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Certified Capital Companies (CAPCOs): Strengths and Shortcomings of the Latest Wave in State-Assisted Venture Capital Programs

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Certified Capital Companies (CAPCOs) are state-certified venture capital companies funded by insurance companies. As an incentive to invest in CAPCOs, insurance companies receive a $1 credit on premium taxes for each $1 invested (tax credits are spread over a 10-year period). The CAPCOs must invest in specific types of businesses according to an established time schedule to ensure the availability of tax credits to the insurance companies. Legislation authorizing CAPCO programs has passed in five states (Louisiana, Missouri, Florida, New York, and Wisconsin) and has been considered in eight other states (Iowa, Illinois, Arizona, Texas, Kansas, Vermont, Colorado, and North Carolina). This article summarizes the characteristics and experiences of CAPCO programs in the states that have passed enabling legislation. Lessons learned from the experiences of the state programs are provided, and the advantages and disadvantages of CAPCOs as compared to alternative state-sponsored venture capital programs are reviewed.

Access to venture capital is recognized as critical for business start-ups and expansions and, consequently, important for state and local economic development prospects (Bingham, Hill, & White, 1990; Federal Reserve Bank of Kansas City, 1999; Florida & Kenney, 1988; Florida & Smith, 1990; Leicht & Jenkins, 1994; Parker & Parker, 1998; Timmons & Bygrave, 1986). Yet, the supply of venture capital is concentrated geographically, and venture capital investments are focused on a relatively small number of regions and industries (PricewaterhouseCoopers, 1999). The geographic concentration and industrial focus of venture capital investments have contributed to the perception that specific regions of the country (the more geographically isolated and/or sparsely populated) and certain industries (traditional, non–high tech) are underserved by private venture capital firms. A common response to this perception of a venture capital shortage is the initiation of public programs to enhance the availability of equity capital for local entrepreneurs and businesses.

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State programs to promote the availability of venture capital first appeared in the late 1970s, with early programs including the Massachusetts Capital Resource Company, the Connecticut Product Development Corporation, and Kansas Venture Capital, Inc. (Daniels & Lynch, 1998; Eisinger, 1991; Fisher, 1988, 1990; Thompson & Bayer, 1992; U.S. Small Business Administration [SBA], 1985). Adoption of state-assisted venture capital programs spread rapidly across the states, and a recent survey of state departments of commerce and economic development identified 144 programs in 46 states (Barkley et al., 2000). These 144 state-assisted venture capital programs fall into five principal program types: publicly funded and publicly managed funds (17), public funding provided for privately managed funds (30), tax credits or incentives for individuals or businesses making venture capital investments (22), state-sponsored or assisted angel networks (53), and state-sponsored or assisted venture capital fairs (22). The development of state-supported venture capital programs was attributed by Eisinger (1991) to the reduction in federal revenue sharing in the late 1970s, which encouraged states to seek innovative methods for stimulating economic development using local resources. Leicht and Jenkins (1996) also suggested that "grow your own" entrepreneurial policies, such as publicly assisted venture capital, are more likely to be adopted in states "pressured by deindustrialization," and these policies spread among states as a result of the movement of development professionals and the tendency for states to mimic successful programs in other states.

The type or organizational structure of the state-assisted venture capital program selected depends to a large extent on the availability and sources of funding and the goals articulated for the program. Public involvement can be viewed as a continuum along which the state makes trade-offs between control over investment decisions and a share in both the upside and downside of investment returns. At one extreme, publicly funded and managed programs provide the greatest public control over investment decisions, thus permitting the targeting of investments to achieve explicit economic development objectives. However, the state also bears total responsibility for funding the program as well as any financial losses or gains that occur under state management. At the other extreme, the state may create enabling legislation that provides tax credits to encourage private venture capital investments. Public control is limited in this model to the restrictions placed in the enabling legislation. The state does not, however, share in the financial gains or losses these investments may incur. The state also may take on a purely facilitative role by supporting networks of individual investors (angels) and venture capital fairs. Again, the state exercises no control over investment decisions and has limited financial responsibility and risk.

The success of state-sponsored venture capital programs (measured in terms of financial returns, economic development impacts, and sustained political support) has been quite mixed. In some states, public venture capital programs were criticized for one or more of the following reasons: inadequate public funding for capitalization and management, lack of needed expertise in fund management, perception of political interference in investment decisions, government regulations that impeded fund operations, and poor financial return on fund investments (Barkley, Markley, & Rubin, 1999). Concerns with previous state-sponsored venture capital programs and/or changes in the fiscal and/or political environments encouraged at least 13 states to investigate Certified Capital Company programs (CAPCOs) as an alternative for increasing the supply of venture capital and enhancing venture capital infrastructure and management capacity in the state. As of October 2000, legislation authorizing CAPCOs was passed in 5 states (Louisiana, Missouri, Florida, New York, and Wisconsin) and was considered in 8 other states (Iowa, Illinois, Arizona, Texas, Kansas, Vermont, Colorado, and North Carolina).

CAPCOs offer state tax credits to insurance companies to encourage private investments in private venture capital firms certified under the state enabling legislation. The certified private venture capital funds (CAPCOs), in turn, must invest in specific types of businesses according to a specified time schedule to ensure the availability of the tax credits. The purpose of this article is to review the characteristics and experiences of CAPCO programs in the five states that have passed enabling legislation. Information on CAPCO programs was obtained from state legislation (passed and proposed) and on-site and telephone interviews with state officials and CAPCO managers.[1] The lessons learned from the experiences of the five operating state programs are summarized in terms of the advantages and disadvantages of CAPCOs versus state-sponsored venture capital

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programs that are publicly funded and managed or those that are publicly funded and privately managed. An appreciation of early CAPCO programs will enable other states to better assess the attractiveness of CAPCOs as an alternative to enhance the availability of venture capital and to stimulate state economic development. An understanding of existing CAPCO legislation also will assist interested states in fashioning legislation that best achieves their specific venture capital and economic development objectives.

