

Fiscal Estimate Narratives

DOR 5/16/2011

LRB Number	11-2076/1	Introduction Number	AB-0129	Estimate Type	Original
Description Creation of the Wisconsin Venture Capital Authority, creation of the badger jobs fund and the jobs now fund certification program, both of which are to be administered by the Wisconsin Venture Capital Authority, making an appropriation, and providing a penalty					

Assumptions Used in Arriving at Fiscal Estimate

This fiscal estimate provides guidance to the legislature on the risks, returns, financial exposure of the bill. Financial certitude is not possible here. Venture capital investments are inherently speculative. The investments, and thus the fiscal effect are subject to a wide range of possible outcomes. As the bill relies on a leveraged investment, small changes in underlying assumptions can produce sharply different results. Actual results will differ from past experience and the assumptions employed in this analysis.

The GPR revenue reduction will range between \$301.4 million to \$770.4 million over the life of the bill. A fuller explanation follows.

The bill has the following provisions that relate to the Department of Revenue:

Wisconsin Venture Capital Authority:

The bill creates a Wisconsin Venture Capital Authority to oversee programs related to venture capital investment in Wisconsin businesses. Under the bill, the Authority is governed by a seven-member board of directors that consists of the chief executive officer of the Wisconsin Economic Development Corporation; four members from the private sector nominated by the governor and appointed with the advice and consent of the senate; one member appointed by the speaker of the assembly; and one member appointed by the senate majority leader.

Badger Jobs Fund:

Also under the bill, there is created a fund to be known as the Badger Jobs Fund for the placement of capital with investors who are certified by the authority and who in turn invest Badger Jobs Fund capital in Wisconsin businesses that meet certain criteria. The bill authorizes the authority to issue up to \$200 million in bonds or other obligations to raise capital for the Badger Jobs Fund.

The authority may contract with a Badger Jobs Fund bondholder to award income and franchise tax credits to a bondholder up to an amount equal to the amount the authority is unable to pay a bondholder on a bond. A bondholder may not claim those tax credits until January 1, 2016. Those tax credits may be carried forward until fully used and may be transferred or sold. The authority may not award tax credits to bondholders that total more than \$300 million.

While the bill specifies that the state is not liable for a debt of the authority, the bill also contains a moral obligation pledge in which the legislature expresses its expectation and aspiration that the legislature will make an appropriation to pay a bondholder the amount of principal and interest or other financing charges the authority fails to pay on a bond.

Under the bill, the authority may invest Badger Jobs Fund capital only in certified investors. The authority may not commit to a single certified investor more than 15% of the total capital that the authority is authorized to raise for the Badger Jobs Fund.

The bill provides that a certified investor must contract with the authority before receiving any capital from the Badger Jobs Fund. Under the contract, the certified investor must agree to all of the following:

1. The certified investor must commit to maintaining a significant physical presence in Wisconsin, including an office that is staffed by at least one full-time employee.
2. The certified investor must invest at least 50% of the Badger Jobs Fund capital it receives in a business that is headquartered in Wisconsin; that employs at least 50% of its employees in Wisconsin; that agrees to

use Badger Jobs Fund capital only for certain approved purposes; and that is not primarily engaged in real estate development or sales, insurance, banking, lending, lobbying, political consulting, professional services, or retail sales, other than direct sales of products the business itself manufactures.

3. The certified investor may not receive capital from the Badger Jobs Fund that exceeds 25% of the total capital the investor raises from all sources, including the Badger Jobs Fund.

4. When a certified investor invests Badger Jobs Fund capital in a business, the certified investor must at least match the Badger Jobs Fund's capital contribution to that investment with capital the certified investor has raised from other sources.

5. The certified investor may not apply the amount of capital it receives from the Badger Jobs Fund toward certification for purposes of receiving early stage or angel investment tax credits from the Department of Commerce.

Jobs Now Fund:

Under the bill, the authority also administers a certified Jobs Now Fund program under which an insurance company or other person subject to Wisconsin premium tax liability invests capital with a certified Jobs Now Fund that in turn invests that capital in certain kinds of Wisconsin businesses.

