Although the Innovate Alabama Act does create

an incentive mechanism to provide funds to economic development organizations (EDOs) for certain qualifying activities. Alabama taxpayers who make cash contributions to EDOs for qualifying projects receive an Innovate Alabama Tax Credit that can offset up to 50% of the following tax types:

- Income tax
- State portion of the financial institution excise tax
- Insurance premium tax
- State utility license tax¹

Refundable tax credits to in-state and out-of-state investors could be a way to draw new capital investment in Alabama while keeping in-state capital at home.

Current research suggests that refundable tax credits have no realized benefit. However, research also suggests that changing the design of the programs may create the desired benefits. If Alabama were to create such a program, four components could increase its chances of success:

1. **Targeting specific high-growth tech companies focused on rapid growth and innovation:** This can be done by setting specific criteria for eligibility based on targeted industry sectors and goals.
2. **Minimize the crowding out of alternative funding by identifying targeted companies that are financially constrained:** This can include excluding

¹ <https://innovatealabama.org/programs/tax-credit/>

company insiders from eligibility, who simply give tax breaks to their employees and current investors.

3. **Promote professional, sophisticated investors with expertise and industry experience:** This minimizes inexperienced investors in these industries who tend to focus more on investments in low-growth companies while also providing much-needed financial, technical, management, and information resources to nurture the company's growth.
4. **Providing refundable tax credits:** This makes the program more attractive to out-of-state investors, who may not otherwise benefit from the credits.

This paper introduces economic development concepts and the importance of start-ups to a growing and developing technological economy. It reviews aspects of existing state investor business incentive tax credit programs across the United States and explores whether these programs are a mechanism for the State of Alabama to enhance its technology sector effectively and efficiently.

Introduction

Economic development, defined here “as public sector interventions that seek to address market imperfections (such as high risk, information gaps, and regulatory barriers) that inhibit the productivity of private firms,”² is a tool governments use to facilitate economic growth to sustain or enhance long-term fiscal sustainability. The purpose of economic development is to improve the standard of living, as well as the quality of life. It includes “the process by which the economic well-being and quality of life of a nation, region, local community, or an individual are improved according to targeted goals and objectives.”³ Many times, these goals and objectives are measured by job creation and per capita income changes.

An ongoing debate in public finance policy is the “tradeoff between maintaining tax revenues and using the tax code to incentivize particular economic activities.”⁴ In other words, for tax incentives to make sense, they should ultimately result in an increase in tax revenues overall, or the achievement of other goals relevant to overall economic development.

Start-ups

One area of economic activity, perhaps worthy of tax incentives, is start-ups.

Start-ups are recognized as an important element of a growing economy. Start-ups are defined as:

businesses that want to disrupt industries and change the world... Start-ups are young companies founded to develop a unique product or service, bring it to market and make it irresistible and irreplaceable for customers. Rooted in innovation, a start-up aims to remedy deficiencies of existing products or create entirely new categories of goods and services, disrupting entrenched ways of thinking and doing business for entire industries.⁵ (emphasis added)

² “Management Policies in Local Government Finance,” edited by John R. Bartle, W. Bartley Hildreth, and Justin Marlowe, 6th ed, 2020, p321.

³ https://en.wikipedia.org/wiki/Economic_development

⁴ Sabrina T. Howell and Filippo Mezzanotti, “Financing Entrepreneurship Through the Tax Code: Angel Investor Tax Credits,” National Bureau of Economic Research, November 2019, <https://www.nber.org/papers/w26486>, Abstract.

⁵ <https://www.forbes.com/advisor/business/what-is-a-startup/>

Start-ups are also an example of the term *firm formation* or a new business. Likewise, entrepreneurs are those “who organize, manage, and assume the risk of a business or enterprise,”⁶ including start-ups. By implementing innovation and efficiencies in their new ventures, entrepreneurs are essential to promulgating start-ups.

“Without start-ups, there would be no net job growth in the U.S. economy,”⁷ according to Kane, who analyzed data from the Business Dynamic Statistics (BDS) US Government dataset, which includes firm age.⁸ Kane showed that start-ups create most net new jobs in the United States.

In a global economy with constant competition, start-ups are necessary to disrupt and innovate existing industries, bringing about new and unique products and services. These attributes are necessary to stay relevant in a changing world.

While start-up businesses or high-growth entrepreneurship have the promise of a significant positive economic impact, they also have many risks to overcome. As such, many feel that the public sector’s subsidization of private investment in these start-ups is necessary and warranted.

However, some believe these start-up data can be misleading. Decker, Haltiwanger, Jarmin, and Miranda note that Kane’s analysis⁹ “might be interpreted as implying that all net job creation is due to start-ups.”¹⁰ Kane defined start-ups as entities in their first year of existence. Decker, Haltiwanger, Jarmin, and Miranda argue that the length of time for the start-up to succeed or fail is important. Governments desire long-term job creation. If start-ups are defined as entities within their first year of existence, there is

⁶ <https://www.merriam-webster.com/dictionary/entrepreneur>
<https://www.merriam-webster.com/dictionary/entrepreneur>
on and Economic Growth, July 2010, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1646934.

⁸ <https://www.census.gov/programs-surveys/bds/about.html>

⁹ <https://www.census.gov/programs-surveys/bds/about.html>

¹⁰ Decker, Haltiwanger, Jarmin, and Miranda, “The Role of Entrepreneurship...”, p6.

nothing to track whether the start-up continues to make a “long-lasting contribution to net job creation.”¹¹

Overall, the evidence shows that most start-ups fail, and most that do survive do not grow. But among the surviving start-ups are high-growth firms that contribute disproportionately to job growth. These high-growth young firms yield the long-lasting contribution of start-ups to net job creation.¹²

“Most business start-ups exit within their first ten years, and most surviving young businesses do not grow but remain small.” Thus, most start-ups either fail or do not result in high growth. In addition, start-up rates have declined since the late 1980s, and even the technology sector has “begun to decline in the post 2000 period.”¹³

Alternatively, a small number grow rapidly and contribute substantially to economic performance.

This latter group of high-growth start-ups is important for persistent job creation, innovation, and productivity growth¹⁴ and is the type states should seek to attract and sustain. They are the focus of the Alabama Innovation Commission.