STRUCTURE OF CAPCOS

The first CAPCO legislation was passed in Louisiana (1983), with more recent adoptions in Missouri (1997), New York (1997), Wisconsin (1997), and Florida (1998). In addition, CAPCO legislation was proposed, but not passed by July 2000, in eight other states (Arizona, Illinois, Iowa, Kansas, Michigan, Texas, Vermont, and Colorado). Enabling legislation for CAPCOs varies by state; key features of CAPCO legislation (passed and proposed) are summarized in Tables 1 and 2. The typical CAPCO model has the following characteristics with respect to sources of capital, certification process, qualified businesses, returns to state treasury, and reporting requirements:

Source of Capital

Tax credits (100% at a rate of 10% per year for 10 years) are allocated to insurance companies in return for investments (certified capital) in CAPCOs.[2] The credits are available for taxes insurance companies pay on premiums collected on policies sold in the state (referred to as premium taxes). An insurance company's premium tax payment is relatively stable over time; thus, insurance companies are willing to make current investments in exchange for tax credits over the next 10 years. Credits are usually transferable or saleable by the insurance companies. Most states place a cap on the total and annual amount of tax credits available and then determine a process for allocating credits among CAPCOs.[3]

Certification Process

Specific certification requirements established by the state include minimum capitalization (typically $500,000), principals with a minimum of venture capital investing experience (e.g., 2 to 5 years), and establishment of an in-state office. To maintain certification (and retain the tax credits for the insurance company investors), CAPCOs must meet specific investment milestones and invest the equivalent of 100% of certified capital before any liquidating distributions can be made, that is, before any gains from the investments can be distributed to the partners. The CAPCOs are permitted, however, to make qualifying distributions that include management fees (usually a maximum of 2.5% of capital available for investment) and other expenses necessary to the operation of the fund.[4]

Qualified Businesses

States define qualified businesses to meet their specific economic development objectives. Generally, the business must be small (at least by the SBA definition) and located and operated within the state, and most of the employees must be residents of the state.[5] Qualified businesses are usually manufacturers or others engaged in commerce and the export of services. Certain sectors generally are specifically excluded from the list of qualified businesses (e.g., banking, real estate, professional services, insurance, and retail). CAPCO investments must be in qualified businesses to ensure the availability of tax credits for insurance company investors.

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TABLE 1
Comparisons of Key Features of CAPCO Legislation Across State-Passed Legislation

State	*Total Credit Allocated*	*Structure of Tax Credit*	*Who Is Eligible for Tax Credit*	*Qualified Businesses*	*State Share in Distribution*	*Timing of Investments*
Florida-CS/HB1575 (passed 1998-1999)	$150 million	100% premium tax credit; maximum 10% per year	Insurance companies	Fewer than 200 employees; 75% employment in state	10% of amount in excess of original certified capital	20% within 1 year; 30% within 2 years; 50% within 4 years; 50% early stage
Louisiana (Act 642, passed 1983)	Unlimited 1983-1997; 1998, $8 million annual cap on premium tax credits; 1999, $4 million annual cap on income tax credits	110% premium tax credit; maximum 11% per year; 35% income tax credit	Insurance companies; individuals; corporations	Fewer than 500 employees; net worth less than $18 million; net income less than $6 million	None, 1983-1997; after 1998, 25% of excess over amount required to yield 15% IRR (including value of tax credits)	50% within 3 years with 40% in qualified businesses; 80% within 5 years with 50% in qualified businesses
Missouri (Certified Capital Company law, passed 1997)	$50 million, 1997; $50 million, 1998; $40 million, 1999	100% premium tax credit; maximum 10% per year	Insurance companies	Fewer than 200 employees; 80% employment in state; revenues less than $4 million	25% of excess over amount required to yield 15% IRR (including value of tax credits)	25% within 2 years; 40% within 3 years; 50% within 4 years
New York (Chapter 397 of 1997 laws)	$100 million (maximum of $50 million in 1999)	100% premium tax credit; maximum 10% per year	Insurance companies	Fewer than 200 employees; 80% employment in state; revenues less than $5 million	None	25% within 2 years; 40% within 3 years; 50% within 4 years; 50% early stage
Wisconsin (SB333, passed 1997)	$50 million	100% premium tax credit; maximum 10% per year	Insurance companies	Fewer than 100 employees; 75% employment in state	None	30% within 3 years; 50% within 5 years

NOTE: CAPCO = Certified Capital Company; IRR = internal rate of return.

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TABLE 2
Comparisons of Key Features of CAPCO Legislation Across State-Proposed Legislation

State	*Total Credit Allocated*	*Structure of Tax Credit*	*Who Is Eligible for Tax Credit*	*Qualified Businesses*	*State Share in Distribution*	*Timing of Investments*
Arizona (SB1415, proposed 1998)	Not specified in the draft legislation	100% premium tax credit; maximum 10% per year	Insurance companies	SBA definition; headquartered in state[a]	None	30% within 3 years; 50% within 5 years
Colorado (HB001296, proposed 2000)	$20 million per year	100% premium tax credit; maximum 10% per year	Insurance companies	SBA definition; headquartered in state[a]	None	30% within 3 years; 50% within 5 years
Illinois (HB0144, proposed 1999)	$30 million per year	100% premium tax credit; maximum 10% per year	Insurance companies	SBA definition[a]	None	30% within 3 years; 50% within 5 years
Iowa (HB513, proposed 1999)	$60 million per year	100% premium tax credit; maximum 10% per year	Insurance companies	Fewer than 100 employees; net income less than $2 million; 75% employment in state	None	25% within 2 years; 40% within 3 years; 50% within 4 years
Kansas (SB315, proposed 1999)	$50 million; maximum $10 million credit per CAPCO	100% premium, income, or privilege tax credit; maximum 10% per year	Persons or entity	50% employees in state; sales less than $1million/year; age younger than 5 years	10% of amount in excess of original certified capital	25% within 3 years; 40% within 4 years; 50% within 5 years; 70% within 7 years
Michigan (HB4137, proposed 1999)	$100 million per year	125% tax credit; maximum 12.5% per year	Any "taxpayer"	SBA definition[a]	None	25% within 3 years; 40% within 4 years; 50% within 5 years
Texas (SB899, proposed 1999)	$100 million per year	100% premium tax credit; maximum 10% per year	Insurance companies	Fewer than 100 employees; 80% in state	None	30% within 3 years; 50% within 5 years; 50% early stage
Vermont (HBH113, proposed 1999)	$25 million per year	100% premium tax credit; maximum 10% per year	Insurance companies	Gross revenues less than $3 million	None	25% within 2 years; 40% within 3 years; 50% within 4 years; 50% early stage

NOTE: CAPCO = Certified Capital Company; SBA = U.S. Small Business Administration.
a. Refer to Note 5 for SBA definition of small business.

State Returns

In return for future tax revenues sacrificed (due to tax credits) the state may receive new tax revenues from the businesses that start, expand, and remain within the state as a result of the CAPCO program. Some states also crafted or amended their legislation to permit state participation in the returns to CAPCO investments. Through these legislative changes, states can share in the returns from investments in businesses along with the additional tax revenues that may be generated through the investments.

