GBPI
Georgia Budget & Policy Institute

Policy Report

CAPCO: A Bad Investment for Georgia

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Introduction

Entrepreneurs and startup companies are vital to the health of any state economy, as new businesses create jobs and spur long-term growth. Developing companies require capital to grow and expand and they sometimes struggle to bridge the "funding gap" between initial seed money (e.g. wealthy "angel" investors) and traditional financing (e.g. private equity, traditional banks). Venture capital (VC) is a form of business financing that helps fuel these early stage companies, especially those in tech-based industries. A growing number of Georgia policymakers and business leaders contend the state has a shortage of venture capital, which is supposedly holding back the state's economy—slowing the growth of high-tech companies incubated here and making Georgia less competitive.

In an effort to catalyze this industry, some Georgia leaders are considering an expensive tax credit program referred to nationally as CAPCO. Advertised as a jobs and economic development bill, Georgia's CAPCO proposal – sometimes referred to as the "Georgia Small Business Investment Company Act," or Senate Bill 203 – would provide $125 million worth of tax credits to "certified capital companies" (CAPCOs), who would then invest in Georgia small businesses. The program almost became law on the last day of the 2011 legislative session and now appears to be back on the agenda.

Although strengthening Georgia's venture capital market could well improve the state's economy long-term, the CAPCO model is a fundamentally-flawed method for doing so. Pushed in numerous states as a "jobs bill," CAPCO is a piece of industry-crafted model legislation that has been described by academics and informed policymakers as "most inefficient[1]," "a raid on state treasuries[2]," "a $200 million toilet[3]" and "a scam[4]." CAPCO's flawed methods in other states have been thoroughly documented, while its supposed benefits are exaggerated and based on questionable reports. If and when CAPCO legislation returns in 2012, lawmakers should reject it as their first order of business.

Dismissing CAPCO is a necessary first step toward developing reasonable "venture capital policy" in Georgia. If state leaders are intent on addressing the real issue, they must transition from CAPCO to a broader discussion of how to maximize the bang for the taxpayers' buck—in other words how to create a "best practices" program that is both highly effective and fiscally responsible. There are available alternatives to CAPCO, such as a recently-created program in Maryland, which Georgia leaders should closely examine as a potential model.

GBPI's recommendations for how to proceed are:

1. Reject CAPCO in any form
2. Consider a customized alternative like Invest Maryland

Overview of Venture Capital

Venture capital (VC) is financial capital – money – provided to startup companies with extraordinary growth potential. Companies and managers that work with venture capital – "venture capitalists" – are essentially financial intermediaries that raise money from wealthy individuals, corporations and institutional funds (e.g. pensions) and invest them in privately-held companies. As a general rule, venture capitalists invest in the early stages of a company, with the goal to turn sizable profits as its value increases several fold. In exchange for their capital, venture capitalists typically take an ownership stake in selected companies and closely monitor, if not directly influence, company decision-making.

Most seed investors look at hundreds of proposals before selecting a handful for investment—every year, there are nearly two million businesses created in the U.S., with only 600-800 receiving VC funding.[5] According to the National Venture Capital Association, a nationwide trade association, companies backed by VC account for 21 percent of U.S. GDP and 11 percent of U.S. jobs.[6] Internet-fueled companies such as Facebook and Apple, as well as traditional household names like FedEx and Home Depot, are examples of companies helped along by VC.

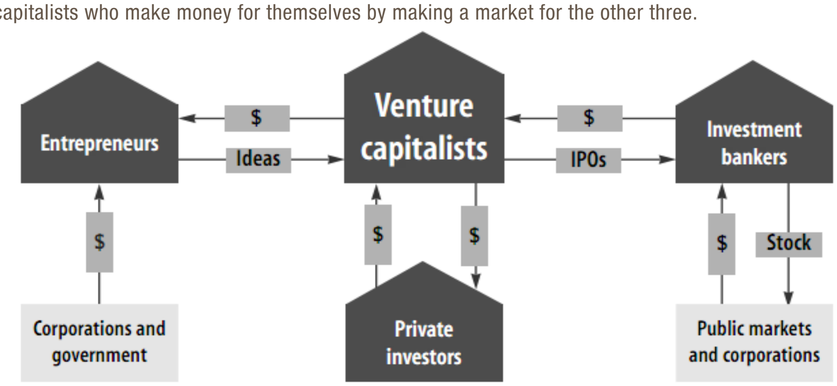
Venture funds are attractive for new companies that are not yet able to secure traditional funding, such as bank loans. This stage of business development is often a kind of "funding gap" where even high-potential companies can struggle to grow due to lack of financing. Obtaining venture capital is substantially different from securing a loan from a lender, as lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of the business. Conversely, the profit for venture capitalists is dependent on the growth and profitability of the business.[7]

For a state or regional economy to have a strong VC market, it is important to have a community of funders who are actually located in the state, as opposed to simply investing there—this enables venture capitalists to become active advisors to their selected companies. Unfortunately VC is highly-concentrated in a few specific locations – Silicon Valley, Boston and New York – in large part because those regions have well-established "ecosystems" for high-growth companies (e.g. multiple funders and their associated networks). This leads to a "virtuous cycle" in these locations, as entrepreneurs choose to locate their businesses closer to funding sources and pools of talented labor.[8] As one report put it, "geography…makes a difference. Investors attract entrepreneurs and entrepreneurs attract investment."[9]

Some business leaders have expressed concern that Georgia needs to strengthen its VC community. When the Technology Association of Georgia (TAG) recently asked the state's "technology decision-makers" to identify the most needed improvement in Georgia's business climate, 41 percent of respondents selected "better funding options/more venture capital"—nearly three times more than any other option.[10] Additionally, Georgia is the only state in the nation that prevents state pensions from

Figure 1 How the Venture Capital Industry Works

The venture capital industry has four main players: entreprenuers who need funding; investors who want high return; investment bankers who need companies to sell; and the venture capitalists who make money for themselves by making a market for the other three.



