

CAPCO Study

Prepared For

**Louisiana Department
of Economic Development**

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Executive Summary

Every public program involves the use of public resources to accomplish a task that, for some reason, is not being accomplished by the private economy or, at least, is judged to not being accomplished by the private economy. One such program in Louisiana is the use of tax credits to encourage the development of a venture capital pool in the state in order to provide sufficient financing for start-up companies, companies with expanding marketplaces, seed capital for companies with new ideas, and other such companies that may have a great future, but just cannot get sufficient financing from traditional sources of capital. Every such public program, however, needs to be evaluated from time to time to determine if the stated objectives of the public program are being achieved, to ascertain the public costs of accomplishing the objectives relative to the economic benefits associated with accomplishing these objectives, and to determine if the public program is needed any longer even if the objectives are being accomplished. This study provides an economic evaluation of a program passed in 1983 and amended several times since then to attract venture capital to Louisiana by the use of insurance premium tax credits and personal and corporate income tax credits. This evaluation is based on calendar year information, unless specifically noted as fiscal year.

Objectives and Contents of the Study

The objective of this report is to provide an evaluation of the CAPCO program, given that major tax credits were and are used as a mechanism of attracting venture capital to Louisiana with the anticipated results being that new jobs would be created in Louisiana, and these are jobs that, otherwise, would not have been created if the CAPCO program did not exist. The CAPCO program is a public program with a cost to the State's Treasury. The focus of the report then is on considering the costs of the program to the State as they relate to the benefits accruing from the investments generated by the CAPCO program, as well as the characteristics of the Program that could be improved. A view forward at the long-term outlook for the program is also provided.

The report contains sections that address the following components of the evaluation:

1. a brief review of the history of venture capital in Louisiana;
2. a comparison of Louisiana with other states pertaining to venture capital markets in general;
3. a complete survey of the development of the CAPCO program in Louisiana from 1983 through the present, including the changes to the laws and regulations relating to the program;

4. a summary of the development of CAPCOs in Louisiana with the focus on the number of CAPCOs created, the diversity of these certified capital companies, the size of the companies, and the investment strategies of each CAPCO;
5. a survey of similarities and differences of the Louisiana approach with New York, Florida, Wisconsin, and Missouri, four states that have patterned venture capital programs after the Louisiana model;
6. a computation of the funds raised for investments in qualified businesses from the insurance premium tax credit and the personal and corporate income tax credit;
7. an assessment of the ability of the program to raise venture capital funds in Louisiana;
8. the specific activity of the certified capital companies including how they attracted investment capital and how they used this investment capital with this information being obtained from information from the Louisiana Department of Economic Development or the appropriate agency and from interviews with the certified capital companies;
9. a qualitative evaluation of the features and characteristics of the Program; and
10. a quantitative evaluation of the outcome of the CAPCO program based on an appropriate accounting of tax credits granted by the state in order to attract investment monies, a complete tabulation of the business activity, jobs, and payroll associated with companies that have received start-up funds from a certified capital company in Louisiana, and an estimate of the spillover of the economic activity of these companies to the rest of the Louisiana economy.

Conclusions and Recommendations

We have developed a number of conclusions regarding the CAPCO Program which, in turn, have given rise to several recommendations for consideration in any extension or evolution of the Program. These conclusions and recommendations were developed from the information presented throughout the report and are restated in the section of the report so titled.

Conclusions

1. The CAPCO Program has enabled private venture capital management firms and BIDCOs in Louisiana to raise over \$517 million from 1988 to 1998 and a projected \$166 million in 1999 and 2000 for an estimated grand total of \$683 million. In 1998 alone the CAPCOs in Louisiana raised \$229 million in certified capital, an amount that exceeded the venture capital raised in states such as Michigan and Ohio, as reported by PriceWaterhouseCoopers, and placed Louisiana as the 17th state in the country in terms of venture capital raised.
2. The CAPCO Program has encouraged and facilitated the development of private venture capital management firms in Louisiana. Presently, there are seventeen

distinct management firms in the CAPCO Program, seven of which began their involvement in 1999. In the early 1980s Louisiana had no discernible venture capital industry, while states such as California, Massachusetts, and New York had 22, 24, and 30 venture capital firms respectively. Additionally, very little identifiable venture capital has been raised in Louisiana outside of the CAPCO Program, which suggests that, without the Program, relatively little venture capital would be available in Louisiana. In fact, the program is now functioning in states such as Florida, Missouri, New York, and Wisconsin and is being seriously considered in Arizona, Iowa, North Carolina, and Texas.

3. Because of the way the Program is currently used, and the lack of capital commitment or formation activity by the most active CAPCOs outside of the Program, permanent discontinuance of the Program, in any form, would leave the CAPCOs without a method for raising additional capital that they have used successfully.

4. The State of Louisiana has granted or is obligated to provide \$610 million in tax credits during the period of 1988 through 2009. The obligations for tax credits already incurred by the State, by fiscal year, are approximately as follows:

Fiscal Year	Tax Credit Obligation
2000	\$61.5 million
2001	\$64.0 million
2002	\$63.3 million
2003	\$61.3 million
2004	\$53.1 million
2005	\$42.3 million
2006	\$37.8 million
2007	\$22.0 million
2008	\$16.0 million
2009	\$ 8.0 million

5. An economic analysis of the CAPCO program from 1988 to 1998 suggests that the 1999 value of all tax credits generated and used or generated and to be used no later than the year 2007 amounts to \$405.4 million, while the 1999 value of estimated tax revenues from 1988 to 2010 associated with the business activity and jobs related to the qualified Louisiana investments is \$1,206 million. The underlying assumptions are the average growth of business activity over the past five years of 29.1 percent per year and 100 percent of all gross receipts being related to the CAPCO financing.

6. The calculation of the 1999 value of the tax benefits associated with the additional business activity related to the CAPCO financing depends on the projected growth of gross receipts of the qualified Louisiana businesses and the fraction of the gross receipts of these Louisiana businesses that can be related to the CAPCO financing. A projected growth rate of 29.1 percent (the average for the last five years) and a 22 percent fraction of gross receipts related to CAPCO financing (based on a sample of financing relationships and the assumption that the other financing would have been available without the CAPCO investment) provide a 1999 estimate of the value of the tax benefits associated with the CAPCO program of \$265.5 million for the time period from 1988 through 2010. The tax benefits will continue to grow after 2010 while the cost of the tax credits will not exceed the \$405.4 million.

7. The CAPCO Program, in its current form, is expensive and inefficient to the State. Louisiana CAPCOs have been able to raise money from national insurance companies primarily by offering an investment-grade financial instrument that is guaranteed by the tax credit and collateralized security. As an example, to raise \$25 million it is estimated that the CAPCO must use \$10 million to collateralize the financial security and about \$1 million to cover financing and related costs. Of the \$25 million raised by the CAPCO from the insurance company, the CAPCO owns approximately \$14 million that it can use for investments in accordance with the rules and regulations pertaining to qualified Louisiana businesses. Accordingly, \$27.5 million in tax credits are generated by a transaction that raises only \$14 million in capital available for investment in qualified businesses. Presumably, if the capital raised by the CAPCOs were in the form of equity, the collateral would not be necessary and an additional \$10 million would be available for investment. It also should be noted that the \$14 million in cash available for investment represents profit to the CAPCO, to be recognized over time, for raising the capital. From 1988 to 1998 the CAPCO Program raised \$517 million of certified capital. During this same time period the CAPCOs have made just over \$149 million in qualified Louisiana investments.

8. The CAPCO Program, in its current form, does not provide adequate features or incentives to encourage investments that offer the greatest potential economic benefit to the State. The current investment mix and investment levels of the CAPCOs suggests that opportunity exists to narrow the investment focus of the Program, and require higher investment levels, although any such initiatives should be carefully considered to avoid unintended consequences.

Recommendations

Louisiana should consider modifications to the program in order to provide a more substantial return to the State from the CAPCO Program. These recommendations include the following:

- For all future allocations of tax credits, the state set limits on the total credits to be granted and the annual credits that will be allowed to be taken. These limits should be based on what amount of credit the State can afford and is willing to invest in the Program. The statutes should allow for the state to control the fiscal consequences of the CAPCOs' activities.

- The investment parameters of the program should be comprehensively reviewed and rewritten to insure that, for tax credits granted, investment focus is on those opportunities determined to be of sufficient potential benefit to the state for inclusion in the Program. Investment parameters should further address issues related to the availability of non-CAPCO financing options to qualified businesses; industry classification; size of business in terms of revenues, assets, and/or personnel; location of the business; stage of development; growth potential; and, any others as determined by a qualified group of policy makers.
- Program performance measures should be established and provisions made for ongoing monitoring and evaluation of the Program's economic performance, as well as regulatory compliance. Financial statements and tax returns of qualified Louisiana businesses; verifiable documentation of jobs and payrolls associated with these businesses; and other such information should be required to be provided to the office responsible for ongoing monitoring and evaluation of the Program, on an annual basis.
- Distributions, related party loans and other business transactions, and other parameters of the Program should be developed, in a comprehensive fashion, to insure that relative benefits inure to participants of the Program as intended. Matters to be considered may include (1) State participation in distributions by a CAPCO, other than "qualified" distributions, that exceed an annual internal rate of return on contributed capital from owners, (2) requiring a higher qualified investment percentage, or even investment multiples, of certified capital in order to decertify without loss of tax credits, (3) allowing only those investments that represent an additional increment of investment over any amount previously invested in a specific business to be counted toward certified capital.

History of Venture Capital in Louisiana

Venture Capital Markets and the Government

Venture capital markets are typically thought to be for the entrepreneur, the risk-taker, the visionary, and the futurist. Venture capital is a private market phenomenon. Government, almost by definition and by design, is not prepared to be a player in the venture capital markets except to make sure that all agreements and contracts are properly honored and to insure that the regulations and rules of society are properly obeyed. New products and services are created in response to a perceived demand from the private sector. A new method of making a product is a response to requests from the private sector to function more cost effectively. The person with the foresight to see what persons will want in the future and be able to deliver it to them will get the reward.

All economic activities require some initial investment to develop the product, to make the first prototype, to enhance the process, and to get the business up and running so that it can create a positive cash flow. This initial investment to help develop the seed, to initiate the start-up, to expand a market, to open up a new market, to alter the production process, or some other phase of starting a business has to be financed. Some persons can use their personal wealth or the personal wealth of his or her family or friends to acquire such funds, while others will have to turn to external financial markets. An industry, the venture capital industry, has developed to provide financing to companies that appear to have the potential to develop into major economic contributors. Venture capitalists generally (1) finance new and rapidly growing companies, (2) purchase equity in the companies in which they are investing, (3) provide management and technical skills, as required, in the development of the products and services or in the operation of the business, (4) interact frequently with the company--that is, be an active participant in the operation of the company, (5) take higher risks but expect higher rewards, and (6) take a long-term orientation.

Venture capital markets are not just individuals looking for ways to get wealthy. Institutional investors, such as insurance companies, can be major sources of capital. These institutional investors have to be tapped. Venture capital markets are pools of funds, organized as a limited partnership or some other business arrangement, that will invest in a number of companies that represent the chance for a high rate of return on the investment. These pools of capital are managed by professional venture capitalists. These professionals become very adept at raising money to be used in these ventures and at selecting the right ventures in which to invest. The market has two sides to it. First, the venture capitalist must be able to raise a pool of money to be invested in enterprises that do not qualify for the traditional capital markets and, secondly, he must be able to make good decisions about companies that did not

qualify for backing from traditional sources of capital such as banks, but which, in his judgment, will be successful.

Louisiana and Venture Capital Markets

A state may not have an active venture capital market because local dollars are just not sufficient to support the types of investments that are typically characterized as venture capital investments or because there are no persons with the expertise to really evaluate the budding investments or some combination of the two. A pool of money must exist or be created in order for a venture capital market to develop, and there must be a pool of professionals who understand how to select a portfolio of companies that, on average, will provide a profitable outcome. In the early 1980s Louisiana did not have either. In 1984 Venture Economics estimated that over \$6.2 billion was raised in the United States and several provinces of Canada for venture capital projects, but Venture Economics showed no discernible amount of funds being raised in Louisiana.¹ For whatever reason, the private market had not generated any significant venture capital market in Louisiana.

Louisiana had ridden the oil and gas expansion in the 1970s. Employment in the oil and gas sector in Louisiana rose from just around 50,000 in the early 1970s to just over 100,000 at the beginning of the 1980s. Local capital went to the oil and gas industries or to industries that serviced the oil and gas industry. The state's economy was dependent on the oil and gas activities, and the state's financial and technical expertise was focused on the oil and gas sector of the economy. This focus is not unexpected given that in the late 1970s and early 1980s the projections for the price of oil was in the \$50 per barrel range with some projections being as high as \$100 per barrel near the end of the 1990s.

Despite these "rosy" oil price projections, at least from Louisiana's perspective, oil prices peaked in 1981. Employment in the oil and gas sector of the economy peaked at just over 100,000 persons in 1981. Oil prices started declining in 1982 and employment in the oil and gas sector also started declining in 1982. An economy that had boomed in the 1970s due to oil and gas was just beginning to experience a bust, also because of the oil and gas sector. Economic development experts and just plain common sense suggested that Louisiana needed to focus on diversification policies--that is, the state had to develop businesses that did not just rely on the natural resources of the state.

Growing new businesses within a state is one way of developing the economic future of the state. These new businesses vary from a creative person starting a business in his or her garage to a college professor creating a potentially commercial product out of fundamental research to someone having an idea that is commercially feasible. All of these businesses may need financial capital to really make their ideas come to life as a business enterprise. However, Louisiana had not developed privately any major sources of venture capital, unless the capital was focused on oil and gas investments. And, there was no indication that such a market would develop in

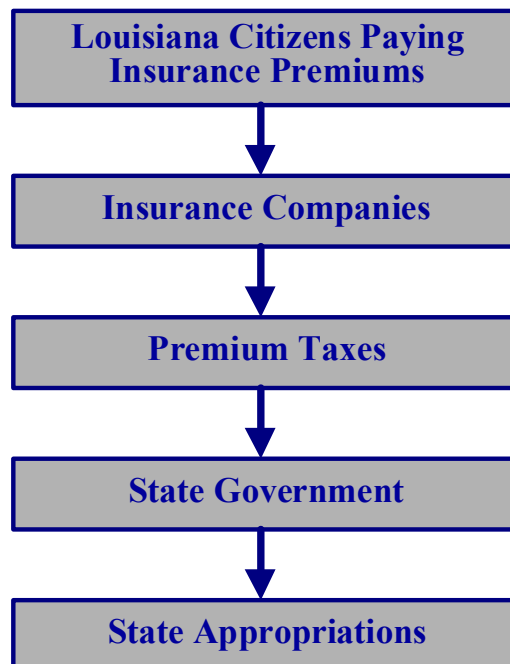
¹Venture Economics (SDC)/National Venture Capital Association. Venture capital data are collected through surveys. Venture capital pools that do not return the surveys to Venture Economics are not included in the totals. The data are consistent through time and are consistent from state to state.

Louisiana in any short period of time. Venture capital markets had developed extensively in California, Massachusetts, and New York with 22, 24, and 30 venture capital funds developing in these states respectively. As of 1984, Texas had only six venture capital funds, and, in the south, only Florida and Tennessee had really started the development of venture capital funds.²

The Louisiana Legislature, on the advice of economic development experts, passed Act 642 of the 1983 Legislative Session creating the CAPCO program for the purpose of developing venture capital funding in Louisiana with the ultimate purpose of diversifying the economy, creating new jobs, and fostering growth in the state's economy. The private market had not developed venture capital funds in Louisiana. The State chose to encourage private market involvement via the use of tax credits. The state bears a cost--the loss of state tax revenues--but hopes to incur long-term benefits in terms of jobs and income that leads to additional state tax collections in the future.