Incentives

Any start-up tax credit incentives offered should do their best to identify and promote those most likely to be high-growth, likely technology-focused, to implement innovative services, processes, and products. In addition, identifying factors that may lead to start-up failures may also be important for any effective tax credit program.

¹¹ Decker, Haltiwanger, Jarmin, and Miranda, “The Role of Entrepreneurship...”, p6.

¹² Decker, Haltiwanger, Jarmin, and Miranda, “The Role of Entrepreneurship...”, p10.

¹³ Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, “The Role of Entrepreneurship in US Job Creation and Economic Dynamism”, *The Journal of Economic Perspectives*, Summer 2014, V.28, No.3, <https://www.aeaweb.org/articles?id=10.1257/jep.28.3.3>, p4,15.

¹⁴ John Haltiwanger, “Entrepreneurship in the twenty-first century,” *Small Business Economics*, Accepted May 2021, Published October 2021, Issue date January 2022, <https://doi.org/10.1007/s11187-021-00542-0>, p27-28.

Some factors that have been found to impact start-up failure include lack of “financial, technical, management and information resources of the start-up,”¹⁵ as well as “entrepreneurs’ lack of industry experience,”¹⁶ and when there is no customer, because “they are not solving a market problem.”¹⁷

Howell and Mezzanotti list three criteria for using the tax code to incentivize high-growth entrepreneurship:

1. It increases the investment that would not have existed without the incentive, in particular for early-stage start-ups that are financially constrained.
2. It creates high-skill jobs.
3. It fosters economic growth.¹⁸

Any governmental program to incentivize the success of start-ups should be enacted with at least these criteria in mind.

Many states have incentivized and encouraged start-up ecosystems. These incentives come in various programs and descriptions, but most involve investor business tax credit programs for angel/seed capital investors, venture capital firms, or both. Angel and seed capital investors generally refer to individuals contributing capital to start-ups rather than venture capital firms. More specifically, “Angel investors are high net worth individuals who provide private capital to start-ups.”¹⁹ “Seed capital refers to funds raised to start a business,” much like angel investors. It is also referred to as “seed money, seed funding, or start-up capital.”²⁰ “A venture capital firm is an investment company that manages venture capital funds and makes the capital from those funds available to start-ups.”²¹ Overall, the terminology across states includes

¹⁵ Jose Santisteban, Vicente Morales, Sussy Bayona, and Johana Morales, “Failure of Tech Startups: A Systematic Literature Review,” https://www.researchgate.net/publication/370422929_Failure_of_Tech_Startups_A_Systematic_Literature_Review, May 2023, In book: CSEI: International Conference on Computer Science, Electronics and Industrial Engineering, p122.

¹⁶ Tom Eisenmann, “Why Start-ups Fail,” Harvard Business Review, <https://hbr.org/2021/05/why-start-ups-fail>, May-June 2021.

¹⁷ Denise Lee Yohn, “Why Startups Fail,” <https://www.forbes.com/sites/deniselyohn/2019/05/01/why-startups-fail/?sh=52fcbe628a5>, May 2019.

¹⁸ Howell and Mezzanotti, “Financing Entrepreneurship Through...”, p1 and 31.

¹⁹ Howell and Mezzanotti, “Financing Entrepreneurship Through...”, p1.

²⁰ <https://smartasset.com/financial-advisor/seed-capital>

²¹ <https://www.forbes.com/advisor/investing/venture-capital/>

one or more of these. Still, the goal is the same: provide start-ups and entrepreneurs with the necessary capital to improve their chance of success with sustainability and job growth.

This paper discusses research regarding past and present investor business tax credit program incentives for start-ups to determine if seed capital incentives are worth the investment from governments. Currently, the State of Alabama does not offer a tax incentive program for investors' direct contributions to start-ups. This exploratory analysis will examine whether the research supports or encourages the effectiveness of these programs and, thus, whether a start-up incentive ecosystem is a good government goal for the State of Alabama.

Existing Investor Business Incentive Tax Credit Programs

As of 2018, the use of investor business incentive tax credit programs has been utilized in 31 states. Maine was the first state to offer such a credit, beginning in 1989. Of the 31 states, six let their programs expire without renewing or implementing a new, updated program (Hawaii 2010, Michigan 2011, North Carolina 2013, Oklahoma 2011, Rhode Island 2016, and West Virginia 2008). Of the remaining 19 states, seven do not have an income tax. Twelve states have income tax but never implemented a program. Alabama is one of these latter states.