Source: Zider, Bob. "How Venture Capital Works," Harvard Business Review. Oct.-Nov. 1998. p. 135

According to a 2009 study by researchers at Georgia Tech, approximately 40 percent of high-tech startups in Atlanta leave the city within three years and 60 percent leave within five years.

investing in various forms of "alternative investments," such as technology startups and VC funds, which some industry leaders claim to be a serious impediment to attracting more VC.[11]

There is at least some evidence warranting these concerns. A commonly-cited report from researchers at the Georgia Institute of Technology found that approximately 40 percent of high-tech startups in Atlanta leave the city within three years, while 60 percent leave within five years.[12] Additionally, PricewaterhouseCoopers' Money Tree report shows that Georgia had only $344 million worth of venture capital activity in 2010, compared to $979 million for Texas, $2.45 billion for Massachusetts and $11.66 billion for California.[13] Meanwhile, the Southeast region accounted for only 3.5 percent of the national VC total in the third quarter of 2011, compared to 38.4 percent for Silicon Valley and 12.8 percent for New York City.[14] Recent reports that about 85 percent of Georgia's VC investments come from out-of-state also raise concern that Georgia's investor network may be too small to service its entrepreneurial talent.[15]

What is CAPCO?

"CAPCO" (short for "Certified Capital Companies") is a complicated program that several states have adopted at various times to address a perceived shortage of venture capital. While there are many ways states can respond to this problem, CAPCO refers to a specific piece of industry-driven "model legislation" created in the early 1980s that a small cadre of large firms have shopped from state to state since the late 1990s.[16] Started in Louisiana in 1983, CAPCO programs currently exist in nine states, while at least 12 others have rejected the concept outright.[17] Several additional states have tried the program and either repealed or chosen not to extend it later on, including Wisconsin, where legislators turned back a renewed version of the proposal in 2011.[18] Many of the model's toughest critics are from states that have experimented with it.

How Does CAPCO Work?[19]

Typically marketed as a "jobs bill," CAPCO creates a highly-complex financing process that converts the value of future tax credits into funds that can be invested in small business today. A basic overview is that the state creates deferred tax credits in the state insurance premium tax, which insurance companies can gain access to by providing loans to "certified capital companies," or CAPCOs, that have been certified by the state. The companies then "invest" those funds in in-state businesses, supposedly increasing economic activity and job creation.

A detailed description of CAPCO's complicated mechanics can be found in Appendix A; however, a brief primer on the process is as follows:

- There are three parties to a CAPCO program's complex process: state government, insurance companies and the CAPCOs;
- CAPCO legislation creates deferred credits in the insurance premium tax that incentivizes insurance

CAPCO's History & Status in Georgia

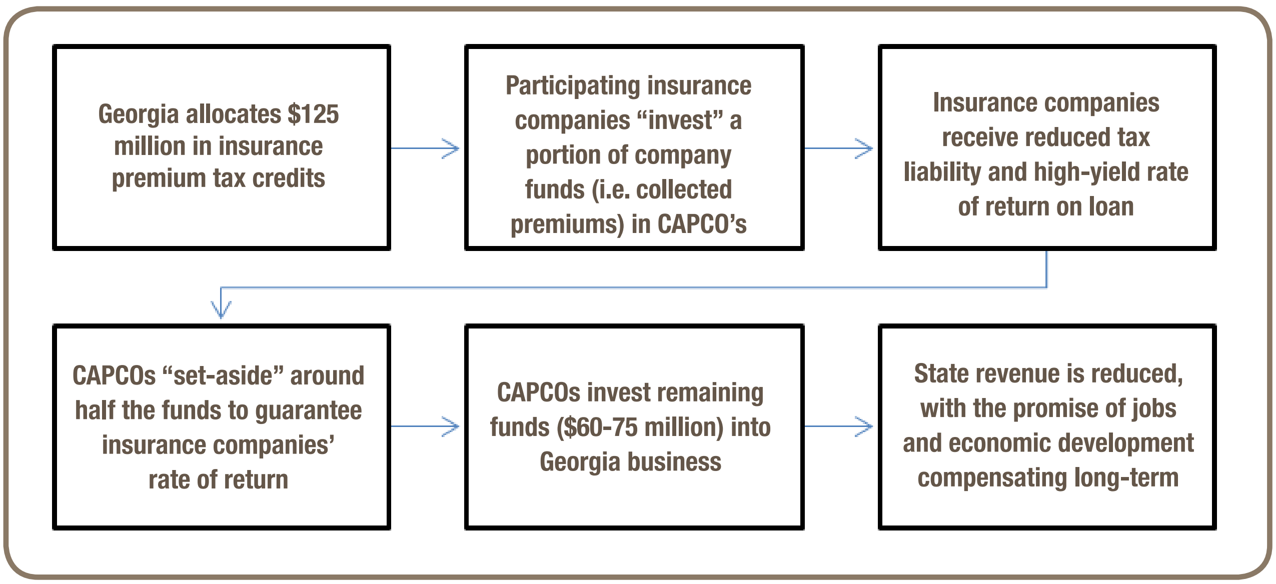
On the last day of session in 2011 the Georgia House substituted language into Senate Bill 203 creating a $125 million "CAPCO" program. The revised bill had to return to the Senate for final passage, but it stalled before becoming law. However a version of the proposal, sometimes referred to as the "Georgia Small Business Investment Company Act," is likely to return in the 2012 session.

