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Original Paper

Tax the Eggs, not the Hen

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Abstract

The VC industry provides an excellent example for an industry that is based on the ability to bring together ideas and high-risk capital in a process that generates value. Of particular interest is the case where the entrepreneurs reside in one country and the investors reside in another country. There are two types of benefits. The first type of benefits depends on the success of the young innovative technology firms. The second type of benefits depends on the total flow of high-risk capital from the country of the investors to the country where the investment takes place. While the benefits to the entrepreneurs and the shareholders are vastly discussed, the benefit to the hosting country is less explored. Successful entrepreneurs earn a lot of money in case of success. The high gains attract public pressure for higher and more effective capital gains tax. In this work we show that this to be a worthless and even harming. We show that the benefits are both direct in the form of taxes and indirect as higher wages. We use hand-picked database to estimate the total benefit to a small country that was successful in attracting international VC funding. Our main result is that the Income tax collected from VC backed employees is 10.7 higher than the Capital tax gained from exits. The call for the taxation of capital gains of the wealthy individuals could materially hurt the revenue of the hosting country

Keywords

Venture Capital Investment, Start-Ups, Economic Growth, Tax

JEL: F38, G23, H21

1. Introduction

Much of the economic and business growth in the world depends on new ideas. New ideas of new products, new services and new processes of production and communication contributed to the rapid growth of the global economy. Transforming ideas to value is not immediate, and it is not a simple

process. Innovative ideas and high-risk capital are two necessary ingredients in the generation of innovation-based economic growth. Innovative ideas can be generated in small countries. It is a function of the local culture as well as the education system. The data on the generation and the realization of new ideas through the venture capital industry in small countries like Sweden and Finland show that. Yet, innovative ideas are a necessary but not sufficient condition for successful VC industry as it is measured by exits. High risk capital is a necessary ingredient in successful Venture Capital (VC) industries. The research proposition of this paper has two related parts; first, sufficient high-risk capital is a necessary condition for successful VC industry as measured by exits, and second, the source of high-risk capital determines the success and the nature of the VC industry in small countries. In small countries the preferred source of high-risk capital is the global market. We show that the import of high-risk capital from outside Israel through Israeli and foreign VC funds contributes to the success of the Israeli VC industry. We also show that the main contribution of the Israeli VC industry to the Israeli economy comes from the fiscal impact of the high wage paid to the workers in the VC industry. The wages are paid by importing high risk capital and exporting specific labor services. The fiscal impact arises from the high-income tax paid by the workers in the VC industry.

2. Method

2.1 Economy and VC Fund Contracting Model

Venture capital is the primary means through which innovative ideas are financed, nurtured, and brought to fruition. Venture capital plays a crucial role in economic growth. Gompers and Lerner (2001a) figure out that over the years venture capitalists have created nearly one third of the total market value of all public companies in the United States. As we have pointed out earlier in this article, venture capital cannot generate value without the ideas of the entrepreneurs, and the entrepreneurs cannot generate value without venture capital.

This relationship was reviewed in many works. Kaplan and Stromberg (2001) provide a comprehensive review of empirical findings concerning venture finance and the agency problem; Hart (2001) provides a review of theoretical models; a topic less discussed is the environment in which the VC funds operate. We focus in this study on the specific relationship between the venture capitalists, often represented by a Venture Capital (VC) fund focus on the relationship between the venture capitalist (and the fund) and the entrepreneurs. The entrepreneurs and the start-up firms that they organize and manage are legal entities in a certain country and therefore the government of that country is a party in the echo system in which the VC investment takes place. The interest of the state is to maximize the contribution of the VC investment to the state, and this is different from those of the venture capitalist and the entrepreneurs. This is particularly true when the location of the entrepreneurs and the investment is different from the residence of those who provide the venture capital. Given limited funds and limited managerial capabilities the investors, institution and/or private individuals must decide in which VC funds to invest as different VC funds invest in different countries. The most natural thing to do is to invest in VC funds

that invest in the country where the investors reside. It is not surprising that most of the venture capital investments are in the US. However, a certain percentage of high-risk investment in non-US VC funds comes from US institutional and private investors, and some of these goes to small countries. The recipient countries try to attract such investments often by "tax holiday" of some sort.