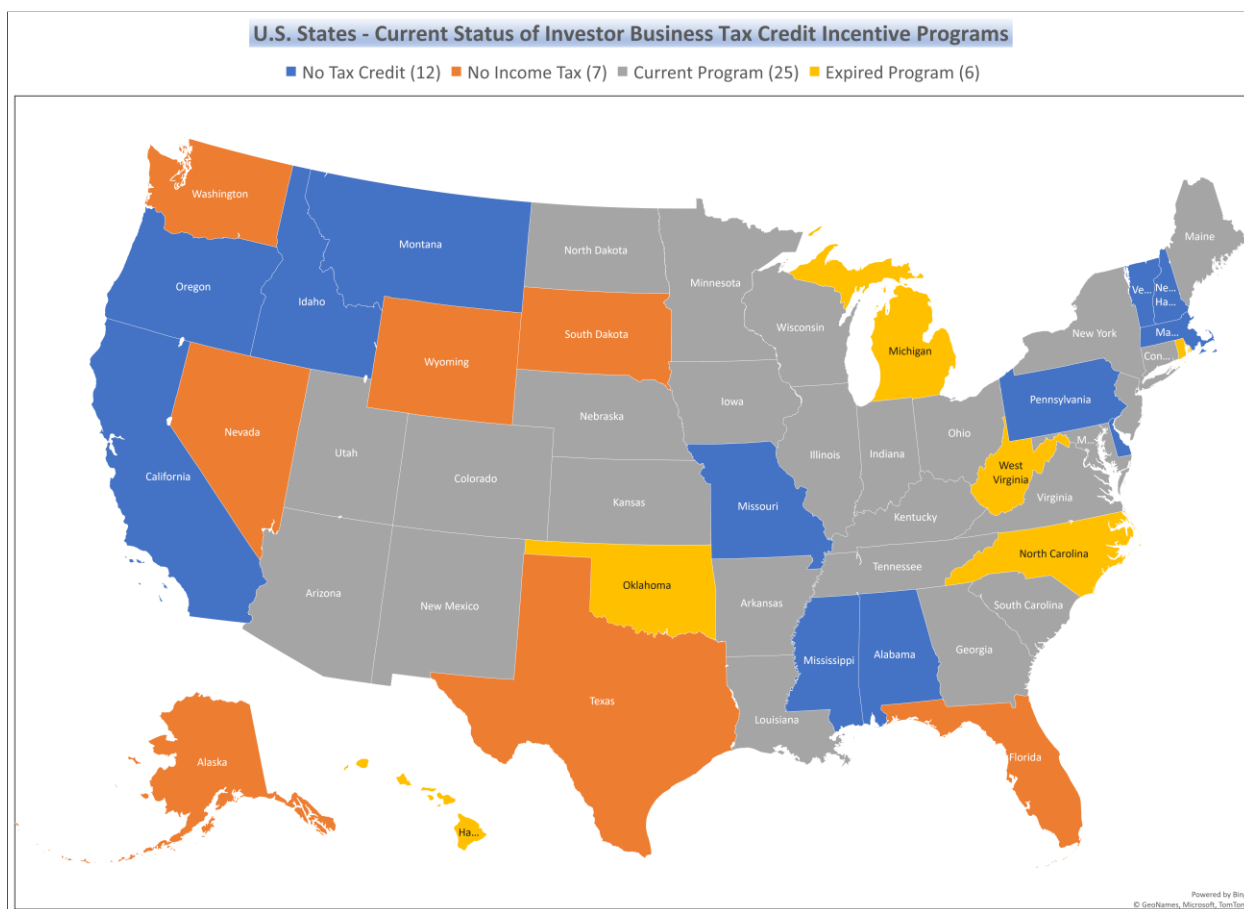
Figure one below depicts these four categories on a map of the United States:

- a. No tax credit past or present (12 states)
- b. No income tax (7 states)
- c. Current investor business incentive tax credit program exists (25 states) and
- d. Expired investor business incentive tax credit program without renewal (6 states).²²

Appendix 1 breaks down each of these four categories by state.

²² A report dated December 2023 from Maryland mentions that nine states have allowed their programs to lapse, but no source was given, <https://dls.maryland.gov/pubs/prod/TaxFiscalPlan/Review-of-the-Innovation-Investment-Incentive-Tax-Credit.pdf>, p8.

Figure 1. Status of States and Their Tax Credit Incentive Programs (as of 2018) ²³



An Analysis of Existing Programs and Their Framework

There is significant diversity in each state's incentive strategy. These include: "the types of businesses that qualify..., the amount of tax credits given to investors, and whether out-of-state investors can benefit from the incentive." This latter criterion refers to the tax credit's refundability. "Most out-of-state investors, including large venture capital firms, do not have a...tax liability and thus," cannot take advantage of a non-refundable program.²⁴ This concept of refundability will be discussed in more detail later. Denes et al., in their comprehensive multi-year research, provide a list of

²³ Matthew R. Denes, Sabrina T. Howell, Filippo Mezzanotti, Xinxin Wang, and Ting Xu, "Investor Tax Credits and Entrepreneurship: Evidence from the States," National Bureau of Economic Research, August 2020, Revised October 2021, p40 and Appendix 5-9.

²⁴ Nicholas J. Herdrich, "Wisconsin's Qualified New Business Venture Program: Building on the Foundation to Maximize Entrepreneurial Growth," Wisconsin Law Review, 2014, p1037, 1047.

criteria they tracked, including refundability, for the various state programs. It is summarized in *Appendix 2*.²⁵

In 2005, Wisconsin enacted the Qualified New Business Venture Program (QNBV) “with the goal of facilitating economic and job growth....to incentivize early-stage investment in high-tech businesses through nonrefundable tax credits.” A 2014 analysis of that program recognized that it did help “capitalize many early-stage companies,” but the state was still struggling “to improve its business climate.” To accomplish its goals of economic growth and job growth, the report recommended Wisconsin

1. Implement refundable tax credits to attract out-of-state investment capital.
2. Provide additional tax credits for investments in accelerators that nurture early-stage businesses.
3. Offer an opportunity for rebuttal of any presumption of disqualification for early-stage businesses in restricted industries.
4. Add incentives for specific industries.²⁶

By offering refundable tax credits, more investment capital can be utilized for the state program. By encouraging capital for accelerators, start-ups can utilize the accelerator services to facilitate growth and success. By offering a rebuttal process to presumptive disqualified businesses, businesses that might have been successful under the program will get a second chance. By incentivizing specific industries, a greater tax credit could promote more specific start-up goals. All these recommendations help to increase capital availability and the breadth of businesses covered.

Beyond Wisconsin, Howell & Mezzanotti conducted broader research across all state angel investment programs. They found no measurable effect “on local economic growth” by financing entrepreneurship through the tax code and tax credits. In sum, the programs had no measurable impact on the outcomes of the beneficiary company because financing would have occurred anyway from other sources. The subsidy only crowded out other funding that would have occurred. This is a major

²⁵ Denes, Howell, Mezzanotti, Wang, and Xu, “Investor Tax Credits and Entrepreneurship...,” Appendix 5-9.

²⁶ Herdrich, “Wisconsin’s Qualified New Business Venture Program...,” p1031-1035, 1047-1059.

argument against these types of tax credits. It is hard to prove that funding would not have occurred without the incentive.

However, despite finding no measurable effect, the authors did suggest specific criteria that could increase program effectiveness and create spillovers to the broader local economy.²⁷ They recommended that the tax credits be directed toward:

1. Companies with a high potential to grow or innovate, and
2. Companies that face “financial friction;” they are financially constrained.... Companies that are financially unconstrained could work, but only if they are likely to have large spillover effects.²⁸

States considering creating or refining incentive programs should consider these recommendations.