The proposal currently on the table is actually Georgia's second bout with the CAPCO model. In 2002 a $75 million version was passed with a start date of 2005, but it was repealed before going into effect by legislation in 2004.

companies to “invest” in certified capital companies. Although the technical mechanics are somewhat different, this can be thought of as the insurance companies “buying” the tax credits from the CAPCOs;

- The insurance companies’ “investments” in CAPCOs are essentially complex loans that provide them with a fixed-income, high-yield return above market rates;
- CAPCO companies then divert approximately half of that loan into safe investments, usually U.S. Treasury notes, which guarantee the insurance companies will receive their return. If Georgia were to create a $125 million program, this “set aside” would mean that only $60-75 million would remain available for actual business investment.
- CAPCO companies invest the remaining funds into qualified businesses in the state;
- Some states have required CAPCOs to return 10-20 percent of profits to the state, but as currently written, the proposed bill in Georgia would let CAPCO companies keep all the profits themselves. The state would only receive the indirect returns of job creation and economic development, which have proven in other states to be minimal; and
- Once all capital is invested, CAPCOs decertify from the program and recoup 100 percent of the original principal, plus 80-100 percent of the profits for their partners, managers and shareholders. This level of compensation is in stark contrast to standard venture capitalists, who not only have to return the original investor’s principal but also hand over approximately 80 percent of the profits.

Figure 2 **Proposed CAPCO Program in Georgia**



Why CAPCO is Bad Public Policy

CAPCO advocates have developed a well-honed set of talking points to demonstrate the program’s supposed success, but the bulk of evidence indicates CAPCO is a flawed and ineffective program.

Several States Have Documented CAPCO’s Poor Performance

The reality is that a broad consensus of academics, agency officials, journalists and informed policymakers has found CAPCOs to be an ineffective and inefficient use of taxpayer dollars. While it is true that nine states currently have CAPCO programs, the scheme has been rejected by at least a dozen other states in all parts of the country, including Nevada, Vermont, Iowa, and both Carolinas.[20] Several additional states that previously experimented with CAPCOs, such as Colorado, Florida and most recently Wisconsin, have changed course with bipartisan support to limit or eliminate the programs later on.

In the first state to adopt the program, Louisiana, a state-sanctioned report in 2000 described CAPCOs as "expensive and inefficient" and found that while the state had awarded more than $600 million in CAPCO credits since its inception, there had been only $180 million in CAPCO-related investments. Mike Williams of the Louisiana Department of Economic Development told a reporter investigating the program, "If you're going to set up something, look at what we did and do the exact opposite."[21]

In Missouri, the $140 million CAPCO program established in 1996 was panned by a 2004 audit as an "inefficient and ineffective tax credit program." The report projected that the program would create only 293 jobs in 15 years and generate only $23.6 million in state revenue, a loss of more than $100 million to taxpayers over the life of the program.[22]

Colorado enacted a $200 million CAPCO program in 2002, but lawmakers were so displeased that they withheld the second round of tax credits two years later.[23] A legislative audit noted that "CAPCO programs are a most inefficient means for the state to raise venture capital" and questioned whether any jobs created were attributable solely to the CAPCO program.The state's governor strongly opposed extending the program – proclaiming in his annual 'state of the state' address that "what separates us from the CAPCO advocates is that we want economic development….we can't mend this program; we must end this program."[24] Meanwhile, the state's treasurer said, "Colorado went down the wrong path when they adopted the CAPCO program. This is a textbook case on what not to do with economic development."[25]

What Experts Say About CAPCOs

"CAPCOs don't much resemble typical venture-capital deals in which investors pouring large sums of money into risky startup companies expect to be highly rewarded. With CAPCOs, the state is taking on nearly all of the risk in exchange for little, if any, of the financial rewards. In fact, states are not really 'investing' their money at all. They are essentially handing it over to the CAPCOs, which, after fulfilling their obligations, are free to keep the remainder." – *"Risky Ventures," Governing Magazine, 2004*

"Certified Capital Companies or CAPCOs are identified as by far the most expensive model to facilitate the formation of venture capital." –*National Association of Seed and Venture Funds (NASVF)*

"The programs have important disadvantages for policymakers to consider. The principal disadvantage of CAPCOs relative to alternative state-assisted programs is the cost to the state treasury resulting from (a) losses of future tax revenues and (b) little to no return to the state from CAPCO profits." – *"CAPCOs Strengths and Shortcomings…" Economic Development Quarterly*