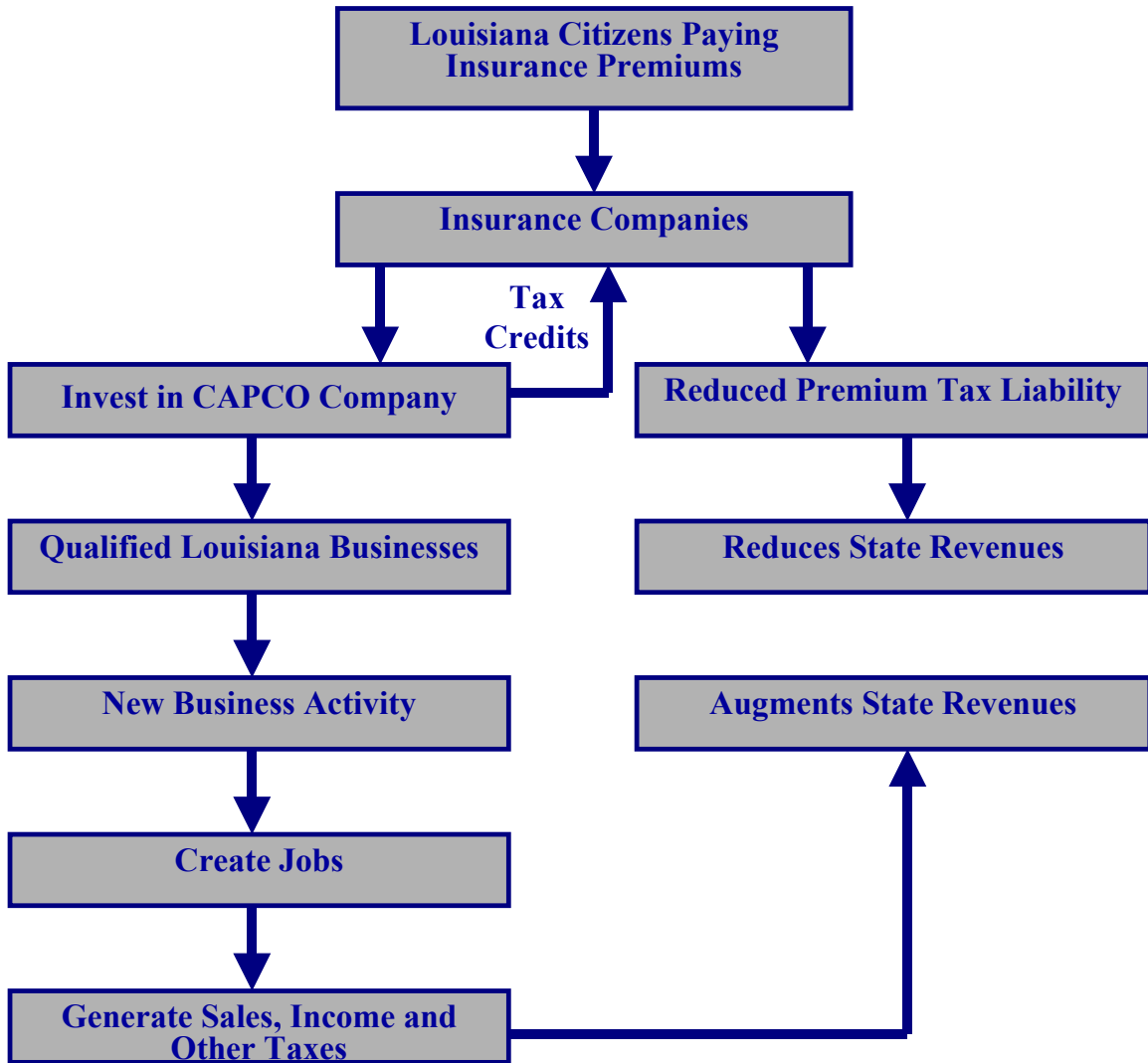
The public policy choices are illustrated in Figure 1 – Scenario A and Figure 2 – Scenario B. In Scenario A, the CAPCO Program does not exist, therefore, insurance premium taxes are paid to the State's General Fund. In Scenario B, the CAPCO Program encourages insurance companies to invest monies in certified capital companies. The insurance companies are granted tax credits for their investments. The tax credit diminishes, at least in the short-run, State revenues. The investments in qualified Louisiana businesses hopefully yield sufficient economic growth that state revenues will increase.

Figure 1: Scenario A – Pay the Taxes



²Ibid.

Figure 2: Scenario B - CAPCO Tax Credit Program



History of the CAPCO and BIDCO Programs

Louisiana Legislative History

Act 642 of the 1983 Regular Session

The “Louisiana Capital Company’s tax credit program” was created by Act 642 of the 1983 regular legislative session. Initially, the program provided for only income tax credits, not insurance premium tax credits. Key provisions of the Act included:

- Capital Companies were required to have a minimum initial capitalization of \$3 million.
- The Act provided for an income tax credit of 20 percent of a person’s cash investment into certified Louisiana capital companies with initial capitalization from \$3 million to \$20 million. The income tax credit increased to 35 percent of a person’s cash investment into certified Louisiana capital companies with initial capitalization of more than \$20 million.
- To continue in certification, capital companies were required to make equity investments into Louisiana and other businesses. At the end of four years, 30 percent of a capital company’s capitalization had to be invested. The percentage of capitalization required to be invested increased to 50 percent after seven years and 75 percent after nine years. Sixty percent of all investments were required to be in Louisiana businesses.
- Investments in oil and gas exploration and development, real estate development or appreciation, or banking or lending did not count toward continuing certification.
- Capital companies were limited to investing no more than 10 percent of their capitalization in any one company.
- The Act provided for voluntary decertification pursuant only to repaying the tax credits.
- The Act provided for certification of capital companies from July 1, 1984 to December 31, 1989. The Act included a date specific sunset provision unless the program was renewed by the Legislature.

Act 537 of the 1984 Regular Session

Act 537 addressed tax credits for insurance companies. Among the credits provided for by the Act was "...a tax reduction for insurers investing in certified capital companies as defined in R.S.51:1921, in industrial or economic development corporations as defined in R.S.12:951, in bonds issued by the Louisiana Science and Technology Foundation and the Louisiana Renewable Resources Foundation, or in investments to the Louisiana Science and Technology Foundation and the Louisiana Renewable Resources Foundation shall be computed as two times the value of the capital investment." This Act provided for a tax credit of 200 percent of monies invested in a Louisiana certified capital company as an offset to insurance premium taxes paid to the State of Louisiana. Also, this tax credit could be taken immediately.

Act 891 of the 1984 Regular Session

Act 891 changed the amount of the income tax credit for investments in capital companies with initial capitalization of \$3 million to \$20 million from 20 percent to 35 percent of the cash investment. The Act also provided that confidential information submitted by capital companies or Louisiana businesses to the State would not be public records.

Act 695 of the 1986 Regular Session

Act 695 reduced the capitalization requirement for capital companies from \$3 million to \$200,000 and increased the percentage of total capitalization allowed to be invested in any one company from 10 percent to 25 percent of a capital company's capitalization.

Act 915 of the 1986 Regular Session

Act 915 provided that CAPCOs shall be exempt from corporation income tax and corporation franchise tax for five consecutive taxable periods.

Act 703 of the 1987 Regular Session

Act 703 provided for voluntary decertification of a CAPCO after ten years of continuing certification by sending written notice of decertification to the Secretary of Commerce and for exemption of the CAPCO from repaying the tax credit claimed by investors under this program.

Act 496 of the 1989 Regular Session

Act 496 represented a major revision of the CAPCO statute. Key provisions included the following:

- The Act restated and/or redefined key terms in the statute as follows:

Renamed "Capital Company" to "Certified Louisiana Capital Company".

Changed the "...department..." from the Department of Commerce to the Department of Economic Development.

Changed the meaning of "...a qualified Louisiana business..." to "...any business which operates primarily in Louisiana or does substantially all of its production in Louisiana and which has no more than 500 employees and has annual business receipts not in excess of \$7 million." Included a provision that "...any business, which is classified as a qualified Louisiana business at the time of the first investment in said business by a certified Louisiana capital company shall remain classified as a qualified Louisiana business for any later additional investment into by that certified Louisiana capital company."

Defined "equity" as "...an ownership interest in the business. An equity investment may include a security which has the characteristics of debt but which provides for conversion into equity at a future date. The Department shall promulgate rules to determine what constitutes equity for the purpose of this definition."

- Included a provision for the Department to provide for the transfer or sale of the income tax credits under the program.
- Changed the investment schedule for continuance of certification to reduce the percentage of total investments required to be in qualified investments, as follows:

Within three years after the date on which the capital company was designated as a certified Louisiana capital company, at least 50 percent of the total certified capital must be invested with at least 30 percent of the total certified capital placed in qualified investments.

Within five years after the date on which the capital company was designated as a certified Louisiana capital company, at least 80 percent of the total certified capital must be invested, with at least 50 percent of the total certified capital placed in qualified investments.

- Limited CAPCOs to investments of no more than 15 percent of total certified capital in any one company.
- Expanded the provisions for voluntary decertification to be either by remitting to the Secretary full payment of all income tax credits claimed by investors, or after 10 years of continuance certification, or when a certified CAPCO has invested 60 percent of its certified capital in qualified investments. The 10 years of continuance certification, or the 60 percent of certified capital being invested in qualified investments, enable the CAPCOs to voluntarily decertify and no longer be subject to repayment, recapture or retaliation.
- Extended the program dates to July 1, 1984 through December 31, 1992.

Act 15 of the First Extra Session of 1989

Act 15 addressed, apparently for the first time in a rigorous manner, the premium tax reduction provision of the statute. We can find no history of how the 200 percent tax credit was initially derived. In retrospect it appears to be extraordinarily generous, and it is a bit surprising that the capital companies were not more successful in raising funds from the insurance industry. Another lesson that can perhaps be learned from this experience is that tax credits alone are not sufficient to acquire venture capital funds from the insurance industry. There was an intense discussion during the special session in 1989 relating to the appropriate magnitude of the tax credit. Key provisions in Act 15 included:

- The Act reduced the premium tax reduction for insurers from 200 percent to 120 percent. The Act provided that "...The tax reduction shall be applied to the premium tax liability not to exceed 10 percent of the premium tax reduction in any one year until 100 percent of the premium tax reduction has been claimed by the insurer; provided, however, that the reduction in any taxable year shall not exceed the premium tax liability for such taxable year."
- The investment shall be in the form of cash and debt instruments which are obligations of the investing insurance company to the certified capital company or the industrial economic development corporation. Such debt instruments shall be converted to cash at a rate of not less than 10 percent per year from the date of the investment.
- The Act limited the total premium tax reduction for investments made in 1989 to 40 percent of the premium tax liability for that taxable year.
- The Act limited the total premium tax reduction for investments made in 1991 to a tax reduction not to exceed 30 percent of the premium tax liability for that taxable year.
- For investments made in 1991 and 1992, the (total) premium tax reduction shall not exceed 25 percent of the tax liability for the respective taxable year.

Act 849 of the 1992 Regular Session

Act 849 extended the certified capital company program through December 31, 1993.

Act 724 of the 1993 Regular Session

Act 724 extended the CAPCO program through July 31, 1994 and made perhaps a subtle but yet a very significant change in the insurance premium tax limitations in order to allow much larger investments, and corresponding premium tax reductions, by individual insurance companies. Key provisions included:

- Altered the wording so that the limitation of the total allocated premium tax reduction to an amount equal to 25 percent of the Company's tax liability in the year of investment was eliminated. Instead the Act provided that "...For investments made during any taxable year beginning on or after January 1, 1991, and before July 1, 1994, the tax reduction *utilized* in any year shall not exceed

twenty-five percent of the tax liability for the year in which the investment was made.” (emphasis added)

- Provided for premium tax reductions to have the same rights with respect to transferability as income tax reductions and to have the same forfeiture and repayment provisions as income tax credits.

Act 279 of the 1993 Regular Session

Act 279 permitted licensed business and industrial development corporations (BIDCOs) to become certified Louisiana Capital Companies and vested the Office of Financial Institutions with the regulatory responsibility for the program. Additional provisions of the Act included:

- Redefined “qualified investments” to include financing assistance provided to a qualified Louisiana business by a BIDCO.
- Changed the rules on involuntary decertification to provide for a limited recapture of tax credits, depending upon when the decertification occurs.
- Extended the CAPCO program through December 31, 1995.

Act 9 of the Third Extra Session of 1994

Act 9 extended the CAPCO program to June 30, 1997 for investments in CAPCOs to earn tax credits and December 31, 1997 for certification of new CAPCOs.

Act 21 of the 1996 Regular Session

Act 21 extended the date for capital to be certified under the CAPCO program and tax credits to be earned to December 31, 1998 and made several seemingly subtle clarifications in the statute, including:

- Clarified the definition of an investment by an insurance company in a CAPCO as an investment of cash by an insurance company in exchange for the equity in a CAPCO, or a loan receivable from a CAPCO which has a stated final maturity of not less than 5 years from the origination date.
- Extended the premium tax limitation “...to a tax reduction utilized in any year *for any group of affiliates* not to exceed 25% of gross premium tax liability *for such group* before any credits for the year in which the investment was made.” (emphasis added)
- Provided a more detailed definition of equity, stating it to be “...common stock, preferred stock, or an equivalent ownership interest in a limited liability company, partnership or other entity. A loan with a stated maturity of not less than 5 years which provides for conversion into equity at a future date or has equity features. The Department shall promulgate rules...”
- A “qualified Louisiana business” must operate primarily in Louisiana or perform substantially all of its production in Louisiana, have together with its affiliates a

net worth of \$18 million or less, and average income with affiliates for the preceding two completed fiscal years not in excess of \$6 million, has together with its affiliates no more than 500 employees.

Act 70 of the 1998 Regular Session

Act 70 limited the cost of the CAPCO program to the State, as a response to a substantial increase in insurance company investments in two of the CAPCOs in 1997. Key provisions included:

- The insurance premium tax credit was reduced from 120 percent to 110 percent.
- The program was extended through December 31, 1999 for certification of new CAPCOs and December 31, 2000 for certification of capital for earning tax credits.
- An annual limitation of premium tax credits to be granted in the program was established at \$8 million per year in additional premium tax credits (\$72,727,272 of investment).
- Established an annual application date for premium tax credits of October 1st, with allocations to be made evenly to applying CAPCOs in the event that requests for certified capital exceeded the \$72,727,272 limit. Also provided for reallocation of unused premium tax credit allocations to be made in proportion to amount of original request.
- Provided for the State to share in CAPCO investment appreciation that exceeds an annual internal rate of return of 15 percent of certified capital, for pools certified after January 1, 1999 for which premium tax credits were granted. The provision specifies that the State is to be reimbursed for credits granted up to 25 percent of such appreciation.
- Investment pools created on or after January 1, 1999 must have 100 percent of certified capital invested in qualified investments prior to applying for voluntary decertification.
- Set limitations on distributions to equity owners from the certified capital to: debt service, tax payments or to pay tax liability created by CAPCO-related income, and management fees of up to 2½% of certified capital.
- Provided for tax credits to be protected once a CAPCO achieved a level of qualified investment of 50% of certified capital.
- Required CAPCOs to enter into agreements with the State to invest up to 5 percent of certified capital investment pools created on or after January 1, 1999 in either capital management funds that invest in pre-seed, seed, or early-stage companies, or another CAPCO whose investment objectives include disadvantaged businesses or economically distressed areas.

Voluntary Agreements, Rules and Regulations

Subsequent to the Legislature passing Act 70, the related parties of two CAPCOs invested approximately \$300 million in 1998 under the income tax credit provisions of the program. Concerned over a potential unplanned, immediate reduction of income tax collections, state officials negotiated an agreement with the two CAPCOs that, among other provisions, reduced the qualifying investments to \$150 million and extended the timeframe for claiming or selling the credits, evenly over a four to five year period. Bank One spread \$35 million of tax credits over a five year period, and Advantage spread \$17.5 million over a four year period. On July 20, 1999, the Office of Financial Institutions promulgated amendments to the CAPCO Program Rules and Regulations that limited total annual income tax credits allowed to be granted under the program to \$4 million, representing maximum certified capital investments of \$11,428,571.