Likewise, Denes et al. found that despite angel investor tax credits being used across the United States to spur high-growth entrepreneurship, they also found “no significant impact on entrepreneurial activity” due to:

1. Crowding out of other financing, and
2. Low sensitivity of professional investors to tax credits²⁹

Crowding out other financing suggests that the tax credit displaced other early-stage capital that already existed before the benefit of the tax break. The crowd out phenomenon is possible, but also very difficult to quantify. There is no way to assess what an investor *might* do if the face of difference market conditions. However, to lessen the risk of crowd out, real or perceived, state programs should exclude insiders of the beneficiary companies. Some of the criteria related to this exclusion

²⁷ “A spillover effect refers to the impact that an activity, event, or transaction has on parties that are not directly involved. These effects can be positive or negative, and they occur when the actions of one entity affect the well-being, behavior, or outcomes of others. Spillover effects can be observed in various contexts, including economics, finance, healthcare, and the environment.
<https://quickonomics.com/terms/spillover-effect/>.

²⁸ Howell and Mezzanotti, “Financing Entrepreneurship Through...”, p2.

²⁹ Denes, Howell, Mezzanotti, Wang, and Xu, “Investor Tax Credits and Entrepreneurship...,” Abstract.

might be to exclude existing owners and their families, full-time employees, executives, and officers, as shown in Appendix 2.

The second area found to limit the impact of the tax credits was related to the type of investor: professional vs. non-professional. The article found that:

to the degree ATCs (angel tax credits) do increase investment, they have little impact on the professional, sophisticated angels who typically fund high-growth start-ups that could generate large benefits for the local economy. Instead, the increase in angel investment following the tax credit is mostly driven by local, inexperienced investors without entrepreneurial backgrounds” and “explains why subsidized firms are relatively low-growth and mature and are therefore unlikely to significantly drive aggregate firm entry and job creation.³⁰ (Emphasis added)

This suggests that state programs should limit tax credit eligibility to high-growth start-ups rather than low-growth or mature businesses. Furthermore, the article sought an answer to why professional investors had such a low response to the tax credits. They found that most professional angels invest based on whether they consider the start-up a “home run,” focusing on the big win company vs. offsetting a loss with a tax credit.^{31, 32} Part of the reason that professional investors may facilitate the success of start-ups is that they have ties to their companies or experiences that are important to the success of start-ups. Thus, in addition to capital, start-ups also need advice and expertise. States should consider ways to incentivize both, which would attract more professional investors.

It is worth noting that the above research focused on individual investors. Seed funds, run by professional managers, have increased since the data set ended in 2018.

³⁰ Denes, Howell, Mezzanotti, Wang, and Xu, “Investor Tax Credits and Entrepreneurship...,” p22.

³¹ Denes, Howell, Mezzanotti, Wang, and Xu, “Investor Tax Credits and Entrepreneurship...,” p29.

³² Geare, Gené. “[Decade In Review: Trends In Seed And Early Stage Funding.](https://news.crunchbase.com/venture/decade-in-review-trends-in-seed-and-early-stage-funding/)” [Crunchbase.com, Marc 13, 2019.](https://news.crunchbase.com/venture/decade-in-review-trends-in-seed-and-early-stage-funding/)

The Current State of Business Investment in Alabama

During the summer of 2020, Alabama established the Alabama Innovation Commission (AIC). The AIC is “aimed at building the state’s competitiveness in the technology sector, inspiring entrepreneurship, and educating a 21st-century workforce. The AIC serves as a platform for innovators to engage policymakers, exchange ideas, and identify policies that promote innovation in the state.” Subsequently, the Hoover Institution prepared a report that included a current assessment of Alabama and suggested recommendations to “transform the state into an innovation hub.”³³

The report reiterated some of the issues found in this paper’s research, including:

- a. “Assessing the efficacy of subsidies in actually attracting business is challenging.”
- b. “It is difficult to know how much of that activity (existing incentives by state governments) would have moved to the state anyway, even if tax incentives had not been offered.”
- c. “Much research in fact suggests that incentive-based approaches are largely ineffective in achieving their intended goals.”³⁴

Despite these drawbacks, the report supported incentivizing new businesses. This assumed that the “state is committed to the idea of innovation-specific financial incentives.” With this assumption, state venture capital funds were recommended “when using a model that matches some level of private investment.”³⁵ Tennessee and its INCITE Fund with Launch Tennessee was a specific fund mentioned to model. As part of its efforts, Tennessee also includes angel funds.³⁶

³³ <https://www.hoover.org/research-teams/hoover-alabama-innovation-initiative/about>

³⁴ A report by the Hoover Institution, “Innovative Alabama,” Prepared for the Alabama Innovative Commission, https://www.hoover.org/sites/default/files/research/docs/innovativealabama_foreword.pdf, p82.

³⁵ A report by the Hoover Institution..., p91-92.

³⁶ <https://www.fcavp.com/insights/2017/6/21/tennessee-is-a-hotbed-for-investable-companies>

If Alabama wants to innovate its business environment, start-ups and early-stage companies are necessary. However, research has shown that many of these programs have been unable to show that the efforts do not necessarily translate into the desired economic outcome. Those same research efforts, though, have recommended changes that should be considered to improve the achievement of sustainable start-ups that impact the state economy in the long term. Can Alabama afford not to directly incentivize investors for these government goals when other states do so? And for those states with refundable investor business incentive tax credits, can Alabama afford to lose in-state investments to other states?

Refundability vs. Non-Refundability

Nonrefundable credits can decrease tax liability, but not beyond what is owed.³⁷ Out-of-state investors who have no tax liability will get no benefit from investing in a state with nonrefundable tax credits.

As mentioned previously, one of the recommendations for Wisconsin's QNBV program was to institute a refundable tax credit. "If the amount of a refundable tax credit is more than the amount of taxes due, the difference will be given back to [the investor] as a tax refund." For the tax credits discussed, refundability allows out-of-state investors who owe no taxes in that state to still benefit from investing in a program with a tax credit. Thus, states can attract capital from out-of-state investors into their state, making it more competitive for capital investment.

Figure 2 below depicts a map of the United States by a state's investor business incentive tax credit program and whether they are refundable. The 25 states designated as "not applicable" include states with expired programs (6), no income tax (7), and no history of a tax credit program (12). For the non-refundable states, they represent 21 of the 25 states with a current tax incentive program. For the "refundable" states, they represent the other 4 of the 25 states with a current tax incentive program.