"The overriding incentive for the CAPCOs is not to make the kind of high quality equity investments that have enabled normal venture capitalists to help grow local economies. The incentive for the CAPCOs is to lend or invest the taxpayers' dollars as quickly as possible, so that the CAPCOs can decertify and keep those dollars as profits." – *Dr. Julia Sass Rubin, Rutgers University*

The most recent state to reject CAPCO was Wisconsin in 2011. There, CAPCO supporters were trying to revive a scaled-up version[26] of a similar program Wisconsin had created in 1997, which allocated $50 million in tax credits beginning in 1999. A bipartisan group of state legislators blocked that program's extension in 2004, and a 2006 state audit found that only 316 jobs had been created through the $26 million invested by participating CAPCOs.[27] Neighboring Minnesota, interested in expanding its own pool of venture capital, commissioned a study in 2010 that analyzed the Wisconsin program, among others. It concluded that "the Wisconsin CAPCO credit had little or no effect, likely displacing venture capital financing that would have otherwise occurred."[28] The ultimately-unsuccessful 2011 effort proved highly controversial, with Wisconsin's state technology council and its leading newspaper coming out in opposition.[29]

CAPCO's Impact on Job Creation is Negligible

The arguments used by CAPCO proponents to illustrate job creation are based on unreliable and misleading evidence. For one, reports that show CAPCO's "success" are typically based on self-reported numbers from the CAPCOs themselves.[30]

In some states these self-reported numbers have been the basis for industry-generated reports that estimate CAPCO's economic impacts without verifying the underlying job numbers themselves.[31] In response to one such industry report, the Colorado Department of Economic Development said, "[we] reviewed the report and found it to be significantly flawed…It is important to note that [the report] relies on information primarily provided by CAPCOs, trade associations supporting CAPCOs, or obscure and unpublished studies."[32]

CAPCO Rejected in Wisconsin in 2011

"[CAPCO would be] the largest special-interest Wisconsin tax cut in history masquerading as an economic development initiative." – *Thomas Hefty, retired CEO, Blue Cross Blue Shield of Wisconsin*

"The [previous] Wisconsin CAPCO credit had little or no effect, likely displacing venture capital financing that would have otherwise occurred." – *Minnesota state report*

"Three other out-of-state firms have spent more than 650 hours and $150,000 trying to persuade lawmakers to make CAPCOs part of the new venture capital plan." – *Milwaukee Journal Sentinel*

Central to the CAPCOs' arguments on job creation is a creative measure deemed "retained" jobs, meaning the number of jobs the investment supposedly "preserved" from being lost. However this is a dubious measurement that CAPCOs use to inflate their impact. For example, in New York, CAPCO proponents argued that $120 million worth of capital raised in only two years (2004-05) resulted in 2,573 jobs either created or retained. Yet this sharply contrasted with a 2007 state audit, which found that the $400 million invested through the entire length of the program (starting in 1997) had created only 1,059 jobs—an average of $377,715 per job created.[33]

A similar discrepancy can be found in Florida, which originally passed CAPCO legislation in 1998, allocating $150 million. A subsequent CAPCO-friendly report claimed those funds created or retained 875 jobs[34], whereas a 2005 state report found that Florida had lost nearly 180 jobs in the first four years of the program.[35] According to a 2007 state report, the most current available, Florida's remaining version of the program had created a net gain of 20 jobs in the nine years it had been in effect.[36]

CAPCO Reduces State Revenue

CAPCO advocates have sometimes asserted that states will recover the lost revenue through long-term economic growth and job creation, but there is simply no reliable evidence to support this claim. One of the first adopters of CAPCO legislation, Missouri, directly refuted this claim in a 2004 state audit: "The CAPCO program will use $140 million in tax credits while only generating $23.6 million in projected revenues and creating an average projected 293 jobs for 15 years. This results in a net reduction in state revenue of $116.4 million over the life of the program," and an average cost of nearly $480,000 per job created.[37]

A similar claim is that CAPCOs are the only way to attract additional "follow-on" capital from other investors (thus providing further fuel for companies to grow). However the aforementioned Missouri audit strongly rejected this argument: "Proponents of the CAPCO program often point out the 'leverage effect' of the CAPCO investments…[but] we have been unable to identify any direct link between the CAPCO investments and any concurrent or subsequent investments by other entities." An example here is useful: in Washington, D.C., CAPCO advocates pointed to Gridpoint, Inc., a company specializing in renewable energy, as showing "the value of CAPCO financing."[38] As a startup, the company had raised a total $9 million from several local investors, including one CAPCO company[39], which it leveraged to eventually raise $220 million overall. However only $600,000 – or 7 percent of the original $9 million – came from the CAPCO company. It is a considerable stretch to believe this was the central driver of all subsequent investments.