The bill provides that any insurance company or other person subject to premium tax liability may apply to the authority to invest in a certified Jobs Now Fund. The bill directs the authority to establish a single 15-day period in which such applications may be submitted. The authority must give reasonable notice to potential applicants in advance of that application period.

The participating investor may claim up to 80% of the amount of its investment as a credit against the participating investor's insurance premium tax liability. The authority may not award more than \$200 million in premium tax credits under the program. The authority may not award more than \$50 million in premium tax credits to a participating investor at any one time. The authority must begin approving investments and awarding corresponding tax credits within 90 days after the bill becomes effective.

Under the bill, a certified Jobs Now Fund is required to make investments in qualified businesses based on a specific investment schedule, and after seven years, a certified Jobs Now Fund must have placed 100% of its capital received from a participating investor with qualified businesses, at least 50% of which must be invested in qualified businesses with gross revenue of \$2 million or less in the fiscal year immediately preceding the date of investment. If a certified Jobs Now Fund fails to satisfy the investment schedule, it may be required to refrain from paying any management or similar fee until required investments are made. Under the bill, a certified Jobs Now Fund may not invest more than 15% of its total capital received from participating investors in any one qualified business.

Once it receives investment capital from a participating investor, the bill authorizes a certified Jobs Now Fund to invest that capital only in certain kinds of businesses. In particular, a qualified business must meet all of the following conditions:

1. The business's headquarters are in Wisconsin.
2. The business is in need of venture capital and is unable to obtain conventional financing.
3. The business employs 100 or fewer employees, and at least 80% of those employees are employed in this state, or at least 80% of the business's payroll is paid to employees employed in this state.
4. The business is not primarily engaged in real estate development or sales, insurance, banking, lending, lobbying, political consulting, professional services, or retail sales, other than direct sales of products the business itself manufactures.

Also under the bill, in order to receive certified jobs fund investments, a qualified business must agree not to relocate its headquarters outside of Wisconsin and to maintain at least 75% of its employees in Wisconsin, or pay at least 75% of its payroll to employees in Wisconsin, as long as the certified Jobs Now Fund continues to hold the investment.

Withholding Tax Transfers:

The authority's administration of the Badger Jobs Fund is supported in part by tax revenue raised from businesses that benefit from the Badger Jobs Fund or from the certified Jobs Now Fund program. Under the bill, the authority and the Department of Revenue (DOR) are to coordinate with each other to determine the amount of withholding taxes that each business that receives investment capital under the Badger Jobs Fund or the certified Jobs Now Fund program paid for the year prior to the first year in which the business received any such investment. Then, each year for 15 years following that first year of investment or until the Badger Jobs Fund is dissolved, whichever occurs first, DOR transfers to the authority an amount equal to

50% of the increase, if any, in withholding taxes paid by the business over the amount determined, as described above, for the year prior to that first year of investment.

Fiscal Estimate:

This analysis is based on numerous assumptions and is highly sensitive to small changes in any of the assumptions. The assumptions include the structure of the bond issues, including the period for deferral of principal and interest payments, the interest rate for the bonds, and the expected return on the funds' investments.

In addition, investments in venture capital by their nature entail a great deal of risk, and under the bill Wisconsin's taxpayers shoulder the vast majority of the risk. The risk to the taxpayers of Wisconsin include the returns of the Badger Jobs fund not being sufficient to cover the debt service requirements, and that the withholding tax transfers under the bill will not be sufficient to pay the administrative expenses of the fund, especially in the first five to seven years.

Income and Franchise Tax Credit under the Badger Jobs Fund:

This fiscal estimate is based on the following assumptions:

- (1) The full \$200 million of debt authority will be used.
- (2) Approximately 90-95% of the \$200 million of bond proceeds will be invested in venture capital.
- (3) Interest will be deferred for the first five years and will be added to the principal repayment.
- (4) The debt will be repaid in equal installments beginning 2017.
- (5) The interest rate on the debt will be 7.15%, which is approximately 100 basis points above a BAA corporate bond for April, 2011.
- (6) The bonds would have a life of 20 years.

The net effect of these assumptions will result in annual debt service payments of \$31.3 million beginning FY 2017 and ending in FY 2031, for a total cost in principal and interest of \$469.6 million.