Current Program Status

Current law, rules and regulations limit the total amount of new tax credits to be generated in any one year to \$84 million. The program's expiration date of December 31, 2000 has the effect of limiting future generation of credits to the \$84 million anticipated to be generated in the Year 2000. In addition, tax credits that have already been granted but not utilized, based on information from the Department of Insurance and the voluntary agreements, are summarized below:

Fiscal Year	Tax Credit to be Used
2000	\$61.5 million
2001	\$64.0 million
2002	\$63.3 million
2003	\$61.3 million
2004	\$53.1 million
2005	\$42.3 million
2006	\$37.8 million
2007	\$22.0 million
2008	\$16.0 million
2009	\$ 8.0 million

Eight new CAPCOs have been licensed in calendar year 1999. Demand for CAPCO investment has remained strong, with applications for both premium tax credits and income tax credits exceeding the maximums allowable. The State should anticipate that the Program will be fully subscribed in the Year 2000.

Development of CAPCOs and BIDCOs in Louisiana, 1983 to 1999

Since the inception of the CAPCO Program, thirty-eight (38) entities have been licensed, with eight of those being licensed in 1999. Separate CAPCO entities are frequently established under the same management. Accordingly, the thirty-two active CAPCOs represent seventeen distinct capital management firms. Six CAPCOs have been decertified and thirty-two are still in existence. Of the six which have been decertified, three had invested over 60 percent of their certified capital in qualified Louisiana businesses and were eligible for voluntary decertification, two were involuntarily decertified because of their failure to meet continuing certification requirements, and one voluntarily surrendered its license as a result of its failure to raise capital and subsequent inability to meet the requirements for continuing certification. Thirteen CAPCOs are currently dually licensed as BIDCOs. A list of the CAPCO licensees and their current status relative to the Program is presented at Table 1.

Table 1: CAPCO Licensee Listing and Current Status

CAPCO	Date Certified	Date Decertified	Status
Advantage Capital Partners I LP	10/09/1992		
Advantage Capital Partners II LP	10/07/1993		
Advantage Capital Partners III LP	05/11/1994		
Advantage Capital Partners IV LP	05/11/1994		
Advantage Capital Partners V LP	05/11/1994		
Advantage Capital Partners VI LP	12/17/1997		
Advantage Capital Partners VII LP	12/17/1997		
Advantage Capital Partners VIII LP	12/17/1997		
Advantage Capital Partners IX LP	12/17/1997		
Advantage Capital Partners X LP	11/08/1999		
Advantage Capital Technology Fund, LLC	05/11/1994		
Advantage Capital BIDCO I, Inc.	10/09/1992		
Advantage Capital BIDCO II, Inc.	10/09/1992		
Alliance Capital BIDCO, Inc.	11/30/1999		
Audubon Capital Fund 1, LP	11/08/1999		
Banc One Capital BIDCO-1998, LLC	12/14/1998		
Cadence BIDCO	12/31/1997		

CAPCO	Date Certified	Date Decertified	Status
Certified Capital Corporation	08/11/1988	01/24/1995	Involuntary Decertification
Certified Capital LP	02/19/1989	01/24/1995	Involuntary Decertification
Chrysalis of Louisiana, L.L.C.	12/23/1997		
ECD Investments BIDCO	06/25/1999		
First Louisiana BIDCO	12/31/1991	11/20/1994	Voluntarily Decertified
First Louisiana BIDCO	07/25/1996		Recertified under same name
Gulf Coast BIDCO, Inc.	07/20/1994		
Hibernia Capital Corporation	08/12/1997		
InterTech Venture Fund, L.P.	11/29/1999		
The Louisiana Community Development Capital Fund BIDCO, Inc. "CAPFUND"	08/06/1997		
Louisiana International BIDCO, Inc.	07/06/1993	03/19/1997	Voluntarily Decertified
Louisiana Seed Capital Fund, LP	09/05/1989	02/01/1994	Voluntarily Decertified
New Orleans SBIDCO, Inc.	12/17/1993		
North Louisiana BIDCO, LLC	11/30/1999		
Premier Venture Capital Corporation	09/18/1988	01/04/1994	Voluntarily Decertified
Revitalization of Louisiana, LLC	12/23/1997		
Sisung Louisiana Platinum Fund, LLC	12/01/1999		
Source Capital Corporation	07/25/1996		
Stonehenge Capital Fund Louisiana, LLC	12/28/1993		
Tiger Capital Company of Louisiana, L.L.C.	12/15/1997		
Wilshire Louisiana Advisors, LLC	09/28/1999		

There is ample diversity among the CAPCOs in terms of staff size, amount of capital under management, investment strategies and objectives, and long-term goals. Several of the BIDCOs focus on providing relatively small loans to small businesses that have been in operation for at least several years and are not necessarily likely to experience significant growth. Many of the loans made by several of the BIDCOs are guaranteed SBA loans. As a specialty BIDCO, New Orleans Specialty BIDCO focuses on an historically economically disadvantaged population. The mission of one of the CAPCO companies is to fund construction or renovation, and operate low-income housing and historic district projects. At least one other CAPCO was formed for the principal purpose of making investments in early stage high-technology companies.

Currently active CAPCOs range in staff size from two full-time employees in a suburban setting to a dozen or more employees in the central business district of New Orleans.

Comparing the Louisiana CAPCO Program with Programs in Florida, Missouri, New York, and Wisconsin

Louisiana was the first state to institute a CAPCO program. Tax credits generated under Louisiana's CAPCO program in the four-year period 1996 through 1999 roughly approximate or exceed the combined maximum allocations in Florida, Missouri, New York, and Wisconsin, the other four states with operating CAPCO programs. Louisiana's CAPCO statute was used as the starting model for the legislation in these other four states that will collectively be referred to as "the other CAPCO states".

A matrix of program features that we considered of greatest value to compare, by state, is presented in Table 2. The Louisiana CAPCO Program has been the model for legislation in the other states. The two largest Louisiana CAPCO firms have been involved with the legislation in those other states and participate, or have affiliates who participate, in those programs. Some of the key differences between Louisiana's CAPCO Program and those programs in other states are:

- Louisiana has the only CAPCO Program that provides an income tax credit.
- The other states have, by statute, limited both the total and annual amount of premium tax credits to be granted by the program.
- The other states provide a 100% premium tax credit to investors, to be taken over a minimum of ten years, rather than 110%.
- The other states require \$500,000 in initial capitalization, rather than \$200,000.
- The other states have, in general, more narrow definitions of what constitutes a "qualified business" than does Louisiana.

Income Tax Credit

It appears that the income tax feature simply was not set forth as a part of the program when crafted in the other states. One or more of the other states has economic development income tax credit incentives already in place. None of the other states report any real impetus to expand the program to include income tax credit incentives.

Tax Credit Limitations

The recent history of the program in Louisiana certainly indicates that it is important for the legislature to assess, in terms of both total and annual investment, what it can and should allocate to a CAPCO program. Louisiana's investment to date, roughly 90% of which has been incurred from 1997 forward, exceeds the current total allocations for the other four programs, combined.

Credit Amount and Capitalization Requirements

The premium tax credit amount in the four other states is 100% of certified capital contributed. CAPCO company capitalization requirements are also somewhat higher in other states, at \$500,000. These points do not appear significant, if a new, substantially different CAPCO Program is developed for Louisiana. If the program is renewed with changes that do not revolutionize the program, these features should certainly be considered for adjustment.

Qualified Businesses and Investments

There appears to be significant variation in the features of the businesses that are considered “qualified” in the various CAPCO programs. The variations are both a function of legislative give-and-take, as well as the normal differences in the needs of the various states.

Louisiana’s definition of a qualified business is less stringent, in terms of its “in state” measures, than any of the other states. All of the other states require a qualified business’ headquarters to be located in-state. Additionally, some “protection” from business relocation on the part of businesses in which investments have been made have been incorporated into other states’ statutes. Considering the tax-credit nature of the program, more stringent location features and restrictions would seem to be appropriate.

All other states exclude from qualified investments those in professional service firms of accountants, lawyers and doctors. Two of the states exclude retail companies. Louisiana may wish to expand its exclusions to include other industry or commercial segments that either should not require assistance or is considered to be of insufficient economic development value to assist with a tax credit-enhanced program.

Several of the other states require documentation supporting an assertion that qualified investments represent investments in qualified businesses that were rejected by conventional sources of capital. Louisiana may wish to consider such a feature in any future program.

Florida has a requirement that qualified businesses have growth estimates in their business plans of expected sales of over \$25 million within five years. Clearly, the goal of the Florida program is to hit home runs, rather than singles. This feature is unique among the CAPCO programs and should be monitored for its impact, its workability and its rate of success.

Table 2: Comparison of CAPCO States - Louisiana, Missouri, Wisconsin, New York, and Florida

Program Feature	Louisiana	Missouri	Wisconsin	New York	Florida
Year of Legislation	1983	1996	1998	1997	1998
Effective Start Date	July 1, 1984	January 1, 1997	July 1, 1999	March 2, 1998	December 1, 1998 deadline to apply to be a CAPCO
Total Program Credits					
Premium Tax	\$556.5 million ¹	\$140 million	\$50 million	\$130 million	\$150 million
Income Tax	\$74 million ²	N/A	N/A	N/A	N/A
Allocation if Demand Exceeds	Pro rata	By date of filing, then in proportion to amount originally requested	In proportion to amount originally requested	By date of filing, then in proportion to amount originally requested	In proportion to amount originally requested
Maximum Annual Credits					
Premium Tax	\$53.9 million ³	\$14 million	\$5 million	\$13 million	\$15 million
Income Tax	\$15.4 million ⁴	N/A	N/A	N/A	N/A Must apply for credits by March 15, 1999
Credit per Investment					
Premium Tax	110%	100%	100%	100%	100%
Income Tax	35%	N/A	N/A	N/A	N/A
Timing Restrictions on Credits					
Premium Tax	Max of 10% per year, until exhausted	Max of 10% per year, until exhausted	Max of 10% per year, until exhausted	Max of 10% per year, until exhausted	Max of 10% per year, until exhausted, with 2017 deadline
Income Tax	None	N/A	N/A	N/A	N/A
Other Limitations on Credits or Investments in CAPCOs	None	Limit \$10 million per investor per year	Limit \$10 million per investor	Limit any one investor to \$18 million per CAPCO	Limit investors to \$15 million per investors in total

Program Feature	Louisiana	Missouri	Wisconsin	New York	Florida
Who is Eligible for Credits					
Premium Tax	Insurance Companies	Insurance Companies	Insurance Companies	Insurance Companies	Insurance Companies
Income Tax	Anyone	N/A	N/A	N/A	N/A
Transferability of Credits	May sell	May sell	May sell	Silent	Related parties
Equity Investment Restrictions	Limited to 15% of certified capital	Limited to 15% of certified capital	Limited to 15% of certified capital	Limited to 15% of certified capital	None
Debt Investment Restrictions	Maturity \geq 5 years with conversion or equity features. For BIDCOs, no restriction	Debt, equity, hybrid conversion or participation	Maturity \geq 5 years and unsecured or convertible	Convertible into equity or warrants	Allows investment in any debt, equity or hybrid security
Qualified Businesses					
Life Cycle or other	Up to 5%, as determined by DED, of premium tax credit certified capital, not decertified by 12/31/98, must be invested in a pre-seed, seed, etc. capital management fund, OR Certified CAPCO investing in disadvantaged businesses or distressed areas.	\$40 million set-aside for distressed areas		50% in early stage (i.e. age < 2 Years or not in production) by year 4	50% in early stage (i.e. age < 2 Years, initial production stage, annual rev < \$3million) technology by year 5
Parameters or set asides	Beginning 1/1/2000, up to 10%, as determined by DED, of insurance premium tax credit capital certified in previous calendar year must be allocated as above.				

Program Feature	Louisiana	Missouri	Wisconsin	New York	Florida
Headquarters	Not addressed	In Missouri	In Wisconsin	In New York	In Florida
Capital to be Used For		Expansion, retention of current operations, modernization		Business operations excluding advertising and sales. Must be in New York.	Principal business operations in Florida
Employee Location	50% wages paid in LA	80% in Missouri	75% in Wisconsin	80% employed in New York	75% employed in Florida
Business Size	(including affiliates) Employees ≤ 500 net worth ≤ \$18 million Net income ≤ \$6 million	Employees ≤ 200 Sales ≤ \$4 million (age ≤ 3 years) Sales ≤ \$3 million (age > 3 years)	Employees ≤ 100 Net income ≤ \$2million Net worth ≤ \$5 million	Employees ≤ 100 or Employees ≤ 200 and gross revenue (consolidated) ≤ \$5 mil	Less than 200 employees SBA definition of small business
Business Plan Growth Estimates	None	None	None	None	Expected sales > \$25 million within 5 years
Business Plan Financing Options	None	Unable to obtain conventional	Unable to obtain conventional	None	Unable to obtain conventional
Restrictions in Nature of Business	Excludes real estate development for resale, banking, lending, gaming, oil and gas exploration and development. Excludes CAPCO associates.	Excludes retail, real estate development, real estate, insurance, and professional services by lawyers, accountants, and doctors. Excludes CAPCO affiliates.	Excludes real estate development, banking, lending, and professional services by lawyers, accountants, and doctors.	Excludes real estate development, real estate, insurance, and professional services by lawyers, accountants, and doctors.	Excludes retail sales, banking, lending, real estate development, insurance, oil and gas exploration, and professional services by lawyers, accountants, and doctors.

Program Feature	Louisiana	Missouri	Wisconsin	New York	Florida
Other Criteria	Operates primarily in LA (gross receipts \geq 50% or value added \geq 50% in LA) or performs substantially all production in LA (i.e. total assets in LA > 50% or wages paid in LA > 50%) will continue in LA \geq 1 year	Primary business operation in MO. Cannot relocate business more than 30 miles from current location without prior approval of DED.			Principal business operations must be in Florida Must agree to keep headquarters and facility financed with CAPCO \$ in Florida for 10 years
Follow-on investments, even if business grows too big	Allowed. CAPCO not allowed to gain control under normal circumstances	7 years after first investment	Not addressed	OK if staying in New York	Not addressed
Investment Requirements					
1 Year					
2 Years		25% in qualified		25% in qualified	20% in qualified
3 Years	50%, 30% in qualified	40% in qualified	30% in qualified	40% in qualified	30% in qualified
4 Years		50% in qualified		50% in qualified with at least 50% in early stage	40% in qualified
5 Years	80%, 50% in qualified		50% in qualified		50% in qualified with at least 50% in early stage technology
6 or More Years					
CAPCO Capitalization	\$200,000	\$500,000	\$500,000	\$500,000	\$500,000 and must raise at least \$15 million in certified capital to receive an allocation

Program Feature	Louisiana	Missouri	Wisconsin	New York	Florida
Listed CAPCOs	See Louisiana list	Advantage Bank One CFB Business Funds Stifel CAPCO CAPCO Holdings	Advantage 16.6 Bank One 16.6 Wilshire 16.6	Advantage Bank One Excelsior Partners Exponential of New York New York Small Business Venture Fund Wilshire Advisors	Advantage Bank One Wilshire Partners Others without allocation
Distribution Restrictions and Voluntary Decertification	10 years compliance or, for pools before 1/1/99, 60% invested in qualified, for pools after 1/1/99, 100% invested in qualified investments debt payments and other “qualified” distributions OK	100% invested in qualified investments Debt payments and other “qualified” distributions OK	100% invested in qualified investments or 10 yrs compliance Debt payments and other “qualified” distributions OK	100% invested in qualified investments Debt payments and other “qualified” distributions OK	100% in qualified investments Debt payments and other “qualified” distributions OK
State Profit Participation	25% of appreciation in excess of 15% AIRR on capital for which premium tax credits were granted after Jan. 1, 1999	25% of distribution exceeding 15% AIRR on certified capital	None	None	10% of distributions exceeding original investment of certified capital, until credits are recaptured
CAPCO Company Structure or Ownership Restrictions	Any legal entity, includes BIDCOs	Insurance company cannot manage or control	Insurance company cannot manage or control	For profit Insurance company cannot manage or control	Insurance company cannot manage or control

Program Feature	Louisiana	Missouri	Wisconsin	New York	Florida
Other	CAPCOs must have 50% of certified capital available to invest or have already invested in qualified investments each year.				