³⁷ <https://www.irs.com/en/refundable-vs-non-refundable-tax-credits/>

U.S. States - Current Status of Investor Business Tax Credit Incentive Programs - Refundability

■ NOT APPLICABLE (25) ■ NON-REFUNDABLE (21) ■ REFUNDABLE (4)

Legend:

- NOT APPLICABLE (25)
- NON-REFUNDABLE (21)
- REFUNDABLE (4)

Map Data:

State	Status
Alaska	NOT APPLICABLE (25)
Alabama	NON-REFUNDABLE (21)
Arizona	NON-REFUNDABLE (21)
Arkansas	NON-REFUNDABLE (21)
California	NOT APPLICABLE (25)
Colorado	NON-REFUNDABLE (21)
Connecticut	NON-REFUNDABLE (21)
Delaware	REFUNDABLE (4)
Florida	NOT APPLICABLE (25)
Georgia	NON-REFUNDABLE (21)
Hawaii	NOT APPLICABLE (25)
Idaho	NOT APPLICABLE (25)
Illinois	NON-REFUNDABLE (21)
Indiana	NON-REFUNDABLE (21)
Iowa	NON-REFUNDABLE (21)
Kansas	NON-REFUNDABLE (21)
Kentucky	NON-REFUNDABLE (21)
Louisiana	NON-REFUNDABLE (21)
Maine	REFUNDABLE (4)
Massachusetts	NON-REFUNDABLE (21)
Michigan	NOT APPLICABLE (25)
Minnesota	REFUNDABLE (4)
Mississippi	NOT APPLICABLE (25)
Missouri	NOT APPLICABLE (25)
Montana	NOT APPLICABLE (25)
Nebraska	NON-REFUNDABLE (21)
Nevada	NOT APPLICABLE (25)
New Hampshire	NOT APPLICABLE (25)
New Jersey	NON-REFUNDABLE (21)
New Mexico	NON-REFUNDABLE (21)
New York	NON-REFUNDABLE (21)
North Carolina	NOT APPLICABLE (25)
North Dakota	NON-REFUNDABLE (21)
Ohio	NON-REFUNDABLE (21)
Oklahoma	NOT APPLICABLE (25)
Oregon	NOT APPLICABLE (25)
Pennsylvania	NOT APPLICABLE (25)
Rhode Island	NON-REFUNDABLE (21)
South Carolina	NON-REFUNDABLE (21)
South Dakota	NOT APPLICABLE (25)
Tennessee	NON-REFUNDABLE (21)
Texas	NOT APPLICABLE (25)
Utah	NON-REFUNDABLE (21)
Vermont	NOT APPLICABLE (25)
Virginia	NON-REFUNDABLE (21)
Washington	NOT APPLICABLE (25)
West Virginia	NON-REFUNDABLE (21)
Wisconsin	NON-REFUNDABLE (21)
Wyoming	NOT APPLICABLE (25)

Table 1 below summarizes the key characteristics of these refundable programs. The tax credit percentage applicable to the investment ranges from 20% to up to a possibility of 50%. Some states have ranges based on other incentives they are trying to reach, such as the type of business to which the investment is applied (e.g., women and minority-owned). In addition, the state refundable credit cap per fiscal

³⁹ Since 2018, Minnesota has since become refundable again, after its program was expired in 2018. Nebraska's refundable Angel Investment Tax Credit program expired in 2019. New York's Qualified Emerging Technology Company Tax Credit program had two parts: 1) capital and 2) employment. The capital portion was not refundable.

year is shown, representing the most credit a state will award for that year. This is a budgeted expenditure item for the state. Finally, the total potential investment for these four states is calculated (assuming the most conservative tax credit percentage when a range is applicable).

Table 1. Active Refundable State Programs and Their Potential Investment⁴⁰

State	Tax Credit % of Investment	State \$ Credit Cap Per Fiscal Year	Total Potential Investment
Maine	40%	\$ 15,000,000	\$ 37,500,000
Maryland	33% to 50%	\$ 2,000,000	\$ 6,060,606
Minnesota	25%	\$ 5,000,000	\$ 20,000,000
New Jersey	20% to 25%	\$ 35,000,000	\$175,000,000
Grand Total		\$ 57,000,000	\$238,560,606

In sum, the four states with refundable programs will grant up to \$57 million in tax credits to receive up to \$238.5 million in investment from investors. This allows out-of-state investors to invest in other state programs and receive a tax credit to reduce the risk of placing capital with newer businesses.

In the past few years, Maine increased their credit cap from \$5 million to \$15 million due to oversubscription. On the other hand, Maryland has been undersubscribed and thus does not issue the total dollar amount of credits allowed.

Maine's legislation mentions the following findings on the reason for its refundable seed capital tax incentive program:

...the growth of new and existing small businesses in the State results in increased job opportunities for Maine residents, produces more spending in the State and increases municipal tax bases. Businesses that export their products or services out of the State bring capital into the State and help to develop export markets for Maine products. Small new and existing businesses can provide significant economic benefits

⁴⁰ Maine: <https://www.famemaine.com/business-financing/for-business-owners/fame-financing-programs/equity-capital-tax-credits/maine-seed-capital-tax-credit/> and <https://www.maineventurefund.com/special-report-maine-seed-capital-tax-credit-program/> and <https://legislature.maine.gov/doc/3701>;
Maryland: <https://commerce.maryland.gov/media/maryland-commerce-accepting-applications-for-cybersecurity-investment-incentive-tax-credit> and <https://dls.maryland.gov/pubs/prod/TaxFiscalPlan/Review-of-the-Innovation-Investment-Incentive-Tax-Credit.pdf>;
Minnesota: <https://www.revenue.state.mn.us/angel-investment-tax-credit> and <https://mn.gov/deed/business/financing-business/tax-credits/angel-tax-credit/>;
New Jersey: <https://www.njeda.gov/angeltaxcredit/>;

to the State if they can obtain sufficient seed equity financing to carry them from start-up through the initial development phases of a business. The jobs created by such businesses tend to pay higher wages and offer more benefits than other businesses; however, the per capita level of private venture capital investment in businesses located in the State is substantially below the national average and the average of the other New England states. In order to encourage the increased availability of risk equity capital to enterprises that have the potential for rapid growth and that bring capital into the State, the authority is authorized to issue certificates of eligibility for the seed capital investment tax credit permitted by Title 36, section 5216-B....⁴¹ (emphasis added)

Maine emphasizes the importance of venture capital in achieving these goals. “Venture capital investment is most robust in a select group of states with strong start-up economies, including networks of existing entrepreneurs, a well-educated workforce, and capabilities in high-growth industries.