Reporting Requirements

CAPCOs are required to report to some regulatory authority on an annual basis. Information reported includes identity and amount of capital received from each investor; the amount of tax credits allocated to each investor; the identity, type, size, and location of qualified businesses in the portfolio; the amount of investment made in each business; jobs created by these companies (reported by the CAPCO but not independently verified by the regulatory authority); and audited financial statements.[6]

SUMMARY OF STATE EXPERIENCES

CAPCO legislation has evolved over time as states attempt to better regulate the timing of the CAPCOs' investments and target these investments toward specific types of businesses. The sections that follow summarize the experiences of Louisiana, Missouri, New York, Florida, and Wisconsin. Greatest attention is given to Louisiana and Missouri because these states have the most mature and active CAPCO programs.

Louisiana

The Louisiana CAPCO program was authorized by the 1983 legislature. The goals of the program included diversifying and stimulating the state economy, attracting and preserving jobs, developing a venture capital infrastructure, and attracting experienced venture capital management to the state. The program initially was structured with a 200% tax credit for insurance companies on the state insurance premium tax (taken over 10 years) and a 35% income tax credit for other investors (taken in the year of the investment). However, there was little activity under the CAPCO program until 1988 as a result of (a) a weak state economy and, consequently, a weak pool of potential investments and (b) regulatory restrictions within the insurance industry that made equity investments relatively unattractive. The program became attractive to insurance companies when the CAPCOs developed a bond-type instrument (fully insured, fully guaranteed, and rated a number 1 by the National Association of Insurance Commissioners) that provided a guaranteed rate of return. Attempts by the CAPCOs to attract insurance company investment using a more traditional venture capital limited partnership structure with an 80/20 split of returns were not successful.

The structure of this guaranteed bond-type instrument is included in the private placement memorandum that is negotiated between the CAPCO and each insurance company. However, the general structure involves the set-aside of 40% of the certified capital in zero-coupon bonds to guarantee that the principal invested by the insurance company is returned at the end of 10 to 12 years. The CAPCO also guarantees the stream of tax benefits over a 10-year period, either through a parent organization (e.g., a bank) or through a third-party guarantor. In most cases, the insurance company takes no equity position in the CAPCO and, as a result, does not share in any final liquidating distributions of the fund.

According to a Louisiana Department of Economic Development (1999) report, the use of a guaranteed bond-type instrument by CAPCOs to attract insurance company funding is an expensive and inefficient means of capitalizing the CAPCOs. For example, the Louisiana study estimated that each $27.5 million of tax credits raises $25 million in certified capital (where tax credits

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equal 110% of certified capital raised) but results in only $14 million of capital available for investments in qualified Louisiana businesses. The remaining $11 million of the original $25 million raised is reserved for $10 million of collateral on the insurance companies' loans to the CAPCOs and $1 million for financing and related costs.

The Louisiana program has been amended over time. The 200% tax credit for insurance company investors was reduced to 120% in 1989 and to 110% in 1998. The original legislation placed no limit on the total amount of credits on premium taxes or income taxes the state would provide. In 1998, the legislature placed an annual limit ($72,727,272) on investments in CAPCOs that would result in premium tax credits. No limit on the availability of income tax credits was enacted at this time. However, in 1999 the Office of Financial Institutions, the state regulatory authority, proposed an annual limit on income tax credits of $11,428,571. This proposal was in response to investments in CAPCOs at the end of 1998 that resulted in unexpectedly large income tax credit liabilities for the state.

As of March 2000, there were 32 CAPCOs certified in Louisiana. Of these 32, 11 were organized by Advantage Capital, 3 by BancOne, and the remaining 18 by other companies within the state. From 1988 to 1991, the CAPCO program raised an annual average of $4.5 million in certified capital. This annual average increased to $27.5 million over the 1992 to 1996 period. In 1997 to 1998, the capital raised jumped to $361.4 million as a result of almost $180 million raised via income tax credits. For the entire period of 1988 to 1998, CAPCOs raised more than $517 million in certified capital (committing the state to more than $570 million in tax credits) and invested more than $149 million in 122 qualified businesses. As of December 1999, the CAPCOs reported investments in 149 qualified businesses and claimed 4,841 jobs created or retained. This employment figure is reported by the CAPCOs to the regulatory authority but is not independently verified.

As the CAPCOs increased in size, they sought larger and later-stage investments.

As the CAPCOs increased in size, they sought larger and later-stage investments. The average investment in portfolio companies over the 1988 to 1998 period was $1.2 million. In an effort to retarget investments toward smaller companies, the state may require that beginning in 2000, 10% of certified capital be invested in either (a) approved capital management funds focused on preseed, seed, or early-stage investments of less than $1 million or (b) CAPCOs whose primary focus is investments of less than $l million in certified economically disadvantaged businesses or in businesses located in economically distressed areas.

To retain their certification, Louisiana CAPCOs must follow a schedule for investing certified capital. Within 3 years, at least 50% of the investment pool must be invested, with 30% in qualified businesses. Within 5 years, at least 80% must be invested, with 50% in qualified businesses. For funds certified before December 31, 1998, the CAPCO may voluntarily decertify once 60% of the investment pool has been invested in qualified businesses. For funds certified after this date, voluntary decertification can occur only when 100% of certified capital has been invested in qualified businesses. No distribution to equity owners—that is, CAPCO partners—can be made before these decertification thresholds are reached, with the exception of qualified distributions (e.g., management fees, debt payments to the insurance companies).

The 1983 legislation provided no return to the state from investments made by CAPCOs; however, in 1998, the legislature added a state profit sharing component to the CAPCO program. The state will receive 25% of the returns above the amount necessary to achieve a 15% internal rate of return (IRR) on a specific pool of certified capital (including value of tax credits). This change was implemented to help the state recoup part of the cost of the program and encourage the CAPCOs to expedite their investments in certified businesses.[7]

In summary, the Louisiana legislation was the result of efforts on the part of state economic development officials to stimulate the economy during a period of decline and to create venture capital resources within the state. According to state officials, Louisiana businesses have a source of venture capital they did not have prior to the CAPCO programs, and there has been a demonstration effect for other venture funds in the state. However, the lack of a cap on tax credits issued, particularly in terms of the income tax credit, created large, unexpected tax credit obligations on the part of the state. These obligations forced negotiations between the state and CAPCOs to postpone realization of tax credits over time.