The CAPCO Model Has Not Improved Upon Earlier Flaws

One common claim of CAPCO proponents is that the program has learned from its earlier mistakes and has been perfected in newer adopters like Texas and Alabama. However, a study authored by professors from Clemson, Harvard and the University of North Carolina noted that "most changes in CAPCO programs over time are little more than fine-tuning a generic model. The CAPCO industry (i.e., established CAPCOs) is aggressively involved in state legislation to ensure that the basic program design is preserved."[40] Another expert who has studied the program since its inception put it this way: "what cannot be fixed…are the fundamental structural flaws of the program, which make it a very, very poor deal for…taxpayers."[41]

Interestingly, even in Texas – the supposed model of CAPCO success – there appears to be a cooling toward the program. That state allocated $200 million to CAPCO starting in 2006 but recently decided not to extend the program past 2015, when it is scheduled to expire. A recent effort there to add another $200 million to the program stalled after the lieutenant governor raised concerns, specifically regarding CAPCO's "[poor] return on investment for Texas taxpayers."[42]

CAPCO Does Not Target High-tech Startups or Encourage Innovation

Georgia needs to expand its innovation sector, but CAPCOs do not prioritize technology-based companies the way normal venture capitalists do. Unlike standard venture funds, CAPCOs lack the incentive to profit from their investments because their profit comes directly from the state's allocation of tax credits. The CAPCO companies receive this return regardless of whether their investments are successful, whereas legitimate venture capitalists only profit if their investments succeed.

Since CAPCOs' primary incentive is to simply meet the bare requirements of the law (so they can "decertify" and pay out profits), they typically select the safest investments available to them. This means they rarely take the type of "technology risk" that is central to normal venture capital and that helps fuel the growth of innovative companies. An illustration of this investment philosophy can be found in an annual report from one of the country's leading CAPCO companies: "(The firm) has made over 30 investments across funds. It is generally *industry agnostic*, investing in sectors including: consumer, technology, business services, financial services, healthcare, telecom, industrials, oil and gas, hospitality, and entertainment."[43] (emphasis added)

CAPCO Companies Do Not Actually "Invest" the Full Amount Called for by Legislation

The complicated mechanics of the CAPCO model can create confusion as to how much money will actually be available for small business investments. After a CAPCO program is created and CAPCO funds raise their "certified capital," approximately half of the original funds are diverted into fees and safe investments (typically U.S. Treasury notes), in order to cover the CAPCOs operating costs while also meeting the guaranteed rate of return to insurance company lenders.

If Georgia were to create a $125 million program, this would leave only about $60-75 million for real business investment. Yet to satisfy the law, CAPCOs must collectively "invest" the full dollar amount called for by legislation. In other words, CAPCOs would need to allocate $60-75 million in a way that would allow them to report $125 million worth of "investments" to state regulators.

How is this possible? CAPCOs accomplish the feat by "churning" investments – a repeating cycle of loan, harvest, loan, harvest – which enables them to recapture short-term investments and then turn them into new capital. Here is how a 2007 annual report from one CAPCO company describes it: "As each CAPCO receives repayment of debt plus interest, as well as return of and on equity investments, it is able to reinvest the funds in other qualified businesses, which in some states may be its affiliated companies or others. It is through this 'investment-return-and-reinvestment' process that our CAPCOs are able to meet the minimum investment requirements of the CAPCO programs."[44] This process differs starkly from legitimate venture capital activities, where fund managers make long-term, "patient" investments dependent on the companies' future success.[45]

CAPCO is Not the Only Available Model for States Looking to Expand Access to Capital

Despite the assertions of some CAPCO advocates, there are several possible alternatives to explore. States such as North Carolina and Florida have created various types of "innovation funds" to support their technology sectors, while Maryland recently created a program explicitly devoted to venture capital. The following section will explore some key principles of venture capital policy for Georgia lawmakers to consider.

Figure 3 CAPCOs vs. Standard Venture Capital

	Standard VC	CAPCO
Source of Funds	Wealthy individuals, pension funds and corporations	Taxpayers, via state government and insurance companies
Targeted Companies	Early stage, high-risk, high-potential startups; most often in technology industries	Low-risk, larger, later stage; companies chosen in "industry agnostic" fashion
$ Kept as Private Profit	20% of investment profits	100% of principal (i.e. full value of tax credits) plus 80-100% of investment profits
$ Returned to Investor(s)	100% of original principal plus 80% of profits	0 - 20% of profits

Exploring Venture Capital Alternatives

If state policymakers choose to develop an alternative to CAPCO, here are some useful guiding principles to consider:[46]

1. **Funds must be invested in the most efficient and cost-effective way possible** – State legislators have a fiduciary responsibility to invest taxpayer dollars in a way that maximizes the "bang for their buck." This means that states should seek the same financial returns as a normal venture capital investor (100 percent of the principal plus 80 percent of the profits); should minimize the amount of funds "set aside" for administrative purposes; and should require measurable returns in job creation and economic development. With the CAPCO model, states lose the entire principal plus 80-100 percent of the profits while also having 40-60 percent of funds diverted to fees and debt service rather than investment in state businesses. In contrast, Maryland has developed a model that still uses tax credits but employs them in a far more efficient manner—specifically by auctioning the credits directly to insurance companies, thereby cutting out the CAPCO middleman.

2. **State funds should not be used to subsidize competition in existing markets –** The core purpose of state venture capital policy is to "prime the pump" by creating a functioning market for venture capitalists where one does not currently exist. It is not to subsidize companies that provide similar functions as standard banks, namely loaning to larger, established firms in traditional industries. CAPCO programs violate this principle because they generally invest in relatively-large later-stage companies (essentially providing loans in a similar manner as banks), rather than funding the type of riskier, early stage companies prioritized by real venture capital.