Israel is the small country with the highest proportion of high-risk investment in VC funds by foreign investors. More than 90% of the venture capital in Israel is generated in foreign markets, mostly in the US. Israel offers several incentives to foreign investors who invest in Israeli VC funds or in non-Israeli VC funds who invest in the Israeli VC -backed industry. Foreign institutional investors do not pay taxes in Israel and for investors who have to pay capital gains tax in case of a successful exits the tax is limited to 25%. This policy raises the question whether the Israeli tax policy towards foreign investment is too lenient? We deal with this issue in the rest of the paper.

2.2 The Venture Capital Funds in a Small Country

Prior to 1994 there was no venture capital funds industry in Israel. Israel has developed technology-based industry, particularly in the defence sector. In 1994 the Office of the Chief Scientist has initiated a governmental program called "Yozma" (initiative in Hebrew), for encouraging VC funds to come to Israel. The program had one innovative requirement and one innovative feature. The requirement was that Israeli VC funds should be professionally controlled by US and other foreign VC funds which would participate in the funding for at least one third of the total sum. The unique feature was that the Israeli government agreed to subsidize the success of the funds in addition to sharing the risk. This was done by signing contracts with the non-government partners in the fund: the government had committed that in case of a success, it would sell them its part at the initial investment cost plus nominal interest after ten years.

The Yozma program set up the ground for the Israeli venture capital industry by initiating the establishment of ten funds, based on joint ventures with US and other international venture capital funds. The budget allocation by the Israeli government was small, $100M. At that time (1994) the US venture capital industry managed $7.5B. Nevertheless, the outcome of the Yozma program was not less than overwhelming, as illustrated in the following table:

Table 1. Outcome of the Yozma Program (1994-2004)

Total Investment	No. of VC funds	Invested ventures	Survivals (2004)	Employees (2004)	Total export (2004)	Market Cap
$100M	10	168	103	6,000	$1.2B	16.55B

Source: authors analysis for of the Ministry of Economy and Industry data

The success of the program brought in many VC funds, by 2001 there were more than 100 active VC funds in Israel. The number of funds decreased to 79 by 2008 and only 48 funds were active in 2018. Of

the 48 active funds, 29 are Israeli and 19 are foreign (Note 1). But based on PWC annual reports on the VC industry (Note 2) almost all the capital for VC funds active in Israel whether they are Israeli or foreign comes from outside Israel. About90% from US institutional investors. This is congruent with a very low investment in Israeli VC funds by Israeli institutional investors. We find that out of total investment over the research period 1996-2020 of $95B only 0.9% was made by Israeli institutional investors.

The important role of imported capital in the high-risk venture capital industry in Israel is not surprising. Israel is a small country. In a small country disproportional large real activity is usually financed by a disproportional large movement in the capital account.

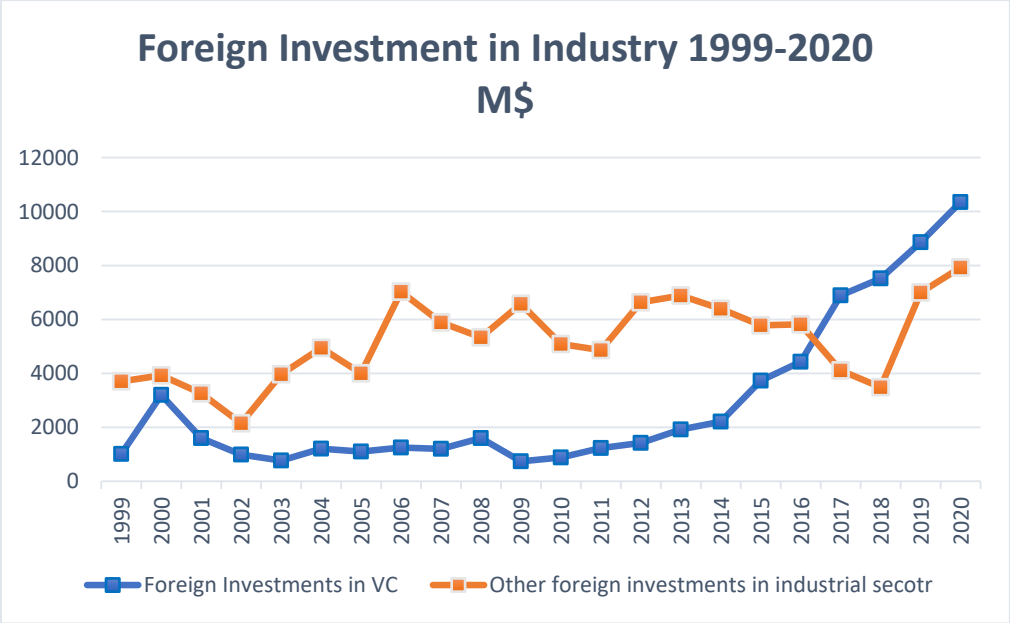

Figure 1. Foreign Investment in the Industrial Sector and VC investment: 1999-2020