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Missouri

The Missouri CAPCO program was authorized in 1997 with the purpose of inducing private investment in new or expanding small businesses. The original legislation was sponsored by a member of the state legislature and championed by a coalition including a St. Louis regional economic development group and Advantage Capital, a partnership that operated CAPCOs in Louisiana. The Missouri Department of Economic Development supported both the CAPCO concept and modifications to the bill as it moved through the legislative process. Several factors made a tax credit program attractive to policy makers in Missouri. First, Missouri is constitutionally prohibited from making any direct investments in businesses, so economic development strategies in the state generally rely on tax credits. Second, Missouri has a limit on state tax revenues, and revenues collected in excess of this cap are returned to taxpayers. As a result, tax credit programs have been attractive, particularly during the recent economic expansion. Third, the Missouri State Retirement Fund's past experience with venture investing was not positive, suffering from poor management and political pressures.

The Missouri program provides a 100% tax credit, taken over 10 years, to insurance companies who invest in CAPCOs. The legislation allocated $50 million in tax credits in 1997 and $50 million in 1998. The state viewed this initial $100 million as a demonstration program to see how well the CAPCO program performed. An additional $40 million allocation of tax credits was made in 1999, with the money targeted to distressed communities in the state. Businesses in these distressed communities could have up to $5 million in revenue as compared to the $4 million limit for businesses in other parts of the state. In 2000, legislation providing additional tax credits for CAPCOs was passed in the Missouri House and Senate but vetoed by the governor.

When CAPCO legislation was passed, the state placed an initial cap of $25 million on total capital that any CAPCO could raise. This limit was designed to encourage the creation of CAPCOs in the state other than established CAPCOs such as Advantage Capital and BancOne. These two existing CAPCOs had a competitive advantage in raising funds from insurance companies relative to newer CAPCOs because of their established relationships with insurance companies and existing investment instruments.

Similar to the revised Louisiana legislation, Missouri legislation allows the state to capture some of the return on investments made in portfolio companies by the CAPCOs. The Missouri Development Finance Board will receive 25% of any distribution in excess of the investment return that, in combination with the value of the tax credits, yields a 15% IRR. Given the short operating history of the program, it is unclear what the magnitude of the return to the state will be.

The Missouri legislation provides a more restrictive definition of qualified businesses than does Louisiana. CAPCO investments must be made in Missouri businesses with fewer than 200 employees, 80% of whom must be employed in Missouri. Annual revenues for qualified businesses cannot exceed $4 million, or $3 million if the firm is less than 3 years old. The business also must demonstrate a need for venture capital and show an inability to obtain conventional financing (i.e., unable to qualify or turned down for a bank loan).

Since 1997, four CAPCOs have been active in Missouri, one established by Advantage Capital, one by BancOne (Gateway Ventures), and two established by other Missouri firms (Stifel CAPCO and CFB Emerging Fund). In 1997, CAPCOs certified $50 million in capital (committing the state to $50 million in future tax credits) and made investments of more than $27 million in 12 firms. Average investment per firm was $2.2 million. In 1998, another $50 million in capital was certified and $5 million invested, all but $504,000 as follow-on investments in existing portfolio companies. The CAPCOs reported total jobs created by these investments as 726.

In summary, state officials believe the program has improved the infrastructure and environment for venture capital in the state. The program provides a demonstration effect for other venture funds and has functioned to attract additional venture capital to the state through coinvestment on CAPCO deals. One state official described the program as "priming the pump." On the other hand, although Missouri's CAPCO legislation is relatively restrictive in defining qualified investments, the legislation has resulted in relatively little seed capital investment within the state. According to

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CAPCO representatives, more restrictive legislation may encourage the CAPCOs to do fewer seed deals. That is, fewer restrictions on investments would encourage more seed investment because the CAPCOs can offset the higher risk seed deals with investments in larger, less risky ventures. The experience in Louisiana, however, suggests that when CAPCOs have no size restrictions, they will focus on relatively large companies and large deals.[8]

New York

The New York CAPCO legislation was signed into law in 1997 with the stated objective of encouraging the investment of private financial resources in state venture capital markets as a means to fostering the creation and expansion of new small business enterprises. The legislation created a 100% tax credit for insurance companies, taken at a rate of 10% over 10 years. A total of $100 million was allocated to the program by the 1997 legislation, with $50 million in tax credits available in 1999 and the remaining $50 million in 2000. An additional $30 million in funding for the program was authorized in 1999, with all $30 million available for tax credits in 2001.

The $30 million appropriation that New York authorized for CAPCOs in 1999 was significantly less than the $150 million proposed initially. In addition to the $30 million, however, the New York legislature also authorized the state controller to invest up to $250 million of state pension funds in New York venture capital firms. The venture capital funds must match the state's investment and place the capital in New York firms that meet the CAPCO definition of qualified businesses. Legislation also was proposed but not passed, enabling banks to receive a 100% tax credit for investing in certified capital companies.

In addition to the $30 million, however, the New York legislature also authorized the state controller to invest up to $250 million of state pension funds in New York venture capital firms. The venture capital funds must match the state's investment . . .

Initially, six CAPCOs qualified for certification in the state. However, one of these CAPCOs opted to manage BancOne's New York CAPCO, reducing the number of CAPCOs to five. The remaining four CAPCOs are Advantage Capital New York Partners, New York Small Business Venture Fund, Wilshire Advisers, and Exponential Business Development Company. The initial $100 million allocation was distributed as follows: approximately $31 million each to Advantage Capital and the New York Small Business Venture Fund, approximately $28 million to BancOne Capital Corporation, and approximately $3 million each to Wilshire Advisers and Exponential Business Development Company.

The New York legislation differs from the standard CAPCO model in that early-stage businesses are targeted. CAPCOs must invest 25% of certified capital within 2 years, 40% within 3 years, and 50% within 4 years, of which at least 50% must be in early-stage businesses as defined by the legislation. The remaining capital can be invested in any qualified business, defined as firms with fewer than 200 employees and less than $5 million in gross revenues.

Florida

The Florida CAPCO program was authorized in 1998 with the goal of stimulating investments in new and expanding businesses in Florida. The legislation allocated $150 million in tax credits at 10% a year over a 10-year period. The program provides a 100% premium tax credit for insurance companies doing business in Florida. Unlike CAPCO programs in other states, the Florida program is administered by three agencies. The Department of Banking and Finance (DBF) certifies and decertifies the CAPCOs; the Governor's Office of Tourism, Trade, and Economic Development (OTTED) allocates the premium tax credits and reports on the program; and the Department of Revenue oversees tax filings, audits, and credit forfeiture.