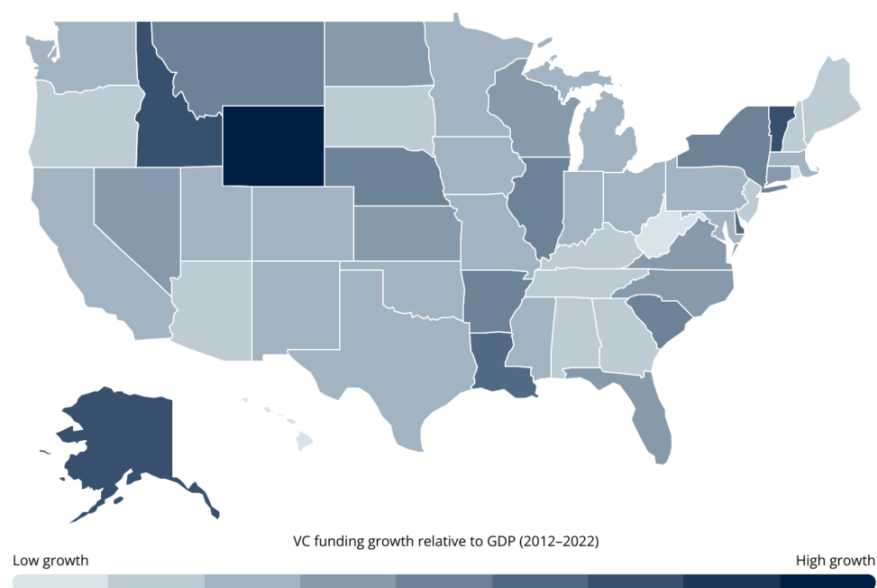
Thus, Maine has enacted its refundable investor business incentive tax credit program to increase private venture capital investment in the state.

More than half of all venture capital funding flows to just two states: California (40.2%) and New York (12.3%).” Figure 3 below depicts a map of the growth from 2012 to 2022 by state.⁴²

⁴¹ <https://legislature.maine.gov/doc/3701>, p2.

⁴² <https://flippa.com/blog/states-with-largest-growth-venture-capital-investment-past-decade/>; Methodology: The data used in this analysis comes from the U.S. Bureau of Economic Analysis and PitchBook, retrieved from the National Science Foundation’s [National Center for Science and Engineering](#). Researchers at Flippa compared total venture capital disbursed in each state relative to the state’s GDP in both 2022 and 2012 to determine those that experienced the most growth. The data represents venture capital funding secured by companies in each state and includes all stages of financing, from seed to later-stage investments.

Figure 3. Venture Capital Funding Growth relative to GDP, 2012 to 2022



Source: Flippa analysis of National Science Foundation/Pitchbook data | Image Credit: Flippa

Appendix 3 provides details of state growth over the past decade, with Alabama highlighted. Alabama is ranked 38 out of 50 states on its growth, which explains why there is a movement for recommendations on how the state can be innovative, and state venture capital funds were one of the suggested ways to achieve this.

In addition to Maine, Maryland, another refundable program, states the purpose of its tax program as:

intended to foster the growth of Maryland's technology sectors by incentivizing investment in early-stage companies with the goal of increasing the number of companies developing innovative technologies in Maryland, increasing overall investments in current and emerging technology sectors, and increasing the number of individual investors actively investing in Maryland's technology companies.⁴³ (emphasis added)

Likewise, New Jersey established its program to stimulate “investment in New Jersey emerging technology businesses.” Moreover, Minnesota’s program is “designed to encourage impact investment in start-ups and early-stage companies; the program is

⁴³ <https://dls.maryland.gov/pubs/prod/TaxFiscalPlan/Review-of-the-Innovation-Investment-Incentive-Tax-Credit.pdf>, p5.

specifically designed towards high technology, new proprietary technology, or new proprietary products, processes, or services in specific fields.”⁴⁴

These states see an opportunity to attract in and out-of-state investors to meet their goals for maximizing the success of early-stage companies to a) foster their growth, b) raise capital for an opportunity to succeed, and c) enhance innovative technologies. This, in turn, will create spillover effects that can contribute to a) increasing tax bases, b) bringing more capital to the states by exporting products, and c) creating higher-wage jobs. By having refundable programs, the number of potential investors who can meet these goals dramatically increases.

In summary, refundability in foreign states can hurt states without an investor business incentive tax credit program if their in-state investors send capital to other states and their start-ups. At the same time, refundability could help a state attract out-of-state investment capital to support its own start-ups. This latter concept would not preclude even the seven states with no income tax if they wanted to attract out-of-state investment capital.

Thus, for Alabama and other states, the question becomes whether it is worth the potential opportunity cost of losing in-state investors to out-of-state programs. Not only do these states, without refundable business investor tax credit programs, potentially lose in-state investors’ capital, but they also miss the opportunity to draw capital from other states to enhance their business climate for innovation. Thus, the opportunity cost is two-fold: 1. losing capital investment to other states, and 2. missing out on capital investment from out-of-state. These are hard costs to measure.

⁴⁴ <https://www.avisenlegal.com/minnesota-angel-tax-credit-program-receives-new-funding-boost-in-2023-tax-bill/>

Conclusion

Governments have identified economic development and its accompanying incentives as an important goal, especially as it relates to innovation. Start-ups play a prominent role in innovating within a global economy. But with start-ups and innovation comes risk. Investors seek places to place their capital. However, investors also realize that while successful start-ups can be a lucrative investment, most start-ups fail. Thus, to offset this risk, many states have developed programs to incentivize investors to place their capital in start-ups, and in return, they get a tax credit for a percentage of that investment.