The fiscal effect of issuing income and franchise tax credits, which will result to the extent that the debt service payments of \$31.3 million per year exceed returns generated by the investments of the fund, depends on the estimated rate of return on the venture capital funds.

The analysis uses the prevailing internal rate of return benchmark statistics for U.S. venture capital funds prepared by Cambridge Associates LLC, in April 2011. The Cambridge study shows that the median rate of return for investments in venture capital during the period of 1999 through 2006 (the last year before the recession) was -1.82%. If the Badger Jobs Fund achieves returns equal to the median return of venture capital funds during the period of 1999-2006, the fiscal effect resulting from issuing tax credits to cover the difference between fund returns and required debt service payments would be an annual reduction in income and franchise tax revenue of \$31.3 million in fiscal years 2017 through 2025. Under this assumption, the Authority would exhaust its authorized allotment of \$300 million in tax credits with a final issuance of \$18.3 million in tax credits in FY 2026.

Proposed s.239.11 (2) (c) of the bill establishes that the State has a moral obligation to pay creditors of the fund if the authority is unable to do so. Assuming the returns to the fund equal the median returns of the Cambridge study, in addition to the \$300 million in authorized tax credits the general fund would be obligated to pay principal and interest of \$169.6 million under the moral obligation clause.

The Cambridge study also shows a median rate of return for the period from 1989 to 2009 was 8.05%. If the Badger Jobs Fund achieves returns equal to the median return of venture capital funds during the period of 1989-2009, the fund would be able to use returns to pay the debt service in its entirety with no need to issue tax credits or make a moral obligation appropriation.

A significant risk factor is that the returns of the fund will be at the median returns for the period of 1999-2006 or less. It is assumed that the businesses with the highest expected returns will receive funding first, but as more capital flows into the market it is reasonable to assume that the funds will be invested in businesses with lower expected returns. According to the National Association of Seed and Venture Capital Funds, as of March 2008 the state with the largest amount of state-supported investment in venture capital was New Mexico, with \$536 million invested. One of the funds that is included in New Mexico's total, the New Mexico Private Equity Investment Program, since its inception in 1993 has funded investments totaling \$303 million through September 2010. The investment had a value of \$209.9 million, a loss of \$93.1 million. The internal rate of return on the program's investments was -9.9% as of September 30, 2010.

Jobs Now Fund:

Under the bill, a participating investor may claim 25% of its approved premium tax credit in one year and may not claim a credit until after January 1, 2014. The Authority may not award more than \$200 million in premiums tax credits to participating Jobs Now Fund investors. Based on this, the bill would result in a reduction in insurance premiums tax revenue of \$50 million annually in fiscal years 2015 through 2018.

Transfer of Withholding Tax Amounts:

The Certified Capital Companies credit program (CAPCO), enacted in 1998, provided \$50 million in credits for insurance companies' investment in startup companies, similar to the credits under the bill's Jobs Now Fund. Based on a review of withholding records for firms that received investments under the CAPCO program, and accounting for the larger size of the Badger Jobs Fund and the Jobs Now Fund, and assuming investments are made over a four-year period, the withholding tax transfer under the bill would reduce revenue as shown below:

FY 2015: \$200,000
FY 2016: \$500,000
FY 2017: \$1.0 million
FY 2018: \$1.6 million
FY 2019: \$2.4 million
FY 2020: \$3.3 million
FY 2021: \$4.7 million
FY 2022: \$6.2 million
FY 2023: \$7.3 million
FY 2024: \$8.5 million
FY 2025: \$9.2 million
FY 2026: \$9.6 million
FY 2027: \$10.1 million
FY 2028: \$10.3 million
FY 2029: \$10.5 million
FY 2030: \$8.0 million
FY 2031: \$5.4 million
FY 2032: \$2.7 million

It should also be noted that the experience under the CAPCO program may not be entirely applicable to the Badger Jobs Fund and the Jobs Now Fund because the types of firms that can receive investments under the bill is more restrictive than under the CAPCO program. There were firms that received investments under the CAPCO program that had positive net returns (and therefore contributed to the program's overall positive net returns) that would not be eligible to receive investments from the Badger Jobs Fund and the Jobs Now Fund.