The implementation of the Florida CAPCO program is illustrative of a potential shortcoming of CAPCO legislation in general. On December 31, 1998, the DBF certified 15 CAPCOs. On January 26, 1999, OTTED notified the 15 CAPCOs that they had until March 15, 1999, to obtain binding investment commitments from insurance companies. Unlike the other state programs, each CAPCO had to receive commitments of at least $15 million. Similar to New York, each CAPCO could not submit commitments of more than the $150 million appropriation. Only 3 of the 15 certified CAPCOs were able to raise $15 million in commitments, and these 3 CAPCOs requested

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$274 million in tax credits. The credits were allocated among the 3 CAPCOs on a pro rata basis with Advantage Capital receiving almost $82 million, BancOne receiving approximately $31 million, and Wilshire Partners receiving about $37 million. It is important to note that all of these CAPCOs were operating in other states at the time of their certification in Florida. This experience supports the idea that existing CAPCOs have a competitive advantage in fund-raising over newer CAPCOs because of (a) their expertise in designing an investment instrument that is acceptable to insurance companies and (b) the contacts that existing CAPCOs have developed within the insurance industry through their activities in other states.

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In Florida, the certification requirements for CAPCO managers are more stringent than in most other states. Managers must have at least 5 years of venture investing experience in a private venture fund, including investing in early-stage businesses. This experience is important because Florida requires, as does New York, that 50% of certified capital be invested within 5 years with at least 50% of these investments in early-stage technology businesses.

Florida also places more restrictions on its definition of a qualified business than do most other states. Qualified businesses must have fewer than 200 employees, and businesses must agree to keep their headquarters and any manufacturing facility financed with CAPCO investments in Florida for 10 years. In addition, there should be a reasonable expectation that the business will grow to have $25 million in revenues within 5 years of the investment.

The Florida legislation provides for state participation in returns to CAPCO investments. No liquidating distributions can be made until 100% of certified capital is invested in qualified businesses, and if distributions to the investors exceed the original amount of certified capital, the CAPCOs must pay 10% of the excess to the state.

As is the case in other states, the legislation passed in Florida was significantly different from that first proposed. Promoters of the initial CAPCO legislation sought tax credits of $500 million with no annual tax credit limit. The amount authorized was $150 million, with an annual limit imposed. The original legislation also contained no provision for the state to share in the gains from CAPCO investments, and CAPCO principals were required to have only 2 years of experience, with no reference to early-stage investing experience. Finally, small businesses were defined more broadly, according to the SBA definition, and there were no additional requirements in terms of workforce size, remaining in Florida, or types of industries that qualified for investment.

Wisconsin

Wisconsin passed CAPCO legislation with an allocation of $50 million in tax credits in 1997; however, the rules implementing the legislation were not established until 1999. Seven CAPCOs were certified by the state (Advantage Capital Wisconsin Partners, BancOne Stonehenge Capital Fund Wisconsin, CFB Wisconsin CAPCO Division, Stifel Wisconsin CAPCO I, Venture Investors CAPCO I, Wilshire Investors, and Wisconsin Development Capital), but only one of these CAPCOs (Venture Investors) was headquartered in Wisconsin prior to passage of the CAPCO legislation. Of the seven CAPCOs, only three submitted applications for tax credits based on certified capital raised from the insurance industry (Advantage Capital, BancOne Stonehenge, and Wilshire Investors). Each of these CAPCOs received an allocation of $16,666,666.65 on October 21, 1999.

The provisions of the Wisconsin CAPCO legislation are similar to the standard CAPCO model with two exceptions. First, qualified businesses are restricted to those with fewer than 100 employees and less than $2 million net income. Second, voluntary decertification of a CAPCO is permitted when the CAPCO has invested an amount equal to 100% of certified capital or when at least 10 years have passed since the last certified capital investment was made in the CAPCO. The state's regulatory authority over the CAPCO ends with voluntary decertification. Because the state requires that only 50% of certified capital be invested within 5 years, it would be possible for a CAPCO to voluntarily decertify after 10 years, having invested only the equivalent of 50% of certified capital. At this point, distributions of profit could be made to the partners, without meeting the 100% investment requirement. This language provides a loophole in the legislation that may be abused by the CAPCOs.

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Program Evolution

CAPCO legislation has evolved over time and across states as state legislatures attempted to address concerns in earlier legislation and better direct the program to the needs of individual states. Changes in CAPCO legislation include a reduction in tax credits for certified capital from 200% to 120% to 100%, limitations on the amount of tax credits available to insurance companies, limitations on the size of individual CAPCOs, greater targeting of the CAPCO investments through more restrictive definitions of qualified businesses, procedures for the state to recoup a portion of CAPCO program costs through state profit sharing with the CAPCOs, the availability of tax credits for investors in CAPCOs other than insurance companies, and attempts to use CAPCO legislation to facilitate the funding of specialized venture capital programs such as Kansas's innovation and commercialization corporations. It should be noted, however, that most changes in CAPCO programs over time are little more than fine-tuning a generic model. The CAPCO industry (i.e., established CAPCOs) is aggressively involved in state legislation to ensure that the basic program design is preserved.

LESSONS LEARNED

The experiences of CAPCOs in the five states with enabling legislation provide insights into the strengths and limitations of CAPCO programs as compared to two alternative state-assisted venture capital programs (publicly funded–publicly managed funds and publicly funded–privately managed funds). These strengths and limitations are summarized below, along with suggestions for ways that public policy might mitigate program shortcomings. Policy makers can use this information to assess the attractiveness of a CAPCO program versus other available alternatives and, if the CAPCO model is considered appropriate, develop CAPCO legislation that best meets the needs of their state.

CAPCO Strengths

1. State-assisted venture capital programs capitalized via tax credits, such as CAPCOs, do not require current state budget expenditures or bond sales (as do public venture capital funds and publicly funded private venture capital funds). Moreover, the actual cost (present value) of tax credit programs to the state, including the CAPCO program, is reduced by the allocation of tax credits over time. For example, tax credits generally are taken in Years 2 to 11 of the CAPCO program; thus, the present value of $100 million in tax credits (assuming a 7% discount rate) is $65,640,960. Funding CAPCOs with tax credits and spreading tax credits over 10 years make CAPCOs an attractive alternative when compared to programs that commit the state to additional current expenditures or debt.
2. According to interviews with managers of public venture funds, state funding for these programs is often insufficient to achieve an optimum program size relative to the desired number of investments in portfolio companies and availability of capital for follow-on investments (Barkley et al., 1999). The 100% tax credits provided in a CAPCO program are a way of raising significant funds ($50 million plus) from insurance companies to capitalize venture capital funds. Through the use of 100% tax credits, in conjunction with an investment instrument providing a guaranteed rate of return, CAPCOs were able to attract funding from insurance companies in a relatively short period of time. These resources, in turn, have contributed to an expansion of venture capital infrastructure, management capacity, and investments in those states with CAPCO legislation.
3. One weakness of publicly funded and managed venture capital programs is the potential for political interference in investment decisions. Similarly, for publicly funded and privately managed venture capital programs, there is the potential for political interference in the selection of the private funds in which the public monies will be placed. With CAPCO programs, political pressure to place state monies in specific private venture capital firms is

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eliminated because the state's role is limited to certifying the capital companies. The participating insurance companies individually select in which of the CAPCOs to place their funds. In addition, political pressure for CAPCOs to make investments in specific businesses also is diminished because the CAPCOs receive no direct state funding.