¹Allocations to date, plus authorized allocation in the year 2000.

²Allocations to date, plus authorized allocation in the year 2000.

³Estimated annual credits available for use in Year 2000, the highest estimated amount available in any one year.

⁴Estimated annual credits available for use in fiscal years ending June 30, 2000 and 2001, pursuant to current statute and agreements between the State and two CAPCOs.

States Considering CAPCOs

Additional states that have considered CAPCO legislation include Arizona, Iowa, North Carolina and Texas³. On balance, it appears that the CAPCO Program has been viewed generally as favorable by legislators. Further, regulators contacted in the other states that have instituted CAPCO programs, in general, consider the programs to be performing well, without major problems.

³ Source: Rural Policy Research Institute, Public Involvement in Venture Capital Funds: Lessons From Three Program Alternatives, November, 1999.

Summary of Benefits of the CAPCO Program

Dollars Raised for Investments in Qualified Louisiana Businesses

The CAPCO program in Louisiana permits certified capital companies to raise monies from insurance companies with tax credits to be used to offset insurance premium taxes and from corporations and individuals with tax credits to be used to offset corporate income tax liability or personal income tax liability. The CAPCOs in Louisiana have used both of these tax credits to raise venture capital funds. From 1988 to 1998 Louisiana CAPCOs raised \$517,105,626 in certified capital. In 1999, the CAPCOs raised \$82,155,844. The time pattern of these funds are illustrated in Table 3, along with insurance tax credits generated and used and income tax credits generated and used. From 1988 to 1991 the CAPCOs raised on average about \$4.5 million per year, while from from 1992 to 1993 they raised about \$17.2 million per year. From 1994 through 1996 the CAPCOs raised about \$34.5 million per year and then in 1997 and 1998 the average jumped to \$180.7 million per year. There has been a definite learning curve throughout the 1990s with the monies raised ratcheting up significantly during the course of the decade. This increase in the raising of monies for the venture capital market has been primarily the increased activities of two CAPCOs, namely Advantage and Bank One, and not the creation of new certified capital companies.

The insurance tax credits were first allowed to be used immediately, but in 1989 the law was changed so the insurance tax credits would be allocated over a ten year period. Hence, at the end of 1998 the CAPCOs have generated \$398.5 million of insurance tax credits but have utilized only \$123.2 million of these credits. This means that \$275.3 million of the insurance tax credits may be utilized over the next ten years, or until exhausted. Insurance premium taxes in fiscal 1994 contributed \$162.4 million to the state's general fund but in fiscal 1998 only contributed \$112.1 million to the general fund. Specific information on taxable premiums written and premium taxes collected are contained in Table 4. This specific source of revenue to the state has certainly been diminished by this tax credit, but this is merely another way of recognizing the cost of the program. The benefits will show up as tax collections in other tax sources. It is also important to note that there are several insurance tax credits, in addition to the tax credits associated with the CAPCO program, that diminish the collection of the insurance premium taxes.

Income tax credits were relatively small until 1998, averaging only \$366,000 per year from 1988 to 1997, and then two Louisiana CAPCOs utilized this tax credit very

effectively in 1998 and generated over \$60 million of tax credits which according to law could have been utilized immediately. Because of the fiscal impact of such a significant tax credit being utilized in one year, the Division of Administration and other state officials asked the CAPCOs to accept a voluntary agreement to spread the tax credits over a period of years. This maintains the tax credit and does not put significant financial pressure on the state budget in any one year. The ability of the CAPCOs in 1998 to invest such a substantial amount of money due to the income tax credits suggests that the program might be revisited legislatively, just as the insurance premium tax credit program was revisited in 1998. Rules and regulations have been adopted by the Office of Financial Institutions that limits the amount of income tax credits that will be accepted by the state. A law might be the more definitive method of establishing the parameters for the tax credit program for certified capital companies.

Table 3: CAPCO Activity in Louisiana: Certified Capital Raised and Tax Credits Generated and Utilized 1988-1998

Year	Certified Capital Raised (millions)	Insurance Tax Credits Generated (millions)	Insurance Tax Credits Used (millions)	Income Tax Credits Generated (millions)	Income Tax Credits Used (millions)
1988	\$6.697	\$12.828	\$11.827	\$0.098	\$0.098
1989	\$4.071	\$4.546	\$0.822	\$0.099	\$0.099
1990	\$2.860	\$0.000	\$0.803	\$1.001	\$1.001
1991	\$4.378	\$5.208	\$0.977	\$0.013	\$0.013
1992	\$14.623	\$17.041	\$2.660	\$0.147	\$0.147
1993	\$19.661	\$19.779	\$4.626	\$1.112	\$1.112
1994	\$32.857	\$37.912	\$7.150	\$0.442	\$0.442
1995	\$31.871	\$37.783	\$10.963	\$0.135	\$0.135
1996	\$38.662	\$45.540	\$16.066	\$0.249	\$0.249
1997	\$131.783	\$148.368	\$30.507	\$2.850	\$2.850
1998	\$229.638	\$69.501	36.785	\$60.101	\$1.760
Total	\$517.106	\$398.509	\$123.186	\$66.247	\$7.806

*Tax credits are for fiscal years starting in calendar year listed.

Table 4: Taxable Premiums, Tax Liability, and Taxes Collected 1988-98 (in millions of dollars)

Year	Taxable Premiums Written	Gross Tax Liability	CAPCO Credits Used	Total Premium Taxes Collected*
1988	\$5,387.6	\$145.8	\$11.827	\$126.0
1989	\$5,114.2	\$141.0	\$0.822	\$126.3
1990	\$5,976.8	\$159.4	\$0.803	\$131.7
1991	\$6,018.6	\$161.8	\$0.977	\$143.4
1992	\$6,253.3	\$167.7	\$2.660	\$152.9
1993	\$6,498.7	\$185.3	\$4.626	\$162.4
1994	\$7,270.6	\$194.1	\$7.150	\$148.5
1995	\$7,878.7	\$210.6	\$10.963	\$153.0
1996	\$8,178.8	\$218.4	\$16.066	\$139.8
1997	\$8,530.2	\$227.5	\$30.507	\$111.6
1998	\$8,644.6	\$231.0	\$36.785	\$112.1

*Tax collections are for fiscal years starting in calendar year listed.

Has CAPCO Program Raised Money for Qualified Louisiana Businesses?

CAPCOs have raised \$517.1 million from 1988 to 1998 to create a pool of funds that can be used for venture capital purposes and that have state guidelines in terms of investment strategies, though these guidelines are relatively flexible. This amounts to approximately \$47 million per year. More impressively in 1998 Louisiana raised \$229 million in venture capital pools which is equal to the amount of money raised in Minnesota and more than the venture capital pools raised in Ohio, Michigan, Arizona, Tennessee, and other such states according to the PricewaterhouseCoopers MoneyTree Report in the fourth quarter of 1998.⁴ Based on information from this report and information collected from Louisiana CAPCOs, Louisiana ranked seventeenth in terms of venture capital fund commitments in 1998. It can be asserted that the CAPCO program in Louisiana has been successful in raising monies for venture capital pools.

There are two other dimensions to this question. First, could the state have raised this money without the CAPCO program, and, secondly, could the state have raised this

⁴ **MoneyTree Report, Q4 1998 and Full year Report**, PriceWaterhouseCoopers. This report is also based on surveys so information for all other states is purely based on PricewaterhouseCoopers survey, whereas Louisiana information is based on data compiled by Postewaite Netterville consultants.

money with different parameters associated with the CAPCO program, such as a tax credit of, say, 100 percent, as opposed to 120 percent or 110 percent. The answer to the first question is fairly straightforward, and that answer is no. In order to raise substantial monies from the insurance companies, the CAPCOs had to invent a very sophisticated financial instrument that is a Triple A rated bond carrying an interest rate of 250 to 350 basis points above treasury bond rates. The insurance companies are not accepting extraordinary risk with their investment in a CAPCO. The CAPCO bears the risk of success or failure of the individual projects, namely the qualified Louisiana businesses. This financial instrument has also been used in other states with CAPCOs. The insurance monies would not, in our judgment, been forthcoming if there had not been a tax credit program.

The income tax credit program is more difficult to evaluate. Investors using the income tax credit feature represent both equity investors and purchasers of notes issued by the CAPCOs. In an example of an equity transaction, a CAPCO raises money for its venture capital pool by selling an equity interest. The investor is entitled to an income tax credit based on 35 percent of the capital contributed. If the investor does not have any income tax liability, it transfers or sells the income tax credit to another entity that does have an income tax liability. In other words, a CAPCO raises, say, \$50 million in capital for its venture capital funds. The investor is granted an income tax credit of \$17.5 million which it sells for, say, \$15 million to another entity with an income tax liability. The purchasing entity made \$2.5 million by buying the tax credit worth \$17.5 million. The investor now has recovered \$15 million of its \$50 million that it invested in the CAPCO. There is no doubt that the income tax credit provides an incentive for the investor to contribute capital to the CAPCO to raise pools of money that are eligible for the income tax credit. We have no evidence, at least in Louisiana, that substantial amounts of monies would be raised without the tax credit program. Other states, such as Arkansas and Mississippi, have no such programs and do not raise substantial amounts of venture capital. Alabama, on the other hand, raises fairly substantial amounts of money according to PriceWaterhouseCoopers. In 1998 Alabama raised \$76.7 million in venture capital funds, and no CAPCO program exists in that state. The income tax credit program certainly assists in raising venture capital funds. The question becomes the magnitude of the tax credit—should it be 35 percent or can it be some lower number.

The same question pertains to the insurance tax credit, namely, does Louisiana have to provide a tax credit of 120 percent or 110 percent or would a smaller tax credit provide the incentive and ability to raise insurance monies for the venture capital pool. Four other states that have adopted CAPCO programs have all settled on a 100 percent tax credit program, and these states have been able to raise money though these programs are very early in their development. Our analysis, discussed in the Qualitative Analysis section of the report, suggests that there may be substantial room for adjustment in the profit potential of the CAPCOs before the Program becomes less than attractive to the CAPCO owners.

Types of Investment Vehicles

The CAPCO companies have used a variety of investment methods to raise capital, including limited partnership interests and preferred stock. The most important and prevalent method, however, is the use of secured notes issued by the CAPCO companies to insurance companies or, other investors. The secured notes have proven to be a very attractive investment for insurance companies with premium tax liability. The concept has also been replicated with investors using the income tax credit feature of the program.

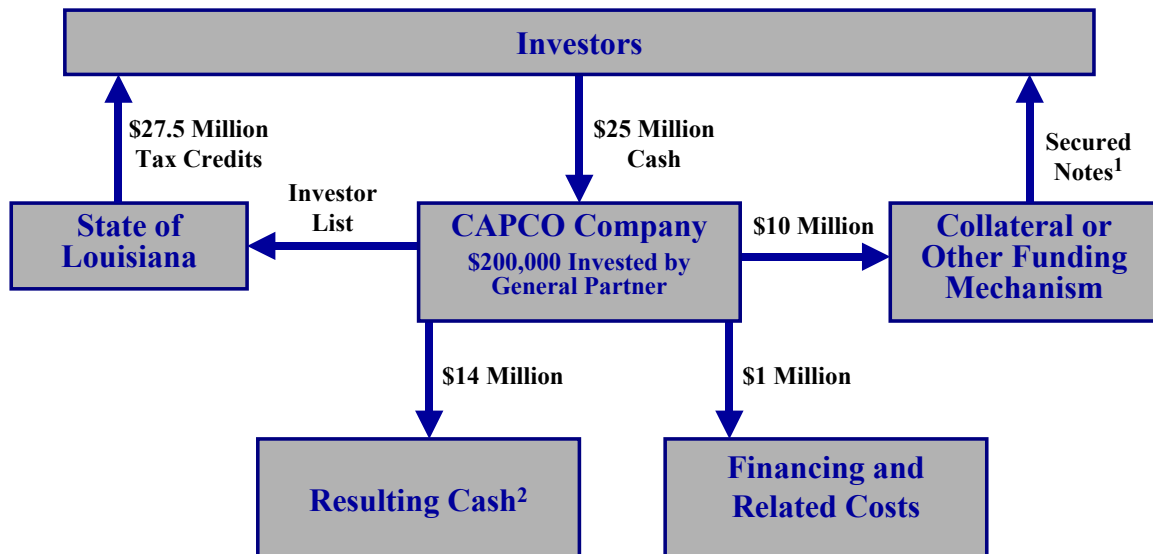
Figure 3 depicts how the CAPCOs raise capital using the secured note investment vehicle with insurance companies as investors. The secured notes are a debt of the CAPCO owed to the investor. Typically, the investor has no ownership interest in the CAPCO or the investments subsequently made by the CAPCO with the capital obtained. In a more traditional venture capital investment model, the insurance companies or other investors may have a limited partnership or other equity interest in the CAPCO that would put their investment at risk, subject to the investment activities of the CAPCO. In such a model, the insurance companies or other investors would be provided a guaranteed, enhanced return on their investment in the form of the tax credits, in return for the money they would be placing at risk. The use of secured notes has allowed the CAPCOs to attract capital from insurance companies and other investors who are not, in essence, participating in a venture capital fund. Instead, the insurance companies or other investors are purchasing low-risk, high interest rate notes. The CAPCOs, in turn, are obtaining capital that is owned solely by the CAPCO company, subject to complying with the requirements of the CAPCO program.

The secured notes are senior debt of the CAPCO companies. The purchasers of the secured notes are the insurance companies or other investors. These purchasers are the recipients of the premium or income tax credits. The note indenture provides for the notes to be repaid, with interest, through a combination of repayments of cash by the CAPCO and application of the tax credits. The tax credits, therefore, serve to reduce the amount of cash payments by the CAPCO that are necessary to repay the notes. The notes are typically secured by the CAPCOs setting aside a portion of the proceeds from the sale of the notes at least sufficient to repay the CAPCO's anticipated cash payment liability. The security which is set aside, initially in the form of cash as proceeds from the sale of the notes, may be U. S. Treasuries or some other form of guaranteed security that bears interest, thereby further reducing the actual cash outlay required by the CAPCO. The maturity dates of the Treasury or other guaranteed securities are shortly before payments are due from the CAPCO to the investors. At maturity, the securities are converted to cash in order to make the payments. Frequently, an additional level of assurance to the noteholder is provided in order to guarantee the noteholder's anticipated rate of return. This assurance may

be in the form of an insurance product or binding obligation of a related party of the CAPCO with significant financial resources.

The resulting cash that is generated through the capital-raising transaction is then used by the CAPCO for its investment activities. The ownership of the resulting cash is with the CAPCO owners. The profit resulting from the sale of the secured notes is typically recognized by the CAPCO over the life of the notes. This profit is made possible by the premium or income tax credits awarded to the purchasers of the notes.

Figure 3: CAPCO Program Sale of Secured Notes to Insurance Company Investors (Highly Simplified for Illustration Purposes)



¹Secured notes to be repaid from the combination of the collateral or funding mechanism and the impact of the tax credits.

²Resulting Cash is owned by the CAPCO and represents potential benefit to the CAPCO owners for executing the financing transaction, subject to fulfilling program requirements and breaking even on investments.

Qualitative Evaluation

The qualitative evaluation of the CAPCO Program attempted, not only to assess those benefits of the program not calculated in the quantitative evaluation, but also to consider the positive and negative characteristics of the program, as currently viewed by concerned parties, stakeholders and participants. In addition to interviews, we referred to a number of other sources, either suggested by our interviewees or otherwise indicated as containing potentially useful information during the course of the study.

We consider it worth noting that, in all of our interviews and discussions conducted during the study, almost everyone we spoke with thought the program should be continued in some form. The rare objection voiced about the program was based on a perception that the program is unnecessarily expensive and the CAPCO companies may now be able to raise funds without the tax credits. Almost every person we interviewed considered the program, in some form, to be either important or vital in continuing to make venture capital accessible in Louisiana.