The withholding tax transfers as outlined above will not cover the expenses of administering the funds until FY 2021. A conservative estimate of the cost to actively manage a venture capital fund is 1% of the amount being managed. Based on this, the cost to administer the Badger Jobs fund and the Jobs Now Fund would be \$4.5 million (\$200 million in the Badger Jobs Fund plus \$250 million in the Jobs Now Fund x 1%). It is not clear how the administrative expenses will be paid in the absence of sufficient withholding tax transfers. The bill does not authorize use of bond proceeds for payment of administrative expenses. It would appear that the alternative would be transfers from the general fund to the appropriation established in the bill for administrative expenses, but the bill is silent on any such transfers.

Total Fiscal Effect:

Based on the above analysis, the total revenue reduction resulting from the bill assuming returns for the Badger Jobs Fund match the median venture capital return for the period of 1999-2006 is \$770.4 million is shown below:

FY 2016: -\$50.5 million
FY 2017: -\$82.3 million
FY 2018: -\$82.9 million
FY 2019: -\$33.7 million
FY 2020: -\$34.6 million
FY 2021: -\$36.0 million
FY 2022: -\$37.5 million

FY 2023: -\$38.6 million
FY 2024: -\$39.8 million
FY 2025: -\$40.5 million
FY 2026: -\$40.9 million
FY 2027: -\$41.4 million
FY 2028: -\$41.6 million
FY 2029: -\$41.8 million
FY 2030: -\$39.3 million
FY 2031: -\$36.2 million
FY 2032: -\$2.7 million

If the returns for the Badger Jobs Fund instead match the median returns for venture capital for the period of 1989-2009, the total revenue reduction of the bill would be \$301.4 million, as shown below

FY 2015: -\$50.2 million
FY 2016: -\$50.5 million
FY 2017: -\$51.0 million
FY 2018: -\$51.6 million
FY 2019: -\$2.4 million
FY 2020: -\$3.3 million
FY 2021: -\$4.7 million
FY 2022: -\$6.2 million
FY 2023: -\$7.3 million
FY 2024: -\$8.5 million
FY 2025: -\$9.2 million
FY 2026: -\$9.6 million
FY 2027: -\$10.1 million
FY 2028: -\$10.3 million
FY 2029: -\$10.5 million
FY 2030: -\$8.0 million
FY 2031: -\$5.4 million
FY 2032: -\$2.7 million

Long-Range Fiscal Implications

Fiscal Estimate Worksheet - 2011 Session

Detailed Estimate of Annual Fiscal Effect

Original
 Updated
 Corrected
 Supplemental

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Description Creation of the Wisconsin Venture Capital Authority, creation of the badger jobs fund and the jobs now fund certification program, both of which are to be administered by the Wisconsin Venture Capital Authority, making an appropriation, and providing a penalty			
I. One-time Costs or Revenue Impacts for State and/or Local Government (do not include in annualized fiscal effect):			
II. Annualized Costs:		Annualized Fiscal Impact on funds from:	
		Increased Costs	Decreased Costs
A. State Costs by Category			
	State Operations - Salaries and Fringes	\$	\$
	(FTE Position Changes)		
	State Operations - Other Costs		
	Local Assistance		
	Aids to Individuals or Organizations		
	TOTAL State Costs by Category	\$	\$
B. State Costs by Source of Funds			
	GPR		
	FED		
	PRO/PRS		
	SEG/SEG-S		
III. State Revenues - Complete this only when proposal will increase or decrease state revenues (e.g., tax increase, decrease in license fee, etc.)			
		Increased Rev	Decreased Rev
	GPR Taxes	\$	\$
	GPR Earned		
	FED		
	PRO/PRS		
	SEG/SEG-S		
	TOTAL State Revenues	\$	\$
NET ANNUALIZED FISCAL IMPACT			
		<u>State</u>	<u>Local</u>
	NET CHANGE IN COSTS	\$	\$
	NET CHANGE IN REVENUE	\$See Text	\$
Agency/Prepared By			
DOR/ Michael Oakleaf (608) 261-5173		Authorized Signature	Date
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