Source: authors analysis of the Bank of Israel reports 2000-2021

In 1999 the total gross investment in the industrial sector in Israel was about 11.8B$, of this, only 35% were in VC. By 2007it grew to 14.7 B$ of which, 59% were in VC funds. In 2020, the total foreign investment in the industrial sector peaked at 36.2 B$, while the VC share is 68%. This is a very large proportion to be invested in high-risk projects, in a high-risk country. Israel can maintain such a high proportion of investment in high-risk new ideas only because it is financed by foreign investors.

In terms of dollars, the investment in Israeli start-up companies by VCF is volatile Yet, it is interesting to note that the investment is allocated to a large number of companies, so the number of receiving companies is less volatile, with a $Std/_{Average}$ .of 0.34 compared to 0.66 for the funding itself. Even during catastrophic years for VC backed high-technology start-ups such as 2002/3 and 2008/9, the stream of investments never stopped (See Figure 2).

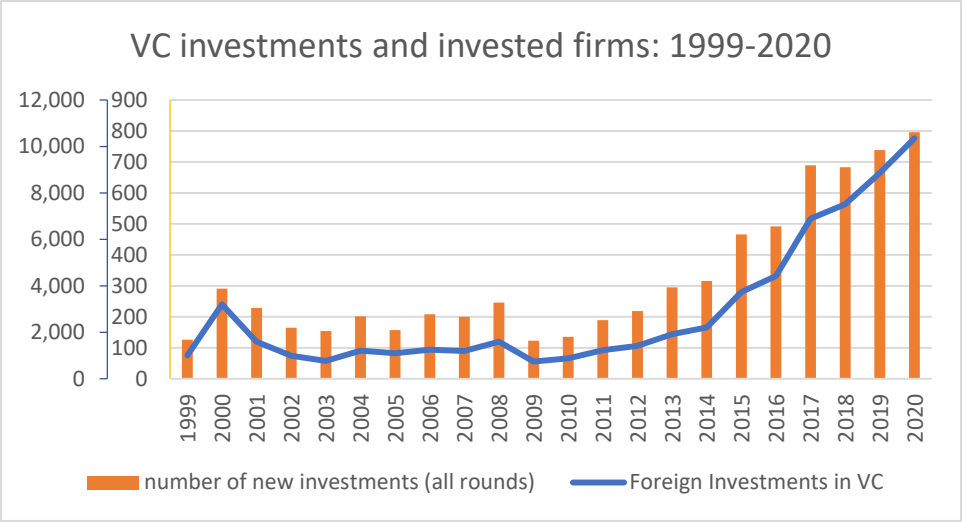

Figure 2. VC Investment and New VC Backed Investment Rounds 1999-2020

Source: author's analysis of the IVC & MoneyTree reports 2000-2021

Israel is an exception even relative to other small, developed countries that were in the focus of the global VC industry in the first decade of the millennium. Countries such as Denmark, Sweden and Ireland attracted significant VCF in the early 2000. This is not surprising given these countries high level of education, their own investment in R&D and their commercial and social connections with the USA, which was and remain the main source of VC capital. What might be of a surprise is the growing role of high-risk capital. In 2005, the 1st year the European Union publish VC investment data, Israel attracted 19% of the total VCF invested in small countries. By 2020 Israel's share rose to 55%. Figure 3 presents the changes in the international VC funding between the years 2005 and 2020.