4. Private venture capital funds are reluctant to coinvest with state-supported funds (both public funds and publicly funded, privately managed funds) because of the perception of potential political interference in fund selection and management. However, private venture funds may be willing to coinvest with the privately managed CAPCOs, thus increasing the funds' ability to participate in syndicated deals and leverage their certified capital.
5. Publicly managed funds in some states are limited by state pay regulations in the amount they can compensate the managers of the public fund. Experienced venture capitalists command significant compensation in the private sector, and such individuals may not be easily attracted to a public fund. CAPCOs do not have restrictions on compensation packages for fund managers; thus, CAPCOs may be able to more easily attract experienced fund managers because of higher salary, profit sharing, and benefit offerings.
6. Some states (e.g., Maine and Iowa) are constitutionally restricted from making direct equity investments in private businesses. In these situations, tax credit programs like CAPCOs may provide the only opportunity for state support for venture capital programs.

Shortcomings/Limitations

1. CAPCOs may be a costly way of increasing equity capital in a state. All state-sponsored venture capital programs result in new costs (state appropriations, debt payments, or tax revenues forgone) and new revenues (returns from investments, new tax revenues) for the state's treasury. The net cost of CAPCOs to the state treasury (costs minus revenues) relative to that of similar-sized alternative programs (publicly funded and managed or publicly funded and privately managed) depends on the performance of the fund. For CAPCOs, the cost to the state is the present value of future tax revenues lost due to tax credits over the 10-year period. For public investments in public or private venture capital funds, the cost to the state is typically the current lump sum value of state funds invested. If returns from program investments were poor, the state treasury would lose less with a program financed with 10 years of tax credits than with a program funded with one lump sum payment.

The net cost of CAPCOs to the state treasury (costs minus revenues) relative to that of similar-sized alternative programs (publicly funded and managed or publicly funded and privately managed) depends on the performance of the fund.

However, in situations where CAPCOs and alternative publicly assisted programs recoup much of their original investment or realize a profit, CAPCOs will have a higher net cost to the state than a comparable state investment in a publicly or privately managed fund. Publicly or privately managed funds will be less costly than CAPCOs because the cost to the state of its investment in these funds will be offset to the extent that proceeds from the funds are distributed to the state as the principal or limited partner in the funds. Alternatively, proceeds from CAPCO investments generally are distributed to the insurance companies providing capital to the CAPCOs and to CAPCO management. Thus, the state does not receive a share of returns from CAPCO investments to help defray program costs.

The potential cost disadvantages of a CAPCO program may be reduced with requirements in the enabling legislation that stipulate a return of a share of CAPCO's liquidating distributions to the state treasury (e.g., the Louisiana and Missouri model). However, even the Missouri and Louisiana legislation does not eliminate the cost disadvantage of the CAPCO alternative. For venture capital programs that provide fair or good returns on their investments, the net cost to the state is less with state investments in publicly or privately managed funds than with tax credits and profit sharing with CAPCOs.

2. With CAPCOs, as opposed to public funds or publicly supported private funds, the state has less control over the quality of the fund managers. Moreover, the CAPCO structure does not include a strong incentive for the CAPCOs to hire the best fund managers. Most insurance companies invest in CAPCOs in exchange for a guaranteed fixed debt instrument; thus, the

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incentive to select CAPCOs that have the most qualified venture capital investors is diminished. Insurance companies do not benefit from any upside in the CAPCO's performance or risk losing money should the CAPCO investments fail to perform. As a result, insurance companies make investments in CAPCOs based on familiarity and the CAPCO's ability to design a debt instrument that the insurance companies find attractive.

States concerned with the quality and experience of CAPCO management should institute a system that ensures adequate due diligence in certifying CAPCO managers.

States concerned with the quality and experience of CAPCO management should institute a system that ensures adequate due diligence in certifying CAPCO managers. One alternative would be to use a review team of professional venture capitalists to assess the qualifications of CAPCO applicants. States also may include more specific and restrictive language in the enabling legislation regarding required managerial experience. For example, Florida legislation requires that managers have at least 5 years of venture investing experience, including investing in early-stage businesses. And proposed Kansas legislation requires that CAPCO managers meet the standards established by SBA for small business investment company programs.

3. CAPCOs make limited seed and start-up investments. CAPCOs try to maximize profitability within the parameters allotted by individual state requirements. As such, they tend to invest at the upper end of the size limit permitted by state law because such investments generally have lower risk and cost than seed and start-up investments. States have attempted to address the limited seed and start-up investment problem with more restrictive legislation regarding qualified businesses, limitations on the size of individual CAPCOs, or with separate (non-CAPCO) venture programs focusing on technology commercialization and seed investments.

Additional Observations

In addition to the strengths and limitations of CAPCO programs, three attributes of CAPCO programs were observed that may influence the attractiveness of the program to a state. First, CAPCOs and insurance companies devote considerable resources to lobbying for additional appropriations in states with existing CAPCO programs and for new CAPCO legislation in states where CAPCOs do not already exist. In all the states that currently have CAPCO legislation, except Louisiana, the legislation was introduced through the efforts and financial investment of the existing CAPCO industry. In general, CAPCOs identified champions in the state legislature to promote the concept and hired lobbyists to push for the legislation's passage. The advantage existing CAPCOs have in obtaining new capital commitments and the program's profitability also encourage CAPCOs to devote resources to lobbying for additional rounds of appropriations. The lobbying efforts by CAPCOs and their supporters may result in an information base that is somewhat biased. States may ensure that more balanced information is available by making time and resources available for an independent review of the state venture capital market and the proposed CAPCO legislation.