3. **State programs should prioritize competition, transparency and accountability–**Whenever the state is directing taxpayer money to private business enterprises, there must be safeguards in place to guarantee the funds are used effectively and ethically. This means that states must ensure politics are taken out of the process and that the

program as a whole can be objectively evaluated by outside observers. Accomplishing this goal requires any state program to be managed by a professional third party – such as a public-private partnership like the Maryland Venture Fund Authority or perhaps the Georgia Research Alliance – rather than by elected officials or unaccountable private companies. It is also important for state programs to be run by competent, professional fund managers with a proven track record of sound investments in the private sector; obstacles to this requirement, such as excessively low ceilings on compensation or lax requirements on experience, should be avoided.

4. **Public venture capital programs must articulate clear benchmarks for determining final success –** State venture capital programs are not intended to be permanent fixtures but rather short-term initiatives that create a self-sustaining ecosystem for private sector activity. In other words, the goal of the state should be to catalyze the venture capital industry and then get "out of the business" as soon as possible. This means that state programs must create measurable end goals, such as a certain number of successful private sector funds or a certain percentage of national VC activity, which signal when the program should end. The basis of this idea is the fact that current hubs for venture investing, such as California and Massachusetts, do not need or have VC programs—the private sector there is effectively operating on its own. The goal of any new program should be to reach a similar point.

5. **Programs must be long-term in scope –** State policymakers should clearly understand that venture capital bills are not jobs bills. Evidence clearly shows that CAPCOs are ineffective at stimulating new jobs, but even an "ideal" venture capital program would not be designed to boost job creation short-term. Venture capital policy is about helping stimulate an important component of the private market so that it can serve and strengthen a state's economy over several decades. As one report put it, "Policymakers should expect no measurable impact for at least five years and do nothing to compromise the integrity of the investment process. Many states have taken shortcuts, only to be embarrassed."[47] If Georgia's leaders intend to create a new venture fund program, they must be clear that it is aimed at strengthening the state's economy of the future, not creating jobs today.

Best Practice: InvestMaryland

In 2011, lawmakers in Maryland concerned about a venture capital shortage rejected the CAPCO model and developed an alternative program designed to maximize the state's return on investment, create a true public-private partnership and incentivize real venture capital—InvestMaryland. Managed by the Maryland Venture Fund Authority, a nine-member board drawing from both the public and private sectors, InvestMaryland is a $70 million program.

The initiative creates new credits in the insurance premium tax as do CAPCO programs, but it leverages them to create new investment capital far more efficiently. Specifically, the Venture Fund Authority auctions the credits to insurance companies directly, rather than giving them away to CAPCOs and relying on their complicated internal mechanics. This process ensures (by law) that the state fund will receive at least $0.70 of capital on the dollar in exchange for the credits, in contrast to CAPCOs which retain as little $0.40 on the dollar. Two-thirds of the capital generated by the fund is provided to in-state venture capitalists for standard VC investment, while the other third is directly invested by the state fund—allowing for investment in high-potential areas not yet served by the private market.

InvestMaryland also includes requirements for third party review of the entire process, as well as annual public reports. Lastly and perhaps most importantly, the program returns 100 percent of Maryland's original investment to taxpayers, along with 80 percent of the profits. This is in glaring contrast to CAPCO programs, where virtually all of the funds are retained by participating CAPCO companies.

Conclusion and Recommendations

The fundamentally-flawed CAPCO model should be firmly rejected as a tool for strengthening Georgia's venture capital market. When lawmakers return in January, members should immediately move to reject or revise Senate Bill 203 – sometimes referred to as the Georgia Small Business Investment Company Act – which passed the House in 2011 and would turn CAPCOs into law if passed by the Senate.

Additionally, since CAPCOs have developed a reputation in other states for attaching themselves to legislation at the last minute (as occurred in Georgia last year), legislators should vigilantly ensure that any alternative bills with CAPCO language are similarly rejected or revised. The broader discussion of whether (and how) taxpayer dollars should be used to strengthen the venture capital industry should be completely decoupled from CAPCO, in order to allow for a good-faith conversation of (a) whether a program is needed at all and (b) what form that program should take.

Addressing the state's shortage of venture capital in a fiscally-responsible manner could be an important component in strengthening Georgia's economy. It could remove current hurdles for tech-based startups in the state and strengthen our "innovation sector," which would have positive benefits on job creation and economic health long-term. Having said that, state leaders must exercise extreme caution when trying to address this issue. State funds today are stretched exceedingly thin and core areas of the state's budget – such as education and public safety – have been enduring deep cuts for years. Allocating Georgia's scarce resources to a poorly-thought-out or inefficient program would do more harm than good. It would further divert funding from areas critical to our economic health, while receiving little or no benefit in return.

If state leaders are intent on creating a new venture fund, then they should tailor a program to Georgia's specific needs – perhaps looking to InvestMaryland for guidance – rather than embracing any prepackaged "model" solution. Such a program should deploy taxpayer dollars efficiently and responsibly; prioritize investment in underserved startup companies; ensure accountability, transparency and measurable impact; and articulate long-term measures for success. A useful asset for developing such an alternative may be the state's Science and Technology Strategic Initiative Joint Study Commission, which was created in 2011 by Senate Resolution 68. Comprised of public officials and private sector leaders, the nonpartisan commission was charged with inventorying Georgia's current assets in science and technology, identifying best practices from policies around the nation, and making recommendations for appropriate state action. Venture capital has been one of several areas examined by the commission, and initial reports suggest the commission may propose some version of a (non-CAPCO) state venture fund.[48] If such a proposal embraces the best practices discussed here, legislators should closely examine it as a possible alternative to CAPCO.