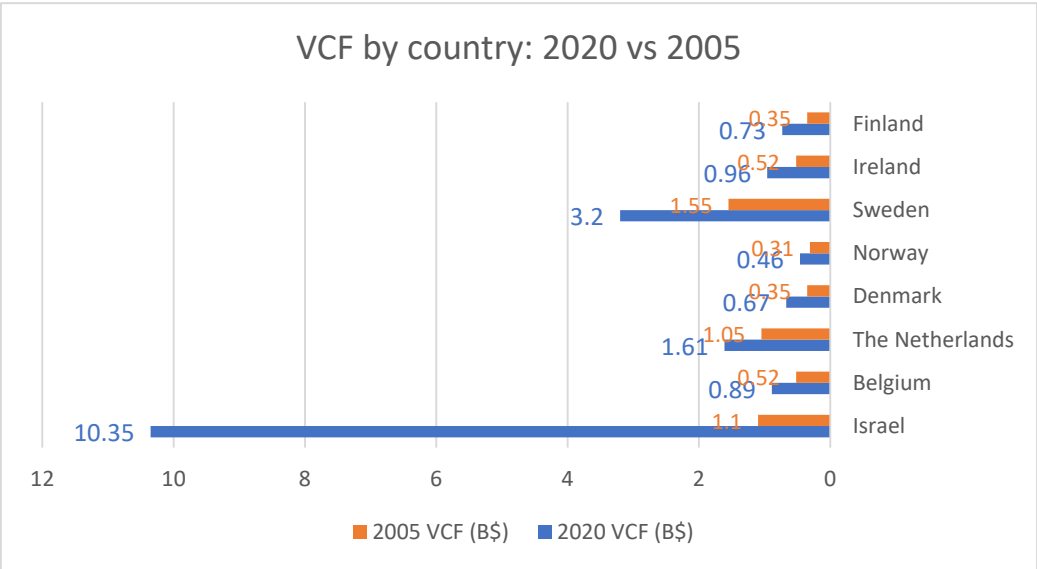

Figure 3. Small Developed Countries VCF 2020 vs 2005 (B$)

Source: Authors' analysis to European Commission data on venture capital 2006 and 2021 reports

Why only in Israel has venture capital become such a large component of investments while in other developed countries it has not succeeded? This is a question worthy of another study. What is evident from the data set is that in Israel, venture capital funds and their investments have an extraordinary impact, worthy of a unique measurement.

3. The Contribution of the Venture Capital Industry to the Israeli Economy: Data and Analysis

Israel is a prime example of the contribution of financial and risk intermediaries for generation of value from intellectual assets. During the period between 1996 and 2020 venture capital funds have invested about 54.3 B$ in 14,700 firms that received seed capital. Out of these figures, 49.5B$ was invested in 5885 firms (included in the 14,700) innovative firms that received at least one additional round after the seed round. The assets of the companies which have received these investments are IPR. The investment of the venture capital funds in these companies comprised 71.3 % of the total investment in them. Other investors and the government have invested 28.7% in these companies to bring the total investment in them to 61 B$. Of these start-up firms 1772 firms were still active at the beginning of 2020, a survival rate of 30%, much higher than the survival rate of US start-ups of about 12%. The typical investment of VC funds in start-ups is divided to up to five rounds, though even many successful firms end up with no more than three rounds. Investment rounds are usually determined by some milestones which are accomplished by the start-ups during their development. We find that the median investment in the seed round is on average 0.6M$ and then it goes up to 3.5 M$ on average, at round 1, 8.5M$ at round 2 and 18.8M$ for round 3

Many of the companies which have received investments in the earlier rounds ceased their operations in later years; a larger number of companies continue to operate, but they will never achieve the exit stage. These companies can cover their operating expenses, but they do not provide any return for the capital invested in them as equity.

3.1 The Distribution of Value: Who Gets What

In start-ups like in any other firm value is generated by future cash flows, the assets of the firm, and it is distributed to those who provide factors of production that generate the cash flows over time. The allocation of the value generated by the firm is done by selling liabilities in exchange for factors of production. In the case of young innovative technology firms, we focus on four factors of production that together generate the cash flows in the future. These factors are the ideas provided by the entrepreneurs, the risk capital provided by the investors (household savers) through the VC funds (the intermediaries), human capital provided by labour, and general services provided by the government. The VCF's money is paid primarily to highly skilled employees in the start-up as wage earners they pay income tax to the tax authorities in Israel. The investors may receive an overall return that exceeds their investment, but as in most cases the investors are not Israeli citizens, they are either exempt from Israeli taxes, particularly if they are institutional investors, or they paid reduced taxes. There is another important difference between two types of cash flows: certain cash flows and success dependent cash

flows. Labor and the Israeli government receive cash flows that are a function of how much money was invested in the start-up. Both labor and therefore the income tax authority in Israel receive cash flows as long as the start-up is operative. Capital gains are a function of success, exit of some sort that may not happen, and indeed it does not happen in most cases.