In the course of our evaluation, it became apparent to us that a thorough qualitative evaluation of the CAPCO Program needed to address the following questions:

1. Has the Program accomplished positive outcomes that, without the program, would not have been accomplished?
2. Who benefits from the Program as currently conducted?
3. Does the Program use the State's resources efficiently?
4. Does the Program reward actions or activities proportionally to their value to the State?
5. Is the Program designed to facilitate effective monitoring, evaluation and regulation?
6. Does the Program provide incentives or other features that encourage the most desirable type of investments (i.e. greatest need, greatest potential economic benefit, or other criteria)?
7. Does the Program minimize government intrusion in the private sector, while simultaneously accomplishing its public purpose?

The above questions are explored in the paragraphs that follow.

Has the Program accomplished positive outcomes that, without the program, would not have been accomplished?

Yes. Louisiana has a reasonably discernible and robust venture capital industry today only by virtue of the CAPCO Program. Dollars available for investment and likely to be invested in Louisiana businesses are far greater than would exist without the Program. Additionally, the CAPCO Program is an incentive for venture capital managers to encourage businesses seeking capital to either remain in the State or relocate to the State. In our view, none of these outcomes would be likely without the CAPCO Program.

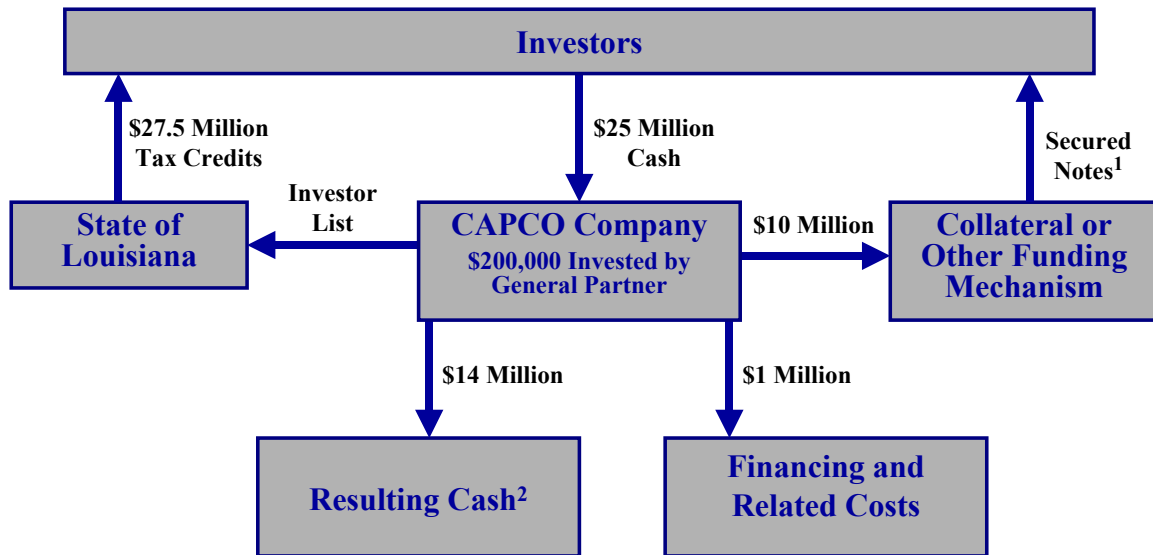
Who benefits from the Program as currently conducted?

Louisiana is, in our view, gaining benefits from the Program that, in the long run, can exceed the costs. Louisiana businesses are gaining benefits from the increased availability of venture and mezzanine capital. Louisiana citizens are gaining benefits of the increased economic prosperity generated by the Program. However, it appears that, as currently conducted, the greatest and most immediate beneficiaries of the CAPCO Program are the CAPCO companies and their owners. The structure of the financial instruments currently in use by many of the CAPCOs to attract investment by insurance companies creates immediate potential wealth for the owners of the CAPCO companies.

Figure 4 illustrates, in a relatively conservative way, the effect that raising \$25 million in certified capital has on the potential wealth of the CAPCO company's owners, on the day of the close of the financing transaction. Secured, highly-rated notes at a very attractive interest rate are issued by the CAPCO company to the insurance company investors for the \$25 million in cash. The conditions of the debt securities provide for the notes to be repaid from a combination of premium tax credits and payments from the CAPCO (the payments are made from the securities or other funding mechanism that serves as the collateral on the notes). The premium tax credit benefit is sufficient to provide the CAPCO with roughly \$14 million in cash, after provision for financing-related costs and purchase of the collateral. At that point, the CAPCO owners have, subject to fulfilling the requirements of the program, and not losing the money in the course of its investing activities, potentially generated \$14 million in wealth that will be recognized over the life of the notes. At that point, the CAPCO owners contributed capital at risk is roughly the \$200,000 they invested in the initial equity of the CAPCO. Although not an actual example, the depicted transaction accurately describes the relative results of the typical transaction.

It is important to note that there is nothing inappropriate about the transaction described. In fact, as discussed more thoroughly in other sections of this report, experience has shown that the secured notes are the only proven effective method of raising money from insurance companies.

Figure 4: CAPCO Program as Functioning. Potential Financial Impact on CAPCO Company for Raising Capital from Insurance Companies (Highly Simplified for Illustration Purposes)



¹Secured notes to be repaid from the combination of the collateral or funding mechanism and the impact of the tax credits.

²Resulting Cash is owned by the CAPCO and represents potential benefit to the CAPCO owners for executing the financing transaction, subject to fulfilling program requirements and breaking even on investments.

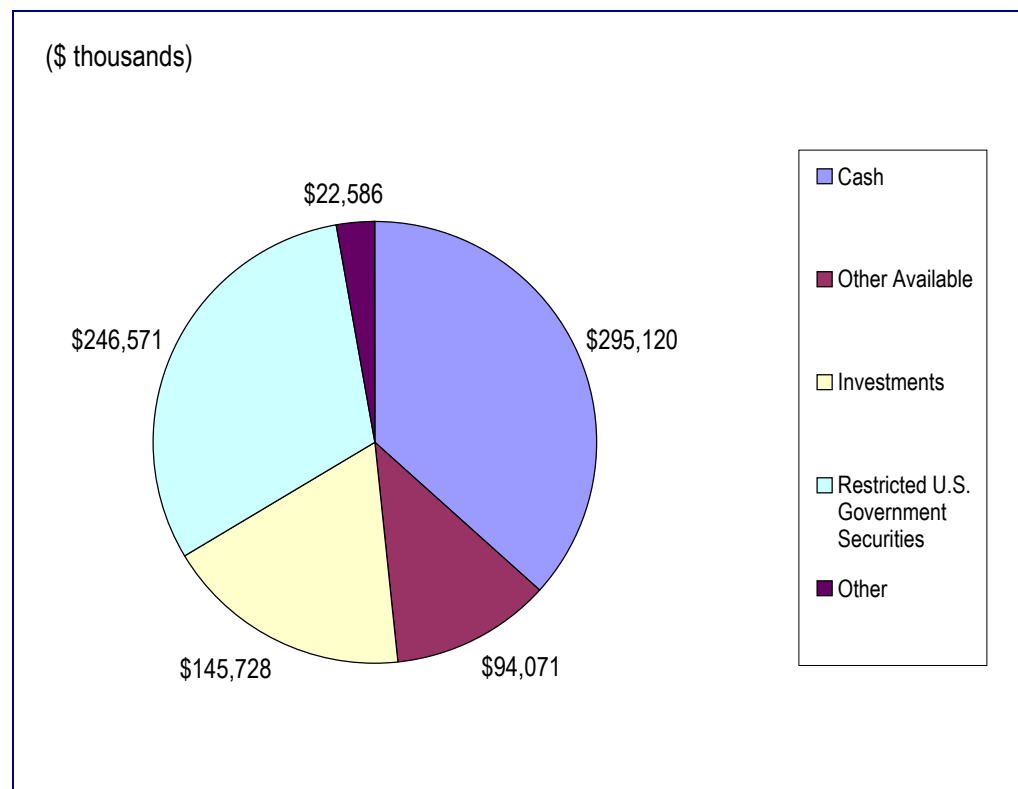
Does the Program use the State's resources efficiently?

Not as currently functioning. The experience of the program in other states suggests that there is certainly room for a lower rate of State investment than Louisiana's current 110% premium tax credit. In its latest change to the statute, the State has also followed the lead of Missouri and Florida in providing for a participation in portfolio appreciation or distributions that exceed a stated annual internal rate of return on certified capital. In our view, it is unlikely that a State will actually share in any such appreciation or distributions, because the State participates only after an amount equal to the certified capital, plus a rate of return on the certified capital, inures to the CAPCO owners. In the example in Figure 4, any such amount is in excess of \$25 million, while the CAPCO owners began receiving a return in excess of their contributed investment on any amount over \$200,000. Based on the wealth-incentive of the Program to the CAPCO owners, there may be significant latitude in these or other aspects of the Program to reduce the cost to the State, or to increase benefits to the State.

Another feature of the financial instruments used by the CAPCOs in raising capital is that they typically involve a substantial amount of overhead, in terms of capital being used to provide collateral for the transactions, rather than being available for

investment in qualified businesses. Figure 5 illustrates the impact that the collateral restrictions on the CAPCOs have on capital available for investment. At the close of 1998, the CAPCOs reported \$804 million in assets. However, only \$145.7 million was invested, and an additional \$389.1 million was available for investment, representing 67% of the total assets of the companies. Presumably, if the capital raised by the CAPCOs were in the form of equity, the collateral would not be necessary and an additional \$246.5 million would be available for investment. The CAPCOs experienced large cash infusions at the end of 1998, some of which was returned in 1999 to the original investors, that inflated the cash at 1998 year-end beyond normal levels.

Figure 5: CAPCO Assets – 1998



The current program has, thus far, generated significantly more in tax credits than in directly-resultant qualified investments. From 1988 to 1998 over \$517 million in tax credits have been generated, of which approximately \$136.9 million have actually been taken. In the same time period, the CAPCOs documented about \$145.7 million of investment in qualified Louisiana businesses.

Does the Program reward actions or activities proportionally to their value to the State?

No. The State gains the greatest benefit when investments, which would not otherwise have been made, are made in businesses that succeed and contribute to economic growth and development in Louisiana. Accordingly, the greatest value to the State is found in the investment activity.

Conversely, the greatest and most immediate probable benefit to the CAPCO is generated by the act of raising the capital. At the time of the capital commitment, a large potential economic benefit is gained by the CAPCO. The CAPCO's primary incentives from that point forward are to protect their potential profits by scrupulously following the Program requirements and minimizing investment risk. This is in no way meant to suggest that the CAPCOs are not trying to make excellent investments, and even take risk where they see a high potential for success. They are. However, the profit motive of the CAPCO will be satisfied, even if investments do not produce economic growth. Without significant economic growth, Louisiana's investment, on the other hand, loses value.

Is the Program designed to facilitate effective monitoring, evaluation and regulation?

No. Measurable goals and objectives to assess success or failure have not been developed for the Program. Neither the statute nor the rules provide for sufficient data collection or analysis to evaluate the Program's success. The Department of Revenue is surely, in most cases, receiving tax returns, W2s and W3s from the companies in which CAPCOs have invested, or such should be obtainable directly from the companies as a condition of investment. Without such records, State officials responsible for monitoring the Program are hampered by the amount or value of information at their disposal or, at a minimum, in their confidence in the accuracy of the information. Additionally, although current law and rules address some types of related party transactions, they do not appear to fully address other types of related party transactions, such as loans, professional services or other financial arrangements. Such arrangements may have the effect of generating profit for the related entity, at the expense of the CAPCO and, accordingly, the Program.

Current staff at the Office of Financial Institutions, although highly qualified and competent, may not be sufficient or may not have the necessary tools in place to adequately react to the creativity and speed the CAPCOs demonstrate in finding new ways to function within the program. The ability of the CAPCOs to generate new ways to function within the Program, to their economic advantage, but not necessarily the State's economic advantage, cannot be overstated. The Program has created and can create wealth for the CAPCO owners, who are willing and able to invest substantial resources in determining the most advantageous way of using the Program, in a very fast-moving marketplace. In other words, the regulators are outnumbered. The State's investment in this Program is substantial. The State needs to invest in the resources necessary for its statutes and rules, as well as its regulatory and program monitoring personnel, to be sufficiently robust to be equal to the challenge of protecting its interests.

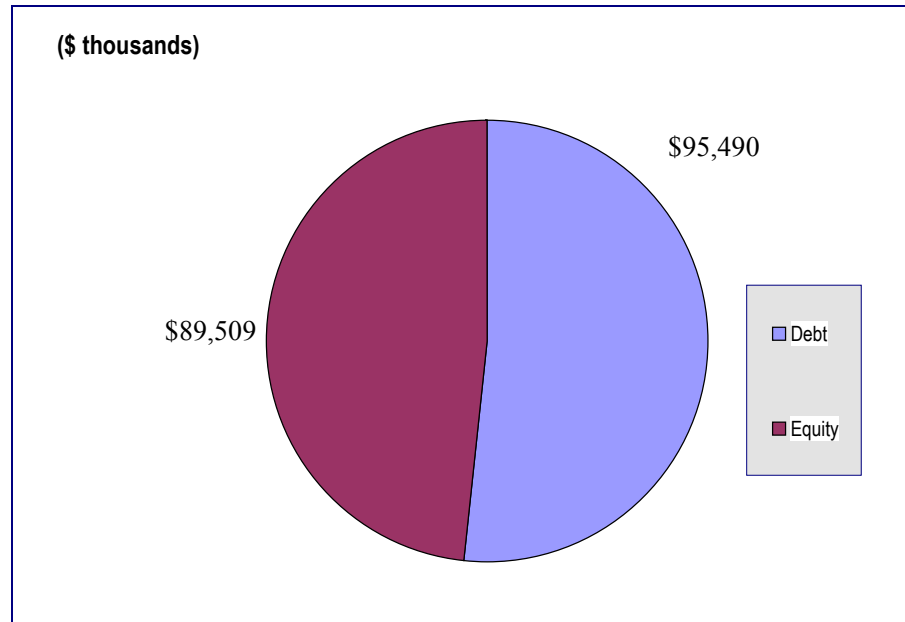
Does the Program provide incentives or other features that encourage the most desirable type of investments (i.e. greatest need, greatest potential economic benefit, or other criteria)?

Somewhat. The statute has historically limited certain investments and the latest change to the statute provided that some capital be set aside for pre-seed or seed stage investments. Louisiana's CAPCO investment parameters are, however, still arguably the least restrictive of all of the states with CAPCO Programs. Several of the other states require proof that a qualified business has been unable to obtain other financing. All of the other states require a qualified business to be headquartered in the state. Several other restrictions may be of interest to Louisiana. However, Louisiana appears to have committed very little, in terms of time and resources, to developing the parameters for investment. A much more robust effort on the part of the State in developing what it considers to be its investment strategy and establishing program features to fulfill that strategy would appear to be advisable. It is important, however, that the investment features of the Program do not restrict the CAPCOs in their investments to such a degree that the benefit of private enterprise control over investment decisions is largely eliminated.

If capital continues to be raised primarily by virtue of the characteristics of debt instruments, rather than equity, the principal investors have little or no economic interest in the investments made by the CAPCOs. Investment restrictions are not a concern of the insurance companies or other investors in secured notes. Accordingly, the restrictions placed on CAPCOs in terms of the type or stage of business in which they must invest, or the type of investment such as debt or equity, that must be made to be a qualifying investment is principally a concern of the State and the CAPCOs.

Figure 6 illustrates the division of CAPCO investments in qualified businesses between debt and equity holdings. This division may indicate a more conservative, or less long-term investment approach than one more heavily weighted to equity investments. It may also be argued that debt service requirements on qualified businesses may restrict their potential growth.

Figure 6: Type of Investment – 1988-1999 (cumulative)



Does the Program minimize government intrusion in the private sector, while simultaneously accomplishing its public purpose?

Yes. The recently published RUPRI Study⁵ of public involvement in venture capital funds addressed three program alternatives in current practice in the United States. Of the three, RUPRI referred to the public involvement through the CAPCO Program as "...a more passive way, through enabling legislation that encourages private sector investment." The benefit of keeping political influence from affecting both capital commitment and investment decisions is, in our view, worth the overhead that may be required by a Program such as CAPCO.