APPENDIX A: DETAILED DESCRIPTION OF CAPCO MECHANICS

There are three parties to a CAPCO program's complicated process:

1. **State government –** The state provides insurance premium tax credits ($125 million in the Georgia proposal) that insurance companies participating in CAPCO can claim at a percentage of their value for a certain number of years. For example, the Georgia proposal would allow participating insurance companies to claim 20 percent of their credits' full value for five years beginning in 2014. This means that if an insurance company "invests" $25 million in CAPCOs, it could then claim $5 million in credits each year for 2014-18. The end-loss in state revenue would be close to $125 million.

2. **Insurance companies –** Responding to the incentive of tax credits, participating insurance companies collectively "invest" the statutory amount ($125 million in Georgia) in the CAPCO companies. However, the transaction between insurance companies and CAPCOs is considerably different than a simple cash payment; it involves a complicated financial instrument that is unique to the CAPCO process. While the precise nature of the instrument can differ between firms, what essentially happens is that participating insurance companies serve as lenders (rather than "investors") that receive a guaranteed rate of return in exchange for providing a kind of multipart loan. There are two key aspects to this transaction that are vital to understand:
   a. First, nearly 50 percent of the loaned funds are placed into a "set aside" escrow account, typically conservatively invested in U.S. Treasury notes, which is used to pay back the insurance companies. If Georgia were to create a $125 million program, this "set aside" would mean that only $60-75 million of the state's allocation would actually remain available for business investment.
   b. Second, CAPCOs must purchase an expensive insurance product that guarantees they will follow the rules of the program, thus ensuring that participating insurance companies will receive their credits. This results in the insurance companies receiving a fixed income, low-risk, high-yield investment with a guaranteed rate of return that exceeds market standards.

3. **Certified capital companies (CAPCOs) –** CAPCO funds assume the dual responsibility of managing the insurance companies' loan and making the amount of investments ($125 million in Georgia) they are required to report to state officials. Once an individual CAPCO company has lent out all of the funds, it "decertifies" from the program and becomes free to pay out profits to its internal stakeholders. Provided the CAPCOs follow the rules, they are entitled to retain nearly all of the fund's value—both the state's original principal and 80-100 percent of profits. This level of compensation is in stark contrast to standard venture capitalists, which not only have to return the original investor's principal but also hand over approximately 80 percent of the profits.