3.2 Estimating the Effect of the VC Backed Firms on the Israeli Industrial Sector

To estimate the impact of the VC backed industry on the local economy we took a different than usual approach. Instead of measuring only foreign investment and contribution to the GDP we set additional measures; (1) the number of highly skilled and highly paid employees and (2) their direct contribution to income tax revenues. In order to estimate these variables, we built a unique data base. We use a unique model and classification based on best practices. Using this information, we built a matrix of four industries in the high technology sector: software, hardware, Internet, and Biotech and Life sciences. Within each industry we distinguish between four stages of the firms, corresponding to the sequential investment rounds. We have calculated the number of employees in each of the 4X4 matrix: four industries and four investment stages. In each industry we distinguish among six levels of pay.

We are using average salary per employees for each rank in each one of the four industries. Given the large number of firms and the great similarity among firms of the same industry/size, the aggregate salary numbers are a good representation.

The growth of the companies which have received investments from venture capital funds is very uneven. One can think the process is as follows: In every year a number of new companies are funded, fully or partially, by venture capital funds. Some of these companies cease operations after some time; others are continuing. Of those that survive, some are growing fast, and some do not grow at all. We classify each of the active companies (Note 3) according to the year in which they were established and their status: small, small-medium, medium and large. We measure the growth of the workforce over time; compute the distribution of the average salary per firm size and per industry; and estimate the contribution of the workforce to consumption and to the level of direct and indirect taxes.

To estimate the growth of the workforce over time we use a variation of the logistic function:

$$k_t = Max[\log_{10}(-t_i - T),1] \tag{3.1}$$

k_t is the yearly workforce parameters, T is the last year on our database and t_i is the time of the firm's founding. By setting the k_t factor in equation 3.1 we can ignore fluctuations in the workforce, since we are interested in the median compensation.

We break the start-up companies to sectors: Software, Hardware, Internet and Biotech and others. We find that the compensation scheme and workforce mixture differ over these clusters. Salaries in the Hardware segment tend to be higher than average. The workforce in the Biotech segment is "flatter" as there are fewer executives. By using the classification of firms to the industries which are discussed above we compute the workforce and salary mixture of small (10 employees), medium (50 and 100 employees) and large (250 and above employees) companies.

We compute the average salary per firm. By applying k_t for the actual number of years that passed since the establishment of each firm, we get the number of annual Employment Years (EY).

The overall employment years are:

$$EY = \sum_{l=1}^{4} SEG_l \sum_{j=}^{4} Size_j \sum_{i=15}^{1} k_i * firm_i \tag{3.2}$$

$firms_i$ is the number of firms from a specific size (as of 2020) and segment established on a specific year i; $size_j$ is a discrete number such that $size_j \in (10,50,250,400+)$ and SEG_l is the segment in which the firm is operating, such that all the segments sum to 100%.

The total number of "Employment Years" that was generated by venture capital backed investment in the high-tech sector over the period 1999-2020 is roughly 2,470,000. From our computation in equation 3.1, we calculate that a total of 132,000 full-time openings were created by the VC industry during the years 1999-2020, (see figure 4 for breakdown).

We do not claim that all these jobs were added to the market. It is obvious that some of the high-technology sector jobs were filled by people who were already working either in the public sector or in other sectors. Low paying jobs that were freed by those who moved to the high-technology industry were either taken by new immigrants or exported (Note 4).

We compute that the real (Israel CPI linked NIS converted to USD) total compensation to the employees in the venture capital backed firms by the end of 2020 is $ 135 Billion. Who paid this amount? This money was paid by investors - primarily US and other foreign investors - through VC funds to receive a part of the future cash flows, money that is to be generated by many small firms which are based on intellectual assets (ideas of technology entrepreneurs). Although many of the ideas (and the start-up companies that were set up to develop them) were proved unsuccessful, the process generates value to a large number of employees; and through their income tax it also generates value to the country as a whole.