Second, the CAPCO industry will resist (lobby against) efforts by states to be too innovative in developing CAPCO legislation in terms of sources of certified capital other than insurance companies or tax credits less than 100%.[9] The reliance on insurance companies as the sole source of certified capital gives existing CAPCOs (i.e., CAPCOs established in other states) a significant advantage over new CAPCOs in obtaining commitments of capital. There are several reasons why this may occur. Existing CAPCOs have an established relationship with insurance companies and a ready-made debt investment instrument that is attractive to the insurance industry and difficult and costly to imitate. Moreover, state legislation does not always provide sufficient time for new CAPCOs to develop a competitive debt investment instrument and market it to insurance companies. Finally, even those in-state funds that are able to obtain some capital commitments may not be able to meet the minimum capitalization stipulated in the state legislation.

Evidence of the dominance of established CAPCOs in raising funds from insurance companies is provided in Table 3. Advantage Capital and BancOne (both established Louisiana CAPCOs)

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TABLE 3
State Allocations of Tax Credits, by CAPCO

State	*CAPCO*	*Total Certified Capital ($)*	*Percentage of State Total*
Missouri (total 1997-1999 allocations)	Advantage Partners	50,685,000	36.2
	BancOne/Gateway Ventures	47,395,000	33.8
	Stifel CAPCO	26,941,000	19.2
	CFB Emerging Fund	12,525,000	8.9
	CAPCO Holdings	2,454,000	1.8
New York (1999-2000 allocations)	Advantage Capital	30,913,844	32.4
	NY Small Business Venture Fund	30,913,844	32.4
	BancOne Capital Corporation	28,282,264	29.6
	Wilshire Advisers	2,673,797	2.8
	Exponential Business Development Company	2,673,797	2.8
Florida (1999 allocations)	Advantage Capital Florida Partners, LP	81,862,834	54.6
	BancOne Capital Finance, LLC	30,753,138	20.5
	Wilshire Partners, LLC	37,384,028	24.9
Wisconsin	Advantage Capital Wisconsin Partners I, LP	16,666,666	33.3
	Wilshire Investors, LLC	16,666,666	33.3
	BancOne Stonehenge Capital Fund WI, LLC	16,666,666	33.3
Louisiana (1999 allocations)	Stonehenge Capital (BancOne)	21,300,000	35.1
	Advantage Capital	21,000,000	34.6
	Wilshire Advisers	16,400,000	27.0
	Source Capital	2,000,000	3.3

NOTE: CAPCO = Certified Capital Company.

have acquired a large share of the certified capital in the four states adopting legislation after Louisiana, and Wilshire (a New York CAPCO) has acquired significant certified capital in the two states (Florida and Wisconsin) that implemented the program after New York. And among the 15 CAPCOs receiving certification in Florida, only 3 CAPCOs (Advantage Capital, BancOne, and Wilshire) were able to meet the $15 million minimum stipulated in the Florida legislation.

States may benefit from a larger number of CAPCOs and CAPCOs with greater in-state investing experience. Venture capital firms tend to specialize according to industry type and stage of investment (e.g., seed, start-up, and expansion). Thus, an increase in CAPCO numbers may provide venture capital access to a greater variety of state businesses. The smaller CAPCOs also may be more willing to consider seed and start-up investments, an area of concern in many states.

States may encourage new, in-state CAPCOs by expanding qualified CAPCO investors to include corporations and individuals, that is, reduce the importance attached to connections to the insurance industry.

States may encourage new, in-state CAPCOs by expanding qualified CAPCO investors to include corporations and individuals, that is, reduce the importance attached to connections to the insurance industry. State legislation may increase CAPCO numbers by providing a longer time for fund-raising, placing a low minimum on certified capital raised, creating a cap on total certified capital raised per CAPCO, and allocating the tax credits equally among CAPCOs (e.g., Louisiana) rather than on a pro rata basis based on insurance company commitments per CAPCO (e.g., Florida). In addition, states could provide prospective CAPCOs with examples of investment instruments needed to attract insurance funds. This tutoring of in-state CAPCOs would reduce the time and expense associated with fund-raising and increase the probability of successfully competing with out-of-state CAPCOs for funding.

Third, CAPCOs can offer more favorable terms to portfolio companies than do other private venture capital firms in the state because of their cost advantage in raising capital. This advantage may lead to the crowding out of other in-state venture capital providers and may ultimately discourage new venture capital formation in the state. A competitive advantage over indigenous venture capital providers may not be a concern in states with little or no formal venture capital infrastructure; however, the potential impact of CAPCOs on the state venture capital industry should be considered in states with numerous private venture capital funds.[10]

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SUMMARY

Interest in establishing state-assisted venture capital programs is unlikely to diminish. As state policy makers consider how best to organize these programs, they must consider the relative strengths and limitations of alternative models. Publicly funded and managed programs and publicly funded, privately managed programs offer states more control over investment decisions; however, these programs also suffer from potential political interference that can jeopardize the effectiveness of the program. The creation of CAPCOs provides a means for the state to attract private sector resources into privately managed venture funds, in this case by using state tax credits to encourage insurance company investments in CAPCOs.

Although CAPCO programs may insulate the capitalization and investment decisions from political pressure, the programs have important disadvantages for policy makers to consider. The principal disadvantage of CAPCOs relative to alternative state-assisted programs is the cost to the state treasury resulting from (a) losses of future tax revenues and (b) little or no return to the state from CAPCO profits. A study prepared by the Louisiana Department of Economic Development (1999) concluded that “the CAPCO program, in its current form, is expensive and inefficient to the state” (p. 64). The study’s principal concern is that CAPCOs typically have a significant amount of overhead, in terms of capital used to provide collateral on insurance company loans, rather than having that capital available for investments in qualified businesses.

The potential high cost of CAPCOs compared to alternative state-assisted venture capital programs should encourage in-depth analysis of the state’s venture capital market and great care in drafting legislation before a CAPCO program is introduced to the state legislature. Recommended analysis includes a cost-benefit study of CAPCOs versus publicly funded–publicly managed funds and publicly funded–privately managed funds. This cost-benefit study should include estimates of jobs generated and costs per job associated with the program alternatives.[11]

If the above cost-benefit analysis indicates that CAPCOs are cost effective, then further research should be undertaken to assess the availability of investment opportunities (deal flow) to determine the appropriate amount of tax credits to be provided in the legislation. Excess tax credits (relative to good venture capital deals) will encourage questionable investments, whereas too few credits will preclude worthy companies from obtaining financing. Next, CAPCO legislation should be carefully written to focus investments on desired recipients or goals. CAPCOs are profit-maximizing entities, and they will seek investments that provide the highest expected rate of return. Thus, if the state wishes to target venture capital at a specific group of businesses, this group must be identified explicitly in the enabling legislation. Third, the state should investigate means of significantly sharing in the upside gains of CAPCOs to reduce the costs to the state treasury. Finally, CAPCOs do not appear to be a panacea for all venture capital needs of state businesses. Entrepreneurs and businesses needing seed or start-up capital are not well served by CAPCOs; thus, legislation and programs addressing the needs of early stage businesses should be considered in conjunction with CAPCO legislation.