⁵ Rural Policy Research Institute. Public Involvement in Venture Capital Funds: Lessons from Three Program Alternatives, November, 1999.

Quantitative Evaluation

Financial Analysis of Economic Impact of CAPCO Program

A flow of funds model was used to identify fully the investment dollars flowing into the certified capital companies, the tax credits associated with these investment dollars, and the use of these dollars by the CAPCOs. The tax credits incorporate both the tax credits that have been used and the tax credits for which the state is obligated. Hence we are dealing with tax credits over the period 1988 through 2007. The economic results of the investments made by the CAPCOs are recorded based on actual company financial statements as they have been reported to the certified capital companies and an estimated growth of these companies or other such companies over this time period. The economic spillovers, including projections of additional state and local revenues, from the economic activity of these companies receiving assistance from the CAPCOs are determined by the use of the Louisiana Input-Output Model.

The economic impact estimates are derived from an input/output model (I/O model) constructed and maintained by the U.S. Department of Commerce for the State of Louisiana. An I/O model captures the economic impacts on industries throughout the economy if one particular industry, such as the creation of new engineering services, increases the amount of services that it delivers to the national economy. These impacts become very pervasive throughout the economy since persons working in providing the engineering services will purchase goods and services from a variety of merchants within the local economy; the engineering companies will purchase goods and services from local industries in order to provide their services; and, companies providing goods and services to the engineering companies will have to purchase goods and services from other industries. These economic impacts can only be appropriately estimated with an I/O model.

An I/O model, in other words, is an economic model that describes interindustry relations within a state and region. The input-output model mathematically describes the transactions necessary among various industries as these industries produce goods and services for consumers, other businesses and industries, and government. It provides a systematic method to analyze interindustry relationships.

The impacts captured by the I/O model fall into these categories—direct, indirect, and induced effects. The direct effects are the most obvious. They are simply the direct purchases of inputs for the operations of the business. These expenditures include materials purchased in Louisiana plus the payroll of the business. The indirect and induced effects are also referred to as multiplier effects. To understand the indirect and induced effects, it may be helpful to think of the Louisiana economy

as an “economic pond.” A large stone labeled, as an example, the “newly created engineering services company” is dropped into the pond. These operating dollars will cause a large splash in the pond, but these dollars will also send out ripples to the edge of the pond. All of these ripples are the indirect and induced or multiplier effects of the new activity.

The Regional Input-Output Modeling System (RIMS II), as created by the United States Department of Commerce, Bureau of Economic Analysis (BEA) will be used in this analysis for capturing these indirect economic impacts. The Input-Output model has been adapted for application to the Louisiana economy. I/O tables are the most widely used and accepted tools for estimating the direct and indirect impact on (1) the business sales of Louisiana firms, (2) personal earnings of Louisiana households, and (3) the number of jobs created by the creation of a new industry selling its services to the state, national, or global economy. In addition, state and local tax increments can also be calculated using information obtained from the I/O tables.

The comparison of dollars foregone by the State in the form of tax credits and dollars forthcoming to the state due to increased jobs and incomes from additional business activity due to investments made by the CAPCOs is illustrated in a hypothetical example in Table 5. This example, presented in Table 5 and discussed in this and following paragraphs, is only a hypothetical one for illustrative purposes. An insurance company is assumed to have invested \$1,000,000 in a CAPCO in 1990 and, in return, the insurance company received a tax credit of 1.2 times the million dollar investment to be taken over a ten year period. The 1990 value (or present value) of the tax credit extended by the state is \$936,203 using a discount rate of 6 percent. The present value of the \$1,200,000 tax credit is only \$936,203 because the credit is spread over ten years. The CAPCO recruited the insurance investment so that it could make an investment in a qualified Louisiana business. The CAPCO will not typically invest the full \$1,000,000 in qualified investments so it is assumed that the CAPCO will invest only 60 percent of the money in Louisiana businesses. It is assumed this is done in the second year.

This investment in a qualified Louisiana business leads to a company producing a product and/or a service and earning revenues. It is assumed in this hypothetical example that the company will earn \$2 million in gross receipts and eventually earn \$6 million per year by the fifth year and then grow by 10 percent per year each year thereafter. In our hypothetical example, we merely assumed the gross receipts earned by the company. This is an assumption that we have made only for illustrative purposes. Given that the CAPCO program has a longevity of over 10 years, then we will have existing information about the gross receipts of companies that have been accomplished after receiving investments from one or more of the Louisiana CAPCOs.

Table 5: Hypothetical Example of Financial Measurement of Benefits and Costs of Certified Capital Company Program in Louisiana (Discount rate is 6.0 percent)

Year	Tax Credits	Qualified Invest. In Louisiana	Gross Receipts from Business (mil of \$s)	Direct and Indirect Earnings (mil of \$s)	Estimated State Taxes	1990 Value of All State Taxes Collected (mil of \$s)
1990	\$120,000	-	-	-	-	-
1991	\$120,000	\$600,000	-	-	-	-
1992	\$120,000	-	\$2.0	\$0.8	\$ 65,520	\$0.059
1993	\$120,000	-	\$3.0	\$1.3	\$ 98,280	\$0.141
1994	\$120,000	-	\$4.0	\$1.7	\$131,040	\$0.245
1995	\$120,000	-	\$5.0	\$2.1	\$163,800	\$0.307
1996	\$120,000	-	\$6.0	\$2.5	\$196,560	\$0.506
1997	\$120,000	-	\$6.6	\$2.8	\$216,216	\$0.649
1998	\$120,000	-	\$7.73	\$3.0	\$237,838	\$0.799
1999	\$120,000	-	\$8.0	\$3.4	\$261,621	\$0.953
2000	-	-	\$8.8	\$3.7	\$287,783	\$1.114
2001	-	-	\$9.7	\$4.1	\$316,562	\$1.200
2002	-	-	\$10.6	\$4.5	\$348,218	\$1.453
2003	-	-	\$11.7	\$4.9	\$383,040	\$1.633
2004			\$12.9	\$5.4	\$421,344	\$1.819
1990 Value	\$936,203	-	-	-	-	-

The next step is to estimate the impact of this Company's gross receipts on the overall state economy. This calculation for each year is completed by use of the Louisiana Input-Output Model as described above. The I/O model calculates both the direct and indirect effects of the business activity so personal earnings represents earnings associated directly with this company as well as personal earnings associated with all of the indirect jobs created due to this expanded activity in the state's economy.

Finally, state tax collections are calculated based on the average relationship between state tax collections and personal income in the state. State tax collections are computed to be about 8 percent of state personal income so it is estimated that, in this case, additional state taxes will be equal to about 8 percent of additional earnings.

The 1990 value of these tax collections are then computed so that we can compare the present value of the cost of the program (that is, the tax credits) to the present value of the benefits of the program (that is, the tax revenues that are forthcoming due to the activities of the various businesses).

The ultimate objective of the study is to be able to indicate if the present value of operating the program compares favorably to the present value of the benefits accruing from the program. In this example the tax benefits from the expanding businesses will offset the tax credits associated with the program by 1999. In 1999 the estimated 1990 value of the tax collections amounts to \$953,000 as opposed to the 1990 value of the tax credits of \$936,203. This conclusion is based on the information available and the projections that were made. Obviously, the results are sensitive to the robustness of the information and the accuracy of the projections. In this study we have almost ten years of actual information regarding gross receipts of companies that were financed by a CAPCO. This type of information enhances the quality of the results. In addition, the tax credits will at some point be eliminated as a burden on the state's treasury, while the emerging companies will survive long after the tax credit has expired. In addition, the qualified Louisiana businesses can generate profits for the CAPCO that can be reinvested. Or, the CAPCO can sell their share in the Company and reinvest the proceeds in another company. In this fashion, while the cost of the tax credit is finite, the potential returns are not.

This model suggests the process by which we calculate the tax benefits associated with the program. The costs of the program are well known and are easily identified. The benefits have to be estimated as carefully and specifically as possible since, as illustrated above, the conclusions and results of the study will be sensitive to the projections regarding the activities of companies receiving financial assistance from a CAPCO.

Small Businesses in Louisiana

The goals of the CAPCO program were to diversify and stimulate the Louisiana economy, attract and create new industries and new jobs, maintain existing industries and existing jobs, and provide equity or loan financing for new product development, market expansion, start-up operations, and other such business developments. The purpose was to provide a financial alternative for small businesses that, for whatever reason, did not qualify or was not able to persuade other private financial markets of their credit needs and the prospects for financial success. The focus was on small businesses since no one doubts the ability of an Exxon, a Texaco, a Dow, an Occidental Chemical, or a large health care provider to raise capital for expansion, new product development, and likewise. In addition, small businesses dominate the economic structure in terms of number of business establishments, the number of employees working for them, and their payroll. Small businesses tend to be more high risk undertakings than established large corporations which may preclude them from raising funds from the traditional money and capital markets. As noted below, small businesses are a large part of the Louisiana economic landscape.

Small Business Definition

The Louisiana statutes define a qualified Louisiana business, or a business that can qualify for an investment by a CAPCO, as the following:

- A business operating primarily in Louisiana or performing substantially all of its production in Louisiana;
- A business which has, together with its affiliates, a net worth which is not in excess of \$18 million;
- A business which has, together with its affiliates, an average annual net income, after federal income taxes, that is not in excess of \$6 million for the preceding two completed fiscal years, and excluding any carry-over losses.

This definition is comparable to the definition used by the Small Business Administration (SBA) in determining the eligibility of companies for small business administration loans. The SBA definition does vary by industry, and does include number of employees as one criterion by which to measure if a business can be defined as a small business for financial borrowing purposes.

The CAPCO definition of a small business can become less meaningful over time since inflation and the general growth of the economy may suggest that \$18 million in net worth perhaps should be adjusted upwards or an average net income after federal income taxes of \$6 million should be adjusted upwards. This definition of what constitutes a qualified Louisiana investment was passed in 1996. In 1989 the specific qualifications for a qualified Louisiana investment was a business with no more than 500 employees and average annual receipts of \$7 million or less. As will be illustrated in the information about small businesses establishing a limit of 500 employees or less does not cause many businesses in Louisiana not to be qualified for a CAPCO investment, assuming that they meet the other criterion.

Business Establishments by Number of Employees and Industrial Sector

Information about business establishments, employment, and payroll by size of business is illustrated in Tables 6, 7, and 8.⁶ In Table 6, the distribution of business establishments by the number of employees is shown. As can be seen, most business establishments have only 1 to 4 employees. In total about 52 percent of all business establishments have 1 to 4 employees. This is true for all sectors of the economy. The manufacturing sector has the smallest percentage of firms with 1 to 4 employees—only about 34 percent. The finance, insurance, and real estate sector has the most firms with only 1 to 4 employees—over 63 percent. Firms with 250 employees or more make up less than 1 percent of all business establishments in total. Only the oil and gas sector and the manufacturing sector have firms with 250 employees or more representing more than 1 percent of all business establishments. Oil and gas businesses with 250 employees or more account for almost 3 percent of

⁶County Business Patterns, Louisiana, various issues.

all oil and gas businesses, while manufacturers with 250 or more employees make up almost 3.5 percent of all manufacturers.

Table 6: Percent of Business Establishments by Number of Employees and by Industrial Classification

Industry Classification	Number of Employees								
	1-4	5-9	10-19	20-49	50-99	100-249	250-499	500-999	over 1,000
Agriculture	62.9	22.4	11.3	2.7	0.4	0.2	0.07	0.0	0.0
Oil/Gas	48.0	15.0	13.0	13.2	5.4	2.7	2.0	0.4	0.4
Construction	56.0	18.6	12.5	8.6	2.4	1.3	0.4	0.15	0.08
Manufacturing	34.5	18.7	16.1	14.9	7.1	5.2	2.0	1.1	0.3
Transportation	50.6	17.3	13.4	10.8	4.6	2.5	0.4	0.4	0.05
Wholesale Trade	44.8	23.1	17.3	11.4	2.5	0.8	0.08	0.01	0.0
Retail Trade	42.6	24.9	15.7	11.2	3.6	1.7	0.4	0.02	0.0
Finance	63.4	19.3	9.2	6.0	1.4	0.6	0.13	0.06	0.02
Services	56.9	20.0	11.2	7.0	2.7	1.6	0.4	10.16	0.12

Source: County Business Patterns, Louisiana 1996.

Table 7: Percent of Employees in Business Establishments by Number of Employees and by Industrial Classification

Industry Classification	Number of Employees								
	1-4	5-9	10-19	20-49	50-99	100-249	250-499	500-999	over 1,000
Agriculture	20.6	29.7	30.1	14.4	0.0	5.2	0.0	0.0	0.0
Oil/Gas	2.5	3.1	5.6	13.3	11.8	12.6	22.1	9.4	19.6
Construction	6.7	8.7	11.8	17.7	11.7	13.6	10.0	7.2	12.6
Manufact.	1.5	2.9	5.1	10.8	11.7	18.7	16.1	18.2	15.2
Transportation	4.6	6.2	10.0	17.8	17.5	20.0	6.7	10.5	6.6
Wholesale Trade	8.0	13.9	21.2	31.1	15.2	10.7	0.0	0.0	0.0
Retail Trade	5.8	11.7	15.2	24.3	17.5	17.5	8.1	0.0	0.0
Finance	17.3	18.6	18.1	26.3	0.0	13.1	0.0	6.7	0.0
Services	6.7	8.6	10.1	14.2	12.7	15.7	8.5	7.3	16.0

Source: County Business Patterns, Louisiana 1996.

Information about the number of employees and the amount of the payroll by size of firm is presented in Tables 7 and 8. Almost 60 percent of all employees work for companies with less than 100 employees. Just over 50 percent of total payroll for all firms is accounted for by firms with fewer than 100 employees. Employees who work for firms with 250 or more employees make on the average higher salaries by about 36 percent than employees who work for firms with less than 250 employees. Employees for the larger firms make around \$29,000 per year, while employees for the smaller firms make around \$22,000 per year.

Small firms are dominant in terms of the number of business establishments. Small firms are also dominant in terms of employees working with relatively small firms. For example, over 70 percent of all employees in agriculture, wholesale trade, retail trade, and financial services work for firms with fewer than 100 employees. In addition to these industrial sectors, over 50 percent of all employees in construction, transportation and communications, and personal and business services work for firms with fewer than 100 employees. The distribution of payroll by size of firm follows a pattern similar to the distribution of employees. Firms with fewer than 100 employees play a major role in the Louisiana economy in terms of providing a place for Louisiana citizens to earn a living and contribute to their economic well-being.

Implications for Study

Small businesses are a large part of the Louisiana economy in terms of the number of business establishments, the number of employees, and the payroll that these companies support. Louisiana, nor any other state, can enhance its economic base without substantial growth in small businesses. Many tax programs exist to promote industrial development. These tax programs are more likely to focus on large business entities because the number of jobs, plus the economic spillovers, are more visible when a new manufacturing concern constructs a new facility in Louisiana. Few business development programs are aimed directly at small businesses. The CAPCO program is definitely aimed at assisting small businesses in terms of having access to financing of product development, market expansion, start-up operations, and so on.

Table 8: Percent of Business Payroll by Number of Employees and by Industrial Classification

Industry Classification	Number of Employees								
	1-4	5-9	10-19	20-49	50-99	100-249	250-499	500-999	over 1,000
Agriculture	19.1	24.7	28.9	19.0	0.0	8.4	0.0	0.0	0.0
Oil/Gas	2.0	2.6	4.5	13.0	11.4	11.8	25.6	7.3	21.7
Construction	5.6	6.1	9.4	16.1	11.7	15.1	12.5	8.5	15.1
Manufact.	1.1	1.7	3.5	8.6	10.1	16.6	18.7	19.9	19.8
Transportation	4.5	5.0	8.6	16.7	17.3	21.1	7.0	13.7	6.1
Wholesale Trade	8.7	12.8	20.9	31.0	16.3	10.3	0.0	0.0	0.0
Retail Trade	7.1	11.0	14.2	21.9	17.6	20.1	8.2	0.0	0.0
Finance	17.0	16.0	18.4	28.5	0.0	12.1	0.0	8.0	0.0
Services	8.9	8.7	10.4	14.6	10.9	12.7	8.6	6.8	18.4

Source: County Business Patterns, Louisiana 1996.