4. The Budget Impact: Fiscal Evaluation of the Industry's Impact

4.1 Calculating the PIT (Personal Income Tax)

We now turn to our main empirical point. In the previous section we have suggested that the true impact of the start-ups industry on the Israeli economy is a function of the process of investment, mainly the capital import and its contribution to employment and the revenues of the government. The expectations for exits are necessary, because this is the motive for the investment. However, the royalties and taxes from exits are not significant; this is not the case of the personal income tax. The Israeli tax code is continually changing over the last decade. In the past three years the average tax rate on wages in Israel has fallen for most income levels, while in developed countries it has been rising on average. However, for the 2% of Israeli workers who are at the highest levels of income, the tax rate in Israel is higher than in two thirds of the countries (Brender, 2009). Since the code is complex and it mixes different taxation levels with different benefits, we use the following simplifications:

1) The inclusive taxation for a certain individual is set by

$$TAX = \sum_{i=1}^{n} \alpha_i \mathbf{IL_i} + \sum_{j=1}^{m} \boldsymbol{\beta}_i \mathbf{NI_j} - \mathbf{C_k} \tag{4.1}$$

were α_i is the tax rate per income level, IL_i is the taxed income level, β_i is the National Insurance rate per income level and NI_j is income level for National Insurance calculations and C_k is the *Personal Tax Credits*. We use the matrices of Table 2 to compute the salaries and quantities of employees per firm.

2) All the employees are citizens and residents, so they are all subject to the same tax regime.

3) The industry's surveys set the percentage of women at 21%-29% with on-going growth. We assume that 25% of the employees are women, evenly distributed over all positions. We apply the relevant tax deductions. We use other tax deductions metrics such as the number of children and marital status based on national data. The results are strictly insensitive to these assumptions.

The personal income tax brackets are taken from the Ministry of Finance database (Note 5). As each year the brackets are updated, the figures we provide are based on the average income tax and national security rates for the decade 2010-2020 The monthly income taxes ranges between 1,420 NIS for a 10,000 NIS salary (~2,700 US$) and 20,609 NIS for the top 60,000 NIS (~15,000 US$) salary. The additional National Insurance payment is 1,250 to 9,965 NIS accordingly.

Table 2. Compensation and Taxation

Employee level	Annual gross compensation (K$)	Actual tax bracket (%)	NI ($)	PIT ($)
CEO, CFO, CS	247	51%	41.1	85.8
C level; Others	165	45%	27.1	47.2
Senior sales, Directors	124	42%	19.7	31.9
T-Leaders, Senior Engineer	87	37%	13.2	19.5
Junior Engineers, QA	62	33%	8.8	11.4
Others	41	27%	5.1	5.9

We match the PIT for each employee and then by means of simple multiplying we compute the total estimated income tax of the entire VC backed sector and so to estimate the fiscal impact.

We find that the total tax collection from the VC backed start-up industry on the year 2020 is 4.28 B$). The total tax collection from the VC backed industry over the entire research period in current (2021) prices is $27.8 Billion $.

Figure 4 shows the percentage of PIT collected from VC backed firms' *employees* as percentage of the total IT collected 1999-2020.