NOTES

1. On-site or telephone interviews were conducted with the following individuals: Dennis Manshack and Mike Williams, Louisiana Economic Development Corporation; Darin Domingue, Louisiana Office of Financial Institutions; Thomas J. Adamek and Michael Kirby, BancOne Stonehenge Capital, Baton Rouge, Louisiana; Bill Bergmeyer and Stacey Hurst, Missouri Department of Economic Development; Chip Cooper, Missouri Innovation Center; Scott A. Zajac, Advantage Capital Partners, St. Louis, Missouri; Monique Cheek, Florida Governor’s Office; Mike Ramsden, Florida Department of Banking and Finance; Colleen Holtan, Wisconsin Department of Commerce; Anna Lemecha, State of New York Insurance Department; Tim Roche, New York State Senate Information Office; George Lipper, Iowa Department of Economic Development; Charles Ranson and Mikel Miller, Kansas, Inc.; and Kevin Carr and Michael J. Wojcicki, Kansas Technology Enterprise Corporation, Topeka, Kansas. This research effort was part of a larger project funded by the U.S. Department of Agriculture’s Fund for Rural America and the Rural Policy Research Institute.

2. The regulated nature of the insurance industry usually precludes insurance companies from investing in Certified Capital Companies (CAPCOs) as limited partners, a model common to more traditional venture capital funds. As a result, the CAPCOs have created an investment instrument that is attractive to insurance companies because it is classified as a

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number 1 rated investment by the National Association of Insurance Commissioners. The insurance company receives a guaranteed rate of return on its investment in the CAPCO rather than a share of future profits. In this way, the insurance company is basically investing in a guaranteed security rather than in a relatively risky equity investment. More detail regarding the structure of the investment instrument is provided in the discussion of the Louisiana program.

3. In most states, the amount of certified capital raised from insurance companies (and the resulting tax credits requested) exceeds the amount of tax credits approved by the state. In these situations, states have allocated tax credits among eligible CAPCOs in one of three ways: first come, first served; a pro rata distribution based on share of total tax credits requested; and an equal split of tax credits among all eligible CAPCOs. The first come, first served and pro rata methods are advantageous to existing CAPCOs (CAPCOs currently operating in other states) because these CAPCOs have well-developed investment instruments and contacts within the insurance industry.

4. State legislation also provides a means for CAPCOs to decertify, either voluntarily or as a result of noncompliance with the rules governing CAPCOs. In most cases, voluntary decertification occurs either when a CAPCO fails to meet requirements for raising certified capital or when a CAPCO has met the investment requirements under the legislation. Based on the experience in Louisiana, decertification for noncompliance and decertification because of fund-raising constraints occur rarely. With the exception of Louisiana, however, CAPCOs can voluntarily decertify once an amount equivalent to 100% of certified capital is invested. After decertification, the CAPCO is no longer required to invest capital in qualified businesses as defined by the state.

5. The Small Business Administration (SBA) definition of small businesses varies by major industry group (e.g., manufacturing, services, retail), and exceptions exist for industries within these major groups. However, in general, the SBA definition for small business is fewer than 500 employees for manufacturing and less than $5.0 million in annual sales for retail trade and services. SBA regulations are available at http://www.sba.gov/regulations/121/210.htm.

6. The Massachusetts Capital Resource Company (MCRC), started in 1978, has similarities with CAPCOs, and its existence may have influenced the design of the Louisiana CAPCO program in 1983. According to Markley and McKee (1992), MCRC was created as a result of a deal struck between the governor of Massachusetts and the state's life insurance industry. The insurance companies agreed to create and manage a $100 million venture capital fund in exchange for repeal of a 1% tax on gross income.

7. The state profit sharing program selected by Louisiana (25% of returns above the amount necessary to achieve a 15% internal rate of return [IRR]) will not likely result in sufficient returns to the state to cover the cost of future tax credits. In a hypothetical analysis of a CAPCO program (Barkley, Markley, & Rubin, 1999, pp. 53-56), it was estimated that the Louisiana profit sharing program will provide returns (present value) to the state treasury exceeding costs of tax credits (present value) only if CAPCOs realized an IRR on their investments exceeding 22%. An IRR above 20% may not be easily attained by CAPCOs if a significant portion (e.g., 40%) of the CAPCOs' certified capital is held in zero-coupon bonds as collateral on insurance company loans to CAPCOs.

8. The lack of seed capital investment in Missouri led to the creation of the Missouri Seed Capital Coalition and the passage of legislation (SB518) in 1999 designed to encourage professional venture capital management to give greater attention to the issue of commercializing university research and other early-stage ventures.

9. The state of Kansas developed CAPCO legislation (HB2688) that differed significantly from CAPCO legislation in other states. The Kansas legislation included (a) tax credits for certified capital provided by individuals, (b) 365 days to raise certified capital, (c) a requirement that 70% of certified capital be invested within 7 years, and (d) a restriction on CAPCO investments to businesses with annual sales less than $1 million. Pressure was brought on Kansas legislators (through the Growth Capital Alliance, a CAPCO lobbying organization) to change their legislation to permit only insurance company investors, increase the size of qualified businesses, reduce CAPCO fund-raising time to 30 to 60 days, and require a less restrictive investment schedule. The Growth Capital Alliance agreed to cease lobbying against the Kansas legislation only if drafters of the legislation agreed not to use the name CAPCO. In the Kansas legislation, Capital Formation Companies was selected as the compromise name for the new venture capital firms.

10. Public venture capital firms and publicly assisted private venture capital firms also may have a cost advantage relative to private venture capital firms. However, the potential for crowding out private venture capital firms is generally greater with CAPCO programs than with other publicly assisted programs because of the relatively large size of CAPCO programs ($50 million or larger).

11. The most thorough study of a CAPCO program to date is the *CAPCO Study* prepared in 1999 for the Louisiana Department of Economic Development by Postlethwaite and Netterville (1999), a professional accounting corporation located in Baton Rouge, Louisiana. A copy of the study is available on the department Web site (http://www.lded.state.la.usa). The Postlethwaite and Netterville study compared the present value of tax credits to the present value of new state tax revenues resulting from the Louisiana CAPCO program (under alternative scenarios regarding the future growth rate of the funded businesses and the percentage of the businesses' financing attributable to CAPCO investments). The Louisiana study found that program costs exceeded new tax revenues for most of the growth rate business financing scenarios estimated.

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