Louisiana Qualified Business Investments

The Louisiana CAPCO program has been successful in terms of raising pools of venture capital funds. CAPCOs have raised \$517.106 million through 1998. Four other states, Florida, Missouri, New York, and Wisconsin, have already adopted a similar program to attract venture capital from major institutional investors--specifically, the insurance industry. The Louisiana CAPCO program has worked with respect to raising monies for venture capital investments. This, of course, is the first test of a policy of a state government to encourage more dollars into entrepreneurial investments. A state must attract venture capital funds. Louisiana was not doing this prior to 1984 and, quite frankly, only slightly during the 1980s. In the 1990s venture capital monies have gradually increased over time with the program raising so many dollars in 1997 and 1998 that the program had to be constrained because of the immediate fiscal impact on the state budget.

The second test of the CAPCO program is the success of the qualified business investments and the impact of these businesses on the overall economy. The state will only regain its foregone tax receipts (in the form of tax credits) if companies are created, existing companies are expanded, and/or new companies move from out of state to take advantage of the venture capital funding in Louisiana. This section of the analysis describes the qualified business investments created by the CAPCOs in terms of Standard Industrial Classification, size of receipts, size of net profits, and other such criteria.

Qualified Louisiana Investments

Qualified Louisiana investments can be categorized in a number of ways. First, these companies that have received CAPCO investments within the time period 1988 through 1998, and are still in existence in 1998, are categorized by the two-digit Standard Industry Classification (SIC) code in Table 9. The SIC is the method that the federal government uses to group similar businesses or businesses that are producing the same product or providing a similar service. For example, all companies providing engineering services are classified in SIC 87, while all companies producing or processing food products are classified in SIC 20. This division will suggest the types of companies, at least from the perspective of the products produced and services provided, in which the CAPCOs have invested in Louisiana.

Another way of assessing the qualified investments in Louisiana is to compare how venture capital funds are used in Louisiana relative to the rest of the country. This comparison does not suggest that there is only one way of investing venture capital funds. In many ways, the comparison points out very vividly the differences in the Louisiana economy and the economies of other states. In addition, national data on venture capital funds are dominated by states such as California and Massachusetts, states in which computer hardware and software are major industries and major players in the venture capital markets. This comparison between the use of venture capital funds in Louisiana and in the United States is presented in Table 10. Nationally, almost 60 percent of all venture capital is invested in the software and

information industry and the communications industry, whereas in Louisiana the communications industry generated only 4.9 percent of the gross receipts of the firms that received CAPCO financing. In Louisiana, 67 percent of all gross receipts from CAPCO investments comes from business services and distribution and retailing. Louisiana is simply not like the rest of the nation in terms of how its venture capital funds are used. However, this does not suggest that the venture capital funds in Louisiana are not using the funds in the most advantageous manner. To the contrary, the CAPCO program is established so that private venture capital fund managers have the most to gain by investing the funds in the most profitable ventures. Certain industries such as the software industry is just not located in Louisiana, and venture capital funds, by themselves, cannot attract such an industry.

Table 9: Louisiana Qualified Investments by SIC Code: Percent of 1998 Gross Revenues Produced by Each Two Digit Industry

Standard Industry Classification	Industry Characteristics	Percent of Gross Revenues Produced in 1998
09	Fishing, Hunting, Trapping	0.0
16	Heavy Construction	0.0
17	Special Trade Contractors	4.7
20	Mfg: Food Products	1.2
25	Mfg: Furniture	0.1
26	Mfg: Paper Products	2.5
27	Mfg: Printing, Publishing	1.2
28	Mfg: Chemicals	0.1
32	Mfg: Stone, Clay, Glass	0.5
34	Mfg: Fabricated Metals	2.1
35	Mfg: Industrial Machinery	10.6
36	Mfg: Electronic Equip.	0.2
38	Measurement and Analyzing Equip.	0.0
39	Misc. Mfg.	0.1
42	Transportation & Warehousing	0.6
44	Water Transportation	0.5
45	Air Transportation	0.2
48	Communications	4.9
49	Electric, Gas, and Sanitary Services	0.0
50	Wholesale Trade: Durable Goods	18.2
51	Wholesale Trade: non-Durable Goods	15.2
52	Retail Trade: Building	0.1
54	Retail Trade: Food Stores	1.2
55	Retail Trade: Auto & Gas	5.7
56	Retail Trade: Apparel	0.1
57	Retail Trade: Furniture	0.3
58	Retail Trade: Eating, Drinking Places	0.7
59	Retail Trade: Misc.	0.6
61	Non-Deposit Credit	0.1
62	Security Brokers	0.0
64	Insurance	3.2
65	Real Estate	0.2
70	Services: Hotels	1.8
72	Personal Services	0.2
73	Business Services	20.4
75	Automotive Repair Serv.	0.1
78	Services: Motion Pictures	0.09
79	Amusement-Recreation Services	0.7
80	Health Services	0.8
82	Educational Services	0.2
83	Social Services	0.01
87	Engineering, Acct., and Research Services	0.6

Table 10: Comparison of Venture Capital Activities in United States and Louisiana, 1998 (in percent)

Industry Classification	United States ¹	Louisiana ²
Software and Information	31.8	0.0
Communications	27.7	4.9
Healthcare Services	7.7	0.8
Business Services	4.4	24.2
Medical Devices	4.8	0.0
Consumer	4.1	3.1
Biotechnology	4.5	0.0
Computers	3.1	0.0
Industrial	2.9	18.6
Distribution-Retailing	2.6	42.7
Electronics-Instrumentation	2.1	0.0
Pharmaceuticals	2.3	0.0
Semiconductors-Equipment	1.6	0.0
Environmental	0.9	0.0
Other	0.6	5.5

Source: PriceWaterhouseCoopers, MoneyTree Report, Q4 1998 and Full Year Results

¹ Venture Capital Investment.

² Gross Receipts of Firms in 1998.

Size of Qualified Louisiana Businesses

Another way of identifying qualified Louisiana businesses is to evaluate them by the size of their gross receipts and payrolls. This information is presented in Tables 11, 12, and 13. In Table 11, the companies that have received financing from certified capital companies in Louisiana are classified by different categories of gross receipts with the largest companies being classified as having \$10,000,000 or more in gross receipts. The smallest companies are classified as having less than \$250,000 in gross receipts. The 15 largest companies in 1998 accounted for over 80 percent of all gross receipts generated by the 104 companies that had received financing from a Louisiana CAPCO and had reported information to their CAPCO. Eighteen companies reported having gross receipts of more than \$5,000,000, while 37 companies reported having gross receipts between \$1,000,000 and \$5,000,000. Eleven companies reported having gross receipts of less than \$250,000. Gross

receipts represent what the companies are selling to their customer base. In the end for the company to succeed it must have a positive net income, but gross receipts are an important measure of the impact of the company on the local economy because this determines how many persons will be required to work for it, how many materials will be purchased from other businesses in the local economy, and how the company will possibly develop in the long-run.

In Table 12, these companies that received financing from Louisiana CAPCOs are classified according to the size of their payroll. Six companies in 1998 had payrolls of \$2,500,000 or more, while 13 companies had payrolls of between \$1,000,000 and \$2,500,000. Fifty-three companies in 1998 reported having payrolls of between \$100,000 and \$1,000,000. The total payroll for all companies receiving financing from Louisiana CAPCOs amounted to \$153,610,000 in 1998.

Gross receipts and payroll are important factors in analyzing the economic significance of a company for the local and state economy. However, in the long-run the most important factor is the ability of the company to survive in the market place. This long-run survivability is measured by the net income before taxes. In Table 13, companies are classified according to having a positive net income before taxes and the size of the company for the years 1988 through 1998. In 1998, 55 percent of all companies that had received CAPCO financing had a positive net income before taxes. The companies that had gross receipts of less than \$500,000 had the smallest percentage of companies that had a positive net income--in this case, only 36 percent of the companies had a positive net income.

Table 11: Gross Revenues By Year

	Gross Revenues (\$ thousands)										
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
\$10,000,000 or greater	\$ -	\$ -	\$ 17,114	\$ 60,434	\$ 68,902	\$150,417	\$175,648	\$293,272	\$342,741	\$402,238	\$623,048
\$5,000,000 to \$9,999,999	-	-	6,618	21,811	19,859	37,698	40,840	27,015	30,884	40,049	17,275
\$2,500,000 to \$4,999,999	3,682	3,185	7,562	9,508	6,785	13,295	22,334	36,260	35,255	49,486	64,970
\$1,000,000 to \$2,499,999	-	1,152	3,975	3,081	4,581	10,544	18,049	24,424	32,995	47,705	31,492
\$500,000 to \$999,999	-	-	622	610	2,120	2,664	3,984	5,599	10,935	9,769	16,830
\$250,000 to \$499,999	-	-	-	253	1,071	1,037	3,117	3,762	4,645	7,688	5,179
less than \$250,000	-	-	-	139	266	610	520	1,382	1,567	1,244	1,245
Total:	\$ 3,682	\$ 4,337	\$ 35,891	\$ 95,836	\$103,584	\$216,265	\$264,492	\$391,714	\$459,022	\$558,179	\$760,039

	Number of Companies										
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
\$10,000,000 or greater	-	-	1	3	4	5	6	10	10	12	15
\$5,000,000 to \$9,999,999	-	1	1	3	3	5	6	4	5	5	3
\$2,500,000 to \$4,999,999	2	1	2	3	2	4	5	11	11	14	18
\$1,000,000 to \$2,499,999	-	-	3	2	3	6	12	16	22	30	19
\$500,000 to \$999,999	-	-	1	1	3	4	5	7	16	14	24
\$250,000 to \$499,999	-	-	-	1	3	3	9	11	14	20	14
less than \$250,000	-	-	-	1	3	5	7	13	11	11	11
Total:	2	2	8	14	21	32	50	72	89	106	104

Table 12: Wages and Salaries by Year

	Wages & Salaries (\$ thousands)											
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	
\$10,000,000 or greater	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 97,587
\$5,000,000 to \$9,999,999	-	-	5,294	-	-	-	-	-	10,036	12,263	6,340	
\$2,500,000 to \$4,999,999	-	-	-	3,509	5,733	3,016	-	3,901	-	-	13,163	
\$1,000,000 to \$2,499,999	-	-	-	1,696	2,859	4,313	4,955	4,841	4,243	9,581	16,424	
\$500,000 to \$999,999	636	-	574	1,518	1,435	2,010	4,263	3,624	3,927	8,413	7,705	
\$250,000 to \$499,999	-	341	-	-	345	917	1,291	4,451	7,502	7,565	8,402	
\$100,000 to \$249,999	148	174	-	227	227	654	1,965	1,778	2,231	3,934	2,857	
\$50,000 to \$99,999	-	-	-	-	193	135	304	384	1,053	755	908	
less than \$50,000	-	-	48	11	8	43	236	259	205	222	224	
Total:	\$ 784	\$ 515	\$ 5,916	\$ 6,961	\$ 10,800	\$ 11,088	\$ 13,014	\$ 19,238	\$ 29,197	\$ 42,733	\$153,610	

	Number of Companies											
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	
\$10,000,000 or greater	-	-	-	-	-	-	-	-	-	-	1	
\$5,000,000 to \$9,999,999	-	-	1	-	-	-	-	-	2	3	1	
\$2,500,000 to \$4,999,999	-	-	-	1	2	1	-	1	-	-	4	
\$1,000,000 to \$2,499,999	-	-	-	1	2	3	3	3	3	7	13	
\$500,000 to \$999,999	1	-	1	2	2	3	6	5	5	11	10	
\$250,000 to \$499,999	-	1	-	-	1	3	4	12	20	22	24	
\$100,000 to \$249,999	1	1	-	2	2	5	11	11	14	25	19	
\$50,000 to \$99,999	-	-	-	-	3	2	4	6	14	10	12	
less than \$50,000	-	-	1	1	1	2	6	9	7	9	9	
Total:	2	2	3	7	13	19	34	47	65	87	93	

Table 13: Positive Net Income Before Taxes

Gross Revenues	1988			1989			1990			1991		
	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT
\$10,000,000 or greater	-	-	-	-	-	-	1	1	100%	3	3	100%
\$5,000,000 to \$9,999,999	-	-	-	-	-	-	1	1	100%	3	3	100%
\$2,500,000 to \$4,999,999	2	1	50%	1	1	100%	2	2	100%	3	3	100%
\$1,000,000 to \$2,499,999	-	-	-	1	-	0%	3	1	33%	2	1	50%
\$500,000 to \$999,999	-	-	-	-	-	-	1	1	100%	1	1	100%
\$250,000 to \$499,999	-	-	-	-	-	-	-	-	-	1	-	0%
less than \$250,000	-	-	-	-	-	-	-	-	-	1	1	100%
Total:	2	1	50%	2	1	50%	8	6	75%	14	12	86%

Gross Revenues	1992			1993			1994			1995		
	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT
\$10,000,000 or greater	4	4	100%	5	4	80%	6	5	83%	10	9	90%
\$5,000,000 to \$9,999,999	3	2	67%	5	2	40%	6	4	67%	4	4	100%
\$2,500,000 to \$4,999,999	2	2	100%	4	1	25%	5	4	80%	11	5	45%
\$1,000,000 to \$2,499,999	3	3	100%	6	2	33%	12	7	58%	16	10	63%
\$500,000 to \$999,999	3	3	100%	4	2	50%	5	4	80%	7	6	86%
\$250,000 to \$499,999	3	2	67%	3	1	33%	9	3	33%	11	5	45%
less than \$250,000	3	1	33%	5	1	20%	7	2	29%	13	2	15%
Total:	21	17	81%	32	13	41%	50	29	58%	72	41	57%

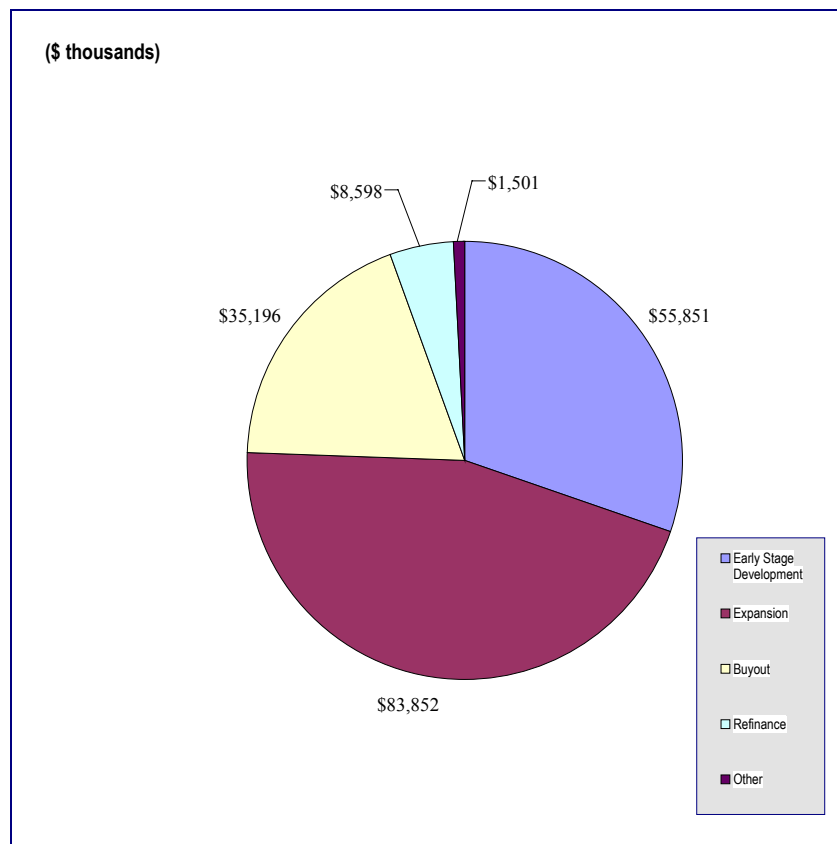
Gross Revenues	1996			1997			1998		
	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT	No. Co.'s	Pos. NIBT	% Pos. NIBT
\$10,000,000 or greater	10	6	60%	12	9	75%	15	9	60%
\$5,000,000 to \$9,999,999	5	3	60%	5	3	60%	3	-	0%
\$2,500,000 to \$4,999,999	11	7	64%	14	8	57%	18	13	72%
\$1,000,000 to \$2,499,999	22	14	64%	30	18	60%	19	11	58%
\$500,000 to \$999,999	16	10	63%	14	9	64%	24	15	63%
\$250,000 to \$499,999	14	7	50%	20	13	65%	14	5	36%
less than \$250,000	11	3	27%	11	5	45%	11	4	36%
Total:	89	50	56%	106	65	61%	104	57	55%

Purpose of Investment

The purposes of the investments by the CAPCOs have been divided into five categories, namely, early financing for starting up a business, expansion financing for a business, buy-out financing, refinancing, and all other types of financing. All of this financing may be crucial to starting a business or saving a business from going under, but if all of the financing was for buy-outs, then you might have a different impression of venture capital markets in Louisiana than if all of the financing was for start-ups or expanding markets. Cumulative financing from 1988 through 1999, by purpose of investment, is illustrated in Figure 7 and further described below.