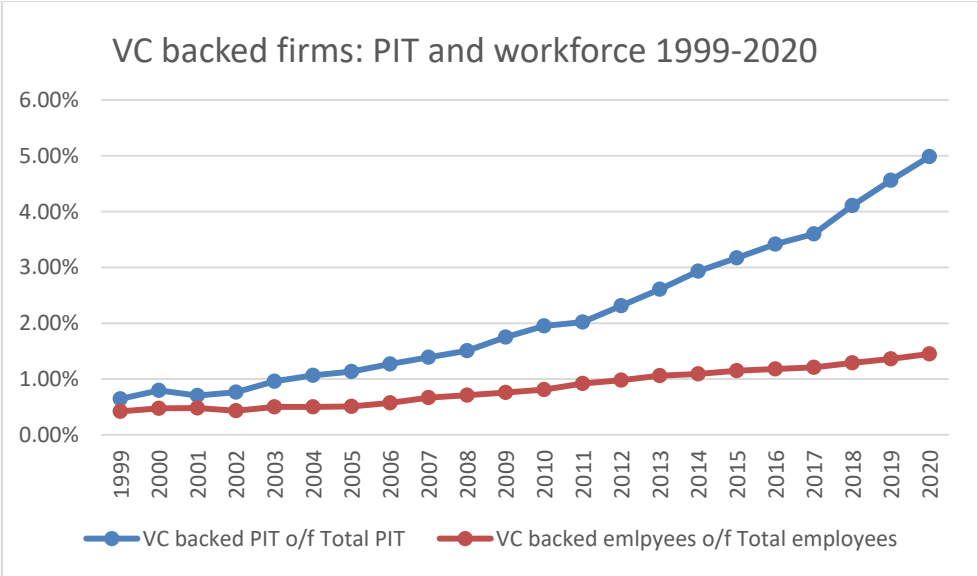

Figure 4. PIT Collected from VC Backed Firms as a Percentage of Total PIT

Source: Authors analysis, based on MoneyTree reports and Tax Authority reports, 2003-2021

4.2 Calculating the CGT (Capital Gain Tax)

Our next step is to compute the Capital Gain Tax (CGT) that was collected by the Treasury from all the *Exits*, both IPO and MNE over the research period. This is a complex task, as most of the Exits are MNE and there were no "taxable event (Note 6)" on the day of the deal if no cash was transferred. Moreover, in many cases, the identity of the shareholder, especially if it a corporation or an institutional investor.

The key factor that determines the low tax collection is that by the time of Exit, only a small fraction of the firms that are undergoing an IPO/MNE, are still owned by Israelis or Israeli corporates. Since the work was manual, we set the following guidelines:

A. We manually analyse exits only if they are worth 200M$ or more.

B. Exits that are worth 50M$ to 200M$ we use the average figures we extract for the 100M$ and more Exits. We use the average for:

a. The total investment

b. The shareholders nationality

We analyze handpicked 515 significant (200m$ or more) Exits with valuation of more than 200 M$ over the research period. The main finding is the low level of Israeli ownership at the Exit stage. The average local ownership pre-exit is less than 19%. This includes individuals such as entrepreneurs and high-ranked employees and local VC funds that pay CGT locally. We compute the expected tax as if the shares are sold at the day of the IPO or MNE (shares of the acquiring firm). We use the tax rate of 25% that is the maximal CGT that was due in Israel over the research period, (the actual tax rate was lower). We find that the total CGT that was collected over the research period is only 2.5 $. Therefore, the PIT is at least, 10.7 times higher than the CGT collected over the same period.

5. Discussion

Wealth taxation is an issue that goes far beyond economic viability. This is an issue that concerns the questions of what justice is and what is a fair distribution. There is no doubt that wealth taxation is a controversial public issue. We certainly do not come to express our opinions on moral issues. We point to one simple fact: in the case we analyze, of investing in small local companies through capital imports, even doubling the capital gains tax from 25% to 50%, even under the exaggerated and unreasonable assumption that it did not adversely affect the rate of capital import. Even if capital gains taxation was 100%, it would still be significantly lower than income tax revenues. What causes this unique situation?

We point to two reasons. One, most of the capital for investment is from external sources and the destination country does not levy tax on the capital gains of foreigners. Accordingly, the host country has difficulty in mass capital gains generated in its territory. Second, the rate of return on work in the high-tech field in general and in start-up companies in particular is very high, which allows the state to tax income from at a very high marginal rate.

Our main conclusion is that in small, developed countries where investment in high-tech high-risk industry is financed by imported capital the main n benefit for the host country is income tax collected from local high skilled-high pay labor. In other words, the country imports high risk capital and exports high skilled labor services “produced” by local workers.

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Notes

Note 1. PWC Moneytree report 2019: https://www.pwc.com/il/en/venture-capital-israel/moneytree-historical-reports.html

Note 2. PWC Moneytree report 2020: https://www.pwc.com/il/en/venture-capital-israel/moneytree-historical-reports.html

Note 3. Active companies as were in December 2020

Note 4. Supporting indirect evidence is the fact that during the 1990s the Israeli low-tech Industry lost more than 40,000 jobs due to import tax cuts. Yet, the unemployment rate decreased over the whole decade.

Note 5. https://www.gov.il/he/departments/publications/reports/press-income-tax-brackets

Note 6. A taxable event is any action or transaction that may result in taxes owed to the government. Common examples of taxable events include receiving a payment of interest and dividends, selling stock shares for a profit, and exercising stock options