End Notes

[1]Claire McCaskill, "Missouri State Auditor, Review of State Tax Credits Administered by the Department of Economic Development," July 2, 2004.
[2]"Capital Subsidy Bill Raked - $75 million deal 'scam,' says Colorado critic," Milwaukee Journal Sentinel. 12/23/03.
[3]Dr. Julia Sass Rubin quoted in: "Georgia Jobs Plan Slammed as a Waste," Atlanta Journal Constitution. 10/23/11.
[4]"Capital Subsidy Bill Raked - $75 million deal 'scam,' says Colorado critic," Milwaukee Journal Sentinel. 12/23/03.
[5]Venture Impact: The Economic Importance of Venture Backed Companies to the U.S. Economy. National Venture Capital Association. 2011.
[6]Ibid.
[7]PrivCo: The Private Company Financial Data Authority. Private Equity and Venture Capital.
[8]Lerner, Josh. "Geography, Venture Capital and Public Policy," Harvard Kennedy School Policy Briefs." March 2010.
[9]Heard, Robert and Sibert, John. "Growing New Businesses with Seed and Venture Capital: State Experiences and Options," National Governors Association. April 2000.
[10]"Key Findings," 2011 State of the Industry: Technology in Georgia. Technology Association of Georgia (TAG).
[11]"Deal may let pension funds be invested in VC," Atlanta Business Chronicle. 9/16/2011.
[12]"Sustainable High-Tech Clusters in Georgia," 2/24/10. Article describes original Georgia Tech report cited here: Breznitz, Dan and Taylor, Mollie, The Communal Roots of Entrepreneurial-Technological Growth? Social Fragmentation and the Economic Stagnation of Atlanta's Technology Cluster.10/2/ 2009.
[13]PricewaterhouseCoopers Moneytree Report, Historical Trend Data (state searches available at bottom of page);
[14]PricewaterhouseCoopers Moneytree Report, Investments by Region
[15]"CAPCO Program: Idea that's for the birds," Atlanta Journal Constitution. 12/16/2011.
[16]"Risky Ventures," Christopher Swope. 4/2004. Mr. Swope describes the history of CAPCO as follows: "The states' boilerplate laws, crafted by CAPCO lobbyists, subtly favor a few established national players who have been around since the early days in Louisiana. Not coincidentally, they are the same players who are lobbying legislatures the hardest."
[17]Dr. Julia Sass Rubin, Rutgers University.Testimony on the Washington, DC CAPCO program.
[18]"Certified Capital Companies Lobby Heavily for Venture Capital Bill," Milwaukee Journal Sentinel.
[19]The description of CAPCO's internal mechanics has been amassed from several different sources, many of them cited elsewhere. Two additional resources are: (1) Cooper, Chip; Barkley, David; and Williams; Mike. Understanding CAPCOs, National Association of Seed and Venture Funds (NASVF). 10/2001. (2) Barkley, David; Markley, Deborah and Rubin, Julia Sass. Certified Capital Companies (CAPCOs): Strengths and Shortcomings of Latest Wave in State-Assisted Venture Capital Programs. Economic Development Quarterly, Vol. 15 No. 4, 11/2001.
[20]Dr. Julia Sass Rubin, Rutgers University.Testimony on the Washington, DC CAPCO program.
[21]State Science & Technology Institute. Weekly Digest. 2004.
[22]Claire McCaskill, Missouri State Auditor, Review of State Tax Credits Administered by the Department of Economic Development," July 2, 2004.
[23]"Colorado CAPCO Demise Leads to Questions for Other States," State Science & Technology Institute. 3/15/04.
[24]Governor Bill Owens, State of the State Address, January 8, 2004.
[25]"Gov. Owens: Colorado CAPCO law must change," Rocky Mountain News. 8/27/03.
[26]Wisconsin's 2011 proposal – pushed by their governor as part of a broader "jobs bill" – would have created $200 million in new tax credits for CAPCO companies.
[27]State Economic Development Programs: A Review, Wisconsin Joint Legislative Audit Committee. 8/2006.
[28]Tax Incentives and Venture Capital Financing. Minnesota House Research Department. 2/9/2010.
[29]Wisconsin's recent CAPCO debate was well chronicled by the Milwaukee Journal Sentinel. Some useful articles can be found here, here, here and here.
[30]In one case, a CAPCO reported to Texas officials that a $500 investment had resulted in 54 jobs, which comes out to less than ten dollars per job. "Georgia Jobs Plan Slammed as a Waste," Atlanta Journal Constitution. 10/23/11.
[31]One example of such reports is "The Certified Capital Company Program: A White Paper Review," which was authored by an international consulting company providing ""economic development advisory services to state and local governments" and "services to assist in every facet of a relocation or expansion project." Another example was a report compiled on the Wisconsin CAPCO program by a university economist, who utilized data "contributed by two of the three CAPCOs" as opposed to independent analyses similar to various states' audit reports.
[32]Office of Economic Development's Response to "The Colorado CAPCO Program: An Analysis" by The Adams Group, Inc. 1/21/04.
[33]Due Diligence Report: Tennessee Small Business Investment Company Credit Act. Tennessee Technology Development Corporation. 5/4/2009. pg. 27
[34]The Colorado CAPCO Program: An Analysis. The Adams Group. 1/21/2004.
[35]"Nothing Ventured, Millions Gained." Palm Beach Post. 5/30/03.
[36]Dr. Julia Sass Rubin, Rutgers University.Testimony on the Washington, DC CAPCO program.
[37]Claire McCaskill, Missouri State Auditor, Review of State Tax Credits Administered by the Department of Economic Development," July 2, 2004.
[38]"CAPCO advocates respond to criticism," Washington Business Journal. 3/27/2009.
[39]Due Diligence Report: Tennessee Small Business Investment Company Credit Act. Tennessee Technology Development Corporation. 5/4/2009. p. 25
[40]David L. Barkley, Deborah M. Markley and Julia Sass Rubin. "Certified Capital Companies (CAPCOs): Strengths and Shortcomings of the Latest Wave in State-Assisted Venture Capital Programs," Economic Development Quarterly 2001; 15; 350.
[41]Dr. Julia Sass Rubin, Rutgers University.Testimony on the Washington, DC CAPCO program.
[42]"Georgia Jobs Plan Slammed as a Waste," Atlanta Journal Constitution. 10/23/11.
[43]Due Diligence Report: Tennessee Small Business Investment Company Credit Act. Tennessee Technology Development Corporation. 5/4/2009. p. 21
[44]2007 Newtek 10-k, p. 13
[45]Due Diligence Report: Tennessee Small Business Investment Company Credit Act. Tennessee Technology Development Corporation. 5/4/2009.
[46]Description of guiding principles for venture capital policy primarily compiled from the following sources, as well as by informal conversations with a small sample of industry leaders: (1) Heard, Robert and Sibert, John. "Growing New Businesses with Seed and Venture Capital: State Experiences

and Options," National Governors Association. April 2000. (2) Lerner, Josh. "Geography, Venture Capital and Public Policy," Harvard Kennedy School Policy Briefs. March 2010. (3) Cromwell, Eric and Schmisseur, Dan. "Smart State-Sponsored Venture Capital Programs for Economic Development Outcomes." Center for State Innovation.2011. (4) "Smart Venture Capital Programs: Smart Public Policy for State Economic Development," Center for State Innovation. 2011. (5) Schmisseur, Dan and Overmoyer, Rich."Texas Venture Capital Programs: Recommendations for Taxpayer Profits and Improved Accountability," Texas Business Review. 10/2010.

[47]Heard, Robert and Sibert, John. "Growing New Businesses with Seed and Venture Capital: State Experiences and Options," National Governors Association. April 2000.

[48]Initial details of the proposal were described in the following news article, as well as in a meeting of the 'Capital Funding Subcommittee' attended by the report's author on November 8, 2011. "State may create $200 million venture fund," Atlanta Business Chronicle. 11/18/2011.