Early Development	30 percent
Expanding Markets	45 percent
Buy-outs	19 percent
Refinancing	5 percent
Other	1 percent

Figure 7: Purpose of Investment – 1988-1999 (cumulative)



The overwhelming majority of the CAPCO investments were for early business development and expanding markets. Buy-outs and refinancing amounted for about 24 percent of all CAPCO financing.

Economic Spillovers from Business Activity

The tax credit program was established to encourage the development of new businesses, the expansion of existing businesses, the development of new products, the search for new markets, and, ultimately, the creation of jobs and earnings for Louisiana workers. In the end the comparison is between the cost of the program in terms of foregone tax revenues to the state and the benefits of the program to the state in terms of additional tax revenues associated with the new jobs and additional earnings related with the new businesses. The process by which the economic costs and benefits are calculated are outlined below.

First, the tax credits are established from 1988 to the year 2007, the year in which all of the tax credits that have been granted may be fully utilized. We have to remember that an insurance tax credit that is granted in 1998 cannot be fully utilized until 2007 because the insurance credit is spread over a minimum of ten years by law. Also, based on a voluntary agreement signed by the two largest CAPCOs in the state and officials of the Division of Administration, sizeable income tax credits were allocated over a four to five year period of time because of the potential fiscal impact in fiscal year 1999. The tax credits that have been used, both insurance and income tax credits, and the tax credits that may be used over the next ten years are itemized in Table 14. These tax credits do not represent the total obligations of the state, as listed on page 16. Rather, they represent the tax credits associated with the qualified Louisiana investments from 1988 to 1998. These credits stretch over a 20 year period so in order to derive one number, that is the 1999 value of the tax credits, we have to compound the tax credits taken prior to 1999 and discount the tax credits that will be taken after 1999. We used an interest rate of 6.0 percent, a rate consistent with rates on government securities. The 1999 value of the tax credits to the State of Louisiana is \$405.4 million. This is not assuming any additional tax credits are allowed; rather, this is merely taking the tax credits that have been granted, the tax credits that have been used, and the tax credits that will be used. These are the tax credits associated with the qualified Louisiana investments from 1988 through 1998.

The cost of the program is fairly definitive. Obviously, we could use different interest rates and that would alter the estimate of the 1999 value of the tax credits extended as of this time. However, a higher interest rate makes the value of the tax credits taken before 1999 higher and the tax credits taken after 1999 lower. Similarly, a lower interest rate makes the tax credits taken before 1999 lower and the tax credits taken after 1999 higher.

The estimated tax revenues from increased business activity are derived in the following steps. First, the gross receipts of all companies receiving financing from a CAPCO were compiled from 1988 through 1999. These financial statements vary from audited financial statements by external accounting firms to memorandums to the CAPCOs regarding the financial condition of the company in which the CAPCO had an equity position or a elaborate loan arrangement. We tried to verify the information by working with the Department of Revenue. However, given the short time frame for completing the study and the amount of work necessary for the Department of Revenue to retrieve the data, this idea was not workable.

Second, the companies were summarized according to SIC codes so these companies would have similar inter-industry transactions. Gross receipts of the companies in

each separate SIC codes were then added together and then applied to the Input-Output Model which then estimates overall business transactions, personal earnings, and new jobs associated with the activity of these companies. This was done for each year from 1988 through 1998.

Third, the ratio of state tax collections to personal earnings was calculated as being approximately 8 percent. The personal earnings associated with the new business activity was used as the input to derive state taxes that would be collected. These are the estimated state tax collections that are shown in Table 14 from 1988 to 1999.

Finally, the tax collections are projected from 1999 to the year 2010, a couple of years after the currently generated tax credits are fully utilized. Three different growth scenarios are estimated. One growth scenario is based on the average growth of actual gross receipts over the last five years for companies that have received financing from the CAPCOs. This is the 29.1 percent growth scenario. The second growth scenario is a 15 percent growth rate based on these start-up companies having an above average growth potential. The last growth scenario is the 10 percent growth rate, a more conservative growth rate for emerging companies. In all of these scenarios we have projected that 100 percent of the gross receipts are related to the CAPCO financing. We will adjust this projection in another analysis.

The 1999 cost of the tax credits to the State of Louisiana is \$405.4 million over the time period from 1988 to 2007. The 1999 value of the state tax collections associated with the increased business activity depends on the growth rate scenario. Based on the 29.1 percent growth rate scenario, the scenario based on the actual growth of companies receiving financing from CAPCOs for the last five years, the 1999 value of the state tax collections from 1988 to 2010 is \$1,206.8 million or about three times the cost of the program. As of the year 2007 the value of the tax collections amount to \$680.4 million, not quite a doubling of the cost of the program. By the year 2005, assuming the growth rate of output of qualified Louisiana businesses continues at 29.1 percent per year, the benefits from the CAPCO program will have repaid the tax credits used to initiate the program.

The 15 percent growth rate scenario produces state tax collections that, as of 2010, yield a 1999 value of \$609.8 million. As of the year 2007, the 1999 value of state tax collections are estimated to be \$446.2 million, an estimate that is slightly higher than the computed costs of the tax credit program.

Finally, the 10 percent growth rate scenario yields state tax collections that, as of 2010, produces a 1999 value of \$496.4 million, again an estimate that is higher than the computed costs of the tax credit program. As of the year 2007, the 1999 value of the state tax collections from 1988 through 2007 associated with companies receiving financing from Louisiana CAPCOs amounts to \$391.6 million. In this case, the estimated benefits of the program are slightly lower than the estimated costs of the tax credit program.

Table 14: Comparison of Benefits and Costs of CAPCO Program in Louisiana - All Gross Receipts Related to CAPCO Financing (in millions of dollars)

Year	Tax Credits* (Nominal Value)	Tax Collections from Increased Business Activity* (Nominal Value)		
		29.1% Growth (from 1999)	15.0% Growth (from 1999)	10.0% Growth (from 1999)
1988	\$11.827	\$0.130	\$0.130	\$0.130
1989	\$0.822	\$0.152	\$0.152	\$0.152
1990	\$0.803	\$1.243	\$1.243	\$1.243
1991	\$0.975	\$4.618	\$4.618	\$4.618
1992	\$2.680	\$4.999	\$4.999	\$4.999
1993	\$4.657	\$9.777	\$9.777	\$9.777
1994	\$8.449	\$12.182	\$12.182	\$12.182
1995	\$12.227	\$17.556	\$17.556	\$17.556
1996	\$16.781	\$19.575	\$19.575	\$19.575
1997	\$31.618	\$24.484	\$24.484	\$24.484
1998	\$38.568	\$24.105	\$24.105	\$24.105
1999	\$38.113	\$25.000	\$25.000	\$25.000
2000	\$49.488	\$31.120	\$27.721	\$26.516
2001	\$48.967	\$40.176	\$31.879	\$29.168
2002	\$47.263	\$51.867	\$36.661	\$32.084
2003	\$45.285	\$66.961	\$42.160	\$35.292
2004	\$37.119	\$86.446	\$48.484	\$38.822
2005	\$26.341	\$111.6.1	\$55.757	\$42.704
2006	\$21.787	\$144.078	\$64.121	\$46.975
2007	\$6.759	\$186.004	\$73.739	\$51.672
2008	\$0.0	\$240.132	\$84.800	\$56.839
2009	\$0.0	\$310.010	\$97.520	\$62.523
2010	\$0.0	\$400.224	\$112.148	\$68.776

*Tax credits associated with qualified Louisiana investments in 1988-1998

*Estimates from 1988 to 1999 based on Louisiana Input-Output Model.

Less Than 100 Percent of Gross Receipts Related to CAPCO Financing

All companies do not rely 100 percent on CAPCO financing. Other sources of equity financing and debt financing are available. One sample of a mixture of financing for twenty companies for one of the CAPCOs suggested that about 22 percent of the financing was CAPCO financing. What is difficult to gauge is if any of this other financing would have been available if the CAPCO had not been available. As a simple calculation we can provide estimates of the benefits of the program if 22 percent of the financing is CAPCO related or if, as an example, 50 percent of the financing is CAPCO related. These estimates are presented below:

Cost/Benefit of Program

Tax Credit Program	\$405.4 million
--------------------	-----------------

Tax Benefits, 29.1% Growth

50% Related	\$603.3 million
-------------	-----------------

22% Related	\$265.5 million
-------------	-----------------

Tax Benefits, 15.0% Growth

50% Related	\$304.9 million
-------------	-----------------

22% Related	\$134.2 million
-------------	-----------------

Tax Benefits, 10% Growth

50% Related	\$248.2 million
-------------	-----------------

22% Related	\$109.2 million.
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As is obvious, the estimates of tax benefits are sensitive to the projected growth rates of gross receipts over the next ten years and the amount of the gross receipts that are related to CAPCO financing.

Conclusions and Recommendations

Conclusions

Conclusions regarding the CAPCO Program which, in turn, have given rise to several recommendations for consideration in any extension or revision of the program, are listed below:

1. The CAPCO Program has enabled private venture capital management firms and BIDCOs in Louisiana to raise over \$517 million from 1988 to 1998 and a projected \$166 million in 1999 and 2000 for an estimated grand total of \$683 million. In 1998 alone the CAPCOs in Louisiana raised \$229 million in certified capital, an amount that exceeded the venture capital raised in states such as Michigan and Ohio, as reported by PriceWaterhouseCoopers, and placed Louisiana as the 17th state in the country in terms of venture capital raised.
2. The CAPCO Program has encouraged and facilitated the development of private venture capital management firms in Louisiana. Presently, there are seventeen distinct management firms in the CAPCO Program, seven of which began their involvement in 1999. In the early 1980s Louisiana had no discernible venture capital industry, while states such as California, Massachusetts, and New York had 22, 24, and 30 venture capital firms respectively. Additionally, very little identifiable venture capital has been raised in Louisiana outside of the CAPCO Program, which suggests that, without the Program, relatively little venture capital would be available in Louisiana. In fact, the program is now functioning in states such as Florida, Missouri, New York, and Wisconsin and is being seriously considered in Arizona, Iowa, North Carolina, and Texas.
3. Because of the way the Program is currently used, and the lack of capital commitment or formation activity by the most active CAPCOs outside of the Program, permanent discontinuance of the Program, in any form, would leave the CAPCOs without a method for raising additional capital that they have used successfully.

4. The State of Louisiana has granted or is obligated to provide \$610 million in tax credits during the period of 1988 through 2009. The obligations for tax credits already incurred by the State, by fiscal year, are approximately as follows:

Fiscal Year	Tax Credit Obligation
2000	\$61.5 million
2001	\$64.0 million
2002	\$63.3 million
2003	\$61.3 million
2004	\$53.1 million
2005	\$42.3 million
2006	\$37.8 million
2007	\$22.0 million
2008	\$16.0 million
2009	\$ 8.0 million

5. An economic analysis of the CAPCO program from 1988 to 1998 suggests that the 1999 value of all tax credits generated and used or generated and to be used no later than the year 2007 amounts to \$405.4 million, while the 1999 value of estimated tax revenues from 1988 to 2010 associated with the business activity and jobs related to the qualified Louisiana investments is \$1,206 million. The underlying assumptions are the average growth of business activity over the past five years of 29.1 percent per year and 100 percent of all gross receipts being related to the CAPCO financing.

6. The calculation of the 1999 value of the tax benefits associated with the additional business activity related to the CAPCO financing depends on the projected growth of gross receipts of the qualified Louisiana businesses and the fraction of the gross receipts of these Louisiana businesses that can be related to the CAPCO financing. A projected growth rate of 29.1 percent (the average for the last five years) and a 22 percent fraction of gross receipts related to CAPCO financing (based on a sample of financing relationships and the assumption that the other financing would have been available without the CAPCO investment) provide a 1999 estimate of the value of the tax benefits associated with the CAPCO program of \$265.5 million for the time period from 1988 through 2010. The tax benefits will continue to grow after 2010 while the cost of the tax credits will not exceed the \$405.4 million.

7. The CAPCO Program, in its current form, is expensive and inefficient to the State. Louisiana CAPCOs have been able to raise money from national insurance companies primarily by offering an investment-grade financial instrument that is guaranteed by the tax credit and collateralized security. As an example, to raise \$25 million it is estimated that the CAPCO must use \$10 million to collateralize the financial security and about \$1 million to cover financing and related costs. Of the \$25 million raised by the CAPCO from the insurance company, the CAPCO owns approximately \$14 million that it can use for investments in accordance with the rules and regulations pertaining to qualified Louisiana businesses. Accordingly, \$27.5 million in tax credits are generated by a transaction that raises only \$14 million in capital available for investment in qualified businesses. Presumably, if the capital raised by the CAPCOs were in the form of equity, the collateral would not be necessary and an additional \$10 million would be available for investment. It also should be noted that the \$14 million in cash available for investment represents profit to the CAPCO, to be recognized over time, for raising the capital. From 1988 to 1998 the CAPCO Program raised \$517 million of certified capital. During this same time period the CAPCOs have made just over \$149 million in qualified Louisiana investments.

8. The CAPCO Program, in its current form, does not provide adequate features or incentives to encourage investments that offer the greatest potential economic benefit to the State. The current investment mix and investment levels of the CAPCOs suggests that opportunity exists to narrow the investment focus of the Program, and require higher investment levels, although any such initiatives should be carefully considered to avoid unintended consequences.

Recommendations

Louisiana should consider modifications to the program in order to provide a more substantial return to the State from the CAPCO Program. These recommendations include the following:

- For all future allocations of tax credits, the state set limits on the total credits to be granted and the annual credits that will be allowed to be taken. These limits should be based on what amount of credit the State can afford and is willing to invest in the Program. The statutes should allow for the state to control the fiscal consequences of the CAPCOs' activities.
- The investment parameters of the program should be comprehensively reviewed and rewritten to insure that, for tax credits granted, investment focus is on those opportunities determined to be of sufficient potential benefit to the state for inclusion in the Program. Investment parameters should further address issues related to the availability of non-CAPCO financing options to qualified businesses; industry classification; size of business in terms of revenues, assets, and/or personnel; location of the business; stage of development; growth potential; and, any others as determined by a qualified group of policy makers.

- Program performance measures should be established and provisions made for ongoing monitoring and evaluation of the Program's economic performance, as well as regulatory compliance. Financial statements and tax returns of qualified Louisiana businesses; verifiable documentation of jobs and payrolls associated with these businesses; and other such information should be required to be provided to the office responsible for ongoing monitoring and evaluation of the Program, on an annual basis.
- Distributions, related party loans and other business transactions, and other parameters of the Program should be developed, in a comprehensive fashion, to insure that relative benefits inure to participants of the Program as intended. Matters to be considered may include (1) State participation in distributions by a CAPCO, other than "qualified" distributions, that exceed an annual internal rate of return on contributed capital from owners, (2) requiring a higher qualified investment percentage, or even investment multiples, of certified capital in order to decertify without loss of tax credits, (3) allowing only those investments that represent an additional increment of investment over any amount previously invested in a specific business to be counted toward certified capital.