Research has overwhelmingly suggested that the success of these programs cannot be measured. At the same time, the research suggests program implementation changes to achieve states' goals, which are to promulgate high-growth start-ups that can innovate and impact the business climate and, ultimately, the state for years to come.

Table 2 below summarizes many of the pros and cons of these tax incentives. The cons, which do not justify the tax incentives, are listed first. Since these were discussed in the research, they were listed, followed by applicable pros that justify these tax incentives. Overall, the pros offset and exceed the cons, especially if the suggestions offered to better these programs do have an impact.

Table 2. Pros and Cons of Investor Business Incentive Tax Credit Programs for Start-ups and Entrepreneurs

INVESTOR BUSINESS INCENTIVE TAX CREDIT FOR STARTUPS AND HIGH GROWTH ENTREPRENEURSHIP	
CONS	PROS
Most start-ups fail or exit within 10 years, so why should we incentivize them	Target specific high-growth tech companies with the greatest chance for success
Investor business tax incentives only crowd out alternative funding	Qualify only the financially constrained and potentially exclude company insiders
Evidence suggests that most startups that do not fail, do not grow	Minimize local, inexperienced investors who focus more on low growth companies
Lack of entrepreneur's industry experience impacts failure	Promote professional, sophisticated investors with expertise & industry experience
Lack of financial, technical, management and information resources impact failure	Promote accelerators that nurture early-stage businesses
Negatively impact racial equity and wealth inequality	Enhance income & job growth for all levels; structure to promote specific industries
It is hard to define whether a true impact is being achieved	Benefits of startups to the economy:
	Facilitates the creation of high-skill jobs
	Fosters innovative, economic growth by offsetting risk
	Important to the future, growing, global economy
	Plays a role in net job growth
	Helps to offset the decline in startups
	High-growth startups can create job & productivity growth, with spillover effects
	Technological focus that implements innovative services, products and processes
	Benefits of private capital investment through investor business incentive tax credits:
	Helps capitalize early-stage companies
	Serves as an intermediary between private capital and state goals
	Nonrefundable credits provide a mechanism to keep in-state investors in state
	Refundable tax credits attract out of state investment

Alabama does not currently have a direct investor business incentive tax credit program. Leaders have called for innovation in the state and enhancement of its technology sector—sectors for which Alabama is not well-known and does not have a strong history in out-of-state investment.

To accomplish these goals, start-ups must be part of the plan. Implementing an incentive program that considers the recommendations of existing research should be considered.

Appendix 1

Detail of U.S. States and Business Tax Incentive Programs by Current Status

Count of States		
Category	State	Total
No Tax Credit	Alabama	1
	California	1
	Delaware	1
	Idaho	1
	Massachusetts	1
	Mississippi	1
	Missouri	1
	Montana	1
	New Hampshire	1
	Oregon	1
	Pennsylvania	1
	Vermont	1
No Tax Credit Total		12
No Income Tax	Alaska	1
	Florida	1
	Nevada	1
	South Dakota	1
	Texas	1
	Washington	1
	Wyoming	1
No Income Tax Total		7
Current Program	Arizona	1
	Arkansas	1
	Colorado	1
	Connecticut	1
	Georgia	1
	Illinois	1
	Indiana	1
	Iowa	1
	Kansas	1
	Kentucky	1
	Louisiana	1
	Maine	1
	Maryland	1
	Minnesota	1
	Nebraska	1
	New Jersey	1
	New Mexico	1
	New York	1
	North Dakota	1
	Ohio	1
	South Carolina	1
	Tennessee	1
	Utah	1
	Virginia	1
	Wisconsin	1
Current Program Total		25
Expired Program	Hawaii	1
	Michigan	1
	North Carolina	1
	Oklahoma	1
	Rhode Island	1
	West Virginia	1
Expired Program Total		6
Grand Total		50

Appendix 2

Some Criteria for Individual or State Tax Credit Programs⁴⁵

Effective year
Expiration year
Individuals or groups qualify for tax credit
Max tax credit percentage
Asset cap (\$ million)
Revenue cap (\$ million)
Employment cap
Age cap (years)
Minimum investment per investor (\$)
Minimum holding period (year)
Ownership cap before investment
Exclude existing owners and their families
Exclude full-time employees
Exclude executives and officers
Reporting requirements for investor's firm
Previous external financing cap (\$ million)
Registration requirement for business
Aggregate tax credit cap (\$ million)
Max tax credit per company (\$)
Max tax credit amount per investor per business per year (\$)
"First come first served policy"
Refundable
Transferable
Carryover
Carry forward (year)
Total angel investment in state during effective year (\$ million)
State funding as share of total angel investment in state
Aggregate tax credit cap (\$ million)

⁴⁵ Denes, Howell, Mezzanotti, Wang, and Xu, "Investor Tax Credits and Entrepreneurship....," Appendix 5-9.

Appendix 3*

States With the Largest Growth in Venture Capital Investment Over the Past Decade

Source: FLIPPA⁴⁶

Rank	State	VC Funding Growth Relative to GDP (2012-2022)	VC Funding Per \$1M GDP (2022)	VC Funding Per \$1M GDP (2012)	Total VC Funding (2022)	Total VC Funding (2012)	Number of Deals (2022)	Number of Deals (2012)
1	Wyoming	+57.9X	\$16,150	\$279	\$792,640,000	\$10,840,000	69	9
2	Idaho	+20.8X	\$3,694	\$177	\$409,590,000	\$10,350,000	76	17
3	Alaska	+16.8X	\$1,813	\$108	\$119,140,000	\$6,290,000	35	4
4	Vermont	+16.3X	\$13,481	\$827	\$550,440,000	\$24,190,000	67	22
5	Delaware	+13.4X	\$27,235	\$2,026	\$2,456,860,000	\$126,300,000	569	66
6	Louisiana	+10.2X	\$1,111	\$109	\$324,450,000	\$25,750,000	96	42
7	Illinois	+9.9X	\$10,768	\$1,087	\$11,044,430,000	\$789,320,000	734	304
8	Nebraska	+9.5X	\$3,042	\$320	\$501,750,000	\$32,890,000	81	22
9	Arkansas	+9.4X	\$1,861	\$198	\$308,960,000	\$21,480,000	79	27
10	South Carolina	+8.4X	\$2,234	\$265	\$664,610,000	\$47,050,000	131	50
11	New York	+7.1X	\$15,344	\$2,147	\$31,430,140,000	\$2,851,310,000	3113	1140
12	Montana	+7.1X	\$4,504	\$634	\$302,110,000	\$26,850,000	53	24
13	Connecticut	+6.3X	\$10,277	\$1,637	\$3,281,830,000	\$394,360,000	254	110
14	North Carolina	+5.7X	\$6,891	\$1,209	\$4,933,770,000	\$538,050,000	536	218
15	Florida	+5.6X	\$6,087	\$1,078	\$8,759,110,000	\$839,640,000	1102	289
16	Kansas	+5.5X	\$3,619	\$663	\$757,520,000	\$94,060,000	95	38
17	Nevada	+5.4X	\$5,492	\$1,020	\$1,224,390,000	\$131,890,000	176	63
18	Virginia	+4.5X	\$5,089	\$1,121	\$3,374,840,000	\$499,960,000	461	181
19	North Dakota	+4.5X	\$1,107	\$245	\$80,460,000	\$12,700,000	21	6
20	Wisconsin	+4.2X	\$2,950	\$700	\$1,168,680,000	\$193,910,000	219	133
21	Pennsylvania	+3.9X	\$5,471	\$1,400	\$4,988,340,000	\$907,150,000	672	338
22	Mississippi	+3.7X	\$616	\$165	\$86,180,000	\$16,550,000	39	10
23	Maryland	+3.7X	\$5,731	\$1,534	\$2,751,300,000	\$510,110,000	408	211
24	Missouri	+3.6X	\$2,162	\$599	\$858,090,000	\$162,740,000	223	123
25	Ohio	+3.6X	\$4,320	\$1,211	\$3,568,080,000	\$660,800,000	366	245
26	New Mexico	+3.4X	\$2,294	\$675	\$287,970,000	\$59,370,000	79	24
27	Indiana	+3.4X	\$2,091	\$616	\$983,620,000	\$185,240,000	279	75
28	Colorado	+3.3X	\$12,747	\$3,850	\$6,262,320,000	\$1,065,660,000	686	309
29	Iowa	+3.2X	\$1,106	\$342	\$263,590,000	\$54,230,000	103	25
30	Massachusetts	+3.1X	\$32,800	\$10,735	\$22,680,130,000	\$4,754,930,000	1468	884
31	Washington	+3.0X	\$11,651	\$3,828	\$8,599,580,000	\$1,533,300,000	768	384
32	Michigan	+3.0X	\$2,122	\$699	\$1,320,900,000	\$295,350,000	327	173
33	California	+3.0X	\$28,232	\$9,390	\$102,812,220,000	\$19,842,600,000	7169	3580
34	Oklahoma	+2.8X	\$1,242	\$438	\$301,450,000	\$76,620,000	76	39
35	Minnesota	+2.7X	\$5,069	\$1,851	\$2,271,060,000	\$552,290,000	334	150
36	Utah	+2.7X	\$10,705	\$3,953	\$2,744,390,000	\$511,910,000	309	126
37	Texas	+2.6X	\$4,662	\$1,811	\$11,198,520,000	\$2,574,280,000	1449	570
38	Alabama	+2.5X	\$1,031	\$419	\$290,420,000	\$79,290,000	130	33
39	Tennessee	+2.3X	\$2,604	\$1,151	\$1,264,840,000	\$329,440,000	261	182
40	Maine	+2.1X	\$1,304	\$623	\$111,900,000	\$33,460,000	73	36
41	South Dakota	+2.0X	\$88	\$43	\$6,030,000	\$1,900,000	12	6
42	Georgia	+2.0X	\$2,973	\$1,487	\$2,281,030,000	\$665,710,000	484	226
43	Oregon	+2.0X	\$3,599	\$1,828	\$1,070,150,000	\$319,240,000	291	142
44	Kentucky	+1.8X	\$525	\$295	\$135,860,000	\$52,620,000	127	56
45	New Hampshire	+1.8X	\$5,769	\$3,278	\$605,870,000	\$224,570,000	77	49
46	Arizona	+1.7X	\$3,230	\$1,947	\$1,536,390,000	\$528,370,000	292	154
47	New Jersey	+1.7X	\$2,787	\$1,684	\$2,104,050,000	\$870,970,000	395	162
48	West Virginia	+1.6X	\$424	\$270	\$41,290,000	\$18,980,000	28	6
49	Hawaii	+1.4X	\$654	\$463	\$66,100,000	\$33,260,000	42	24
50	Rhode Island	+1.2X	\$3,221	\$2,742	\$234,430,000	\$141,430,000	66	47

⁴⁶ <https://flippa.com/blog/states-with-largest-growth-venture-capital-investment-past-decade/>

*Capital investment can vary wildly from year to year. Comparing two points in time obscures this.



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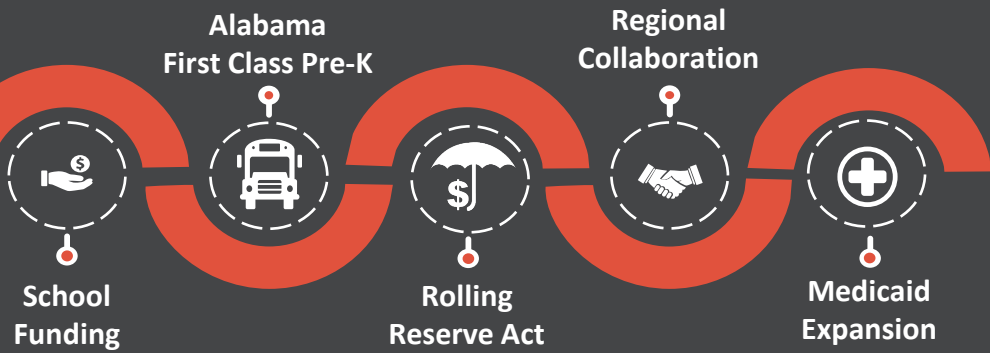


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