Pennsylvania House Finance Committee
Public Hearing on Innovate PA
Submitted Testimony of Dan Schmisseur
Cromwell Schmisseur LLC
April 23, 2013

Chairman Benninghoff, Chairwoman Mundy and Members of the Committee:

Thank you for the opportunity to submit testimony on HB 898, the Innovate Pennsylvania Act (Innovate PA), a strategy to accelerate economic growth through capital investment and innovation development. As regional economies continue recovering from this prolonged period of economic turmoil, state policy-makers need new tools in the economic development toolbox to support sustainable economic growth and improved competitiveness in a global economy. Our firm commends the Commonwealth of Pennsylvania for its continued national leadership in developing effective support systems and capital resources for high-growth, jobs-creating small businesses.

Cromwell Schmisseur is a Nashville-based consulting firm that specializes in technology-based economic development strategies. Eric Cromwell and I have experience leading innovation and entrepreneurial development organizations at the local and state levels, and we frequently advise policy makers, program managers and business leaders across the country on a principles-based approach to innovation development strategies. In particular, we have developed a niche expertise in designing state-sponsored venture capital programs.

Perspective on Innovate PA

Innovate PA is a jobs bill intended to produce incremental investment capital for a portfolio of PA economic development programs while matching the timing of the fiscal impact with the expected maturation of program investments.

Innovate PA is modeled after legislation in Maryland that created $84 million of economic development program investment capital from $100 million of deferred insurance premium tax credits. With improvements learned from the Maryland experience, Innovate PA could potentially realize a higher yield from comparable tax credits for the purpose of financing important innovation programs with long-term comprehensive economic development benefits.

Insurance Premium Tax Credits as the Financing Mechanism

Insurance companies collect cash premiums from customers and pay a kind of sales tax to the state. Tax credits to offset these liabilities are attractive to insurance companies as a low-risk investment. There are dozens of potential bidders for PA tax credits willing to invest cash today at a reasonable discount in exchange for reductions to tax payments in future years. No other mechanism can accomplish the goals of the Innovate in PA program as efficiently.

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It is important to recognize that the insurance companies are not a primary beneficiary of this legislation but rather a conduit for financing economic development programs while matching the fiscal impact with the projected maturation of the program investments. The goal is to maximize the price the insurance companies will ultimately pay for the tax credits while minimizing the administrative costs. Accordingly, the Innovate PA legislation is designed to reduce financing costs and maximize the attractiveness of the tax credits to insurance companies with the following features:

- <u>Immediately vested tax credits with no clawback provisions</u> – There are no future performance requirements of the insurance companies, so there are no provisions that would cancel the tax credits based on future outcomes. Clawback provisions dramatically increase the financing costs because the insurance companies require 3rd party guarantors to insure against the risk of losing the expected benefit from the investment.

- <u>Fully transferable and usable against other Commonwealth tax liabilities within a specified time period</u> – These provisions are accounting requirements applicable to insurance companies that allow the tax credits to be classified in state reports as "admitted assets."

Innovate PA can potentially improve on the Maryland yield of 84% on the sale of $100 million of tax credits in 2012 by allowing greater flexibility in structuring the tax credit auctions.

- Maryland's legislation required a one-time auction of its tax credits and provided that buyers of its tax credits may use the benefits in 20% increments beginning in the 3rd year after purchase. PA could sell its tax credits more efficiently by allowing for multiple auctions and placing the 20%/yr pacing requirement on the Department of Revenue rather than the taxpayer. This would allow Revenue to sell the tax credits in blocks by year, selling all of the 2016-2017 maturities first and potentially delaying the sale of 2018-2010 maturities until the periods between the auction and maturity dates are shorter.

- Maryland included a "floor" price of 70% for the tax credits. The benefit was two-fold: 1) ensured legislators that the state would not accept an inefficient outcome experienced by other states where similar tax credits allocated to private sector firms yielded as low as 50%; and 2) communicated to insurance companies an attractive price sufficient to capture their interest and motivate their staff to fully investigate the investment opportunity. Setting the floor price too high (85%) can counterproductively discourage insurance companies from performing the necessary due diligence prior to the bidding process. A 70-75% floor price for Innovate PA is advisable.

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There are a few important things to understand about using deferred insurance premiums taxes to finance an innovation development program.

1. The financing mechanism works and is capable of pooling capital as demonstrated in Tennessee and Maryland.

2. Coordination with Commonwealth officials in the capital pooling process is highly recommended, for specific rules and regulations related to insurance taxes need to be understood by all parties and addressed to improve the efficiency of the monetization process.

3. It is advisable to have experienced financial consultants involved in determining the appropriate strategy for monetizing the tax credits, for there are options to consider that can limit value leakage and yield more capital for investment in small businesses.

Conclusion

Innovation and entrepreneurship are the pillars for sustainable economic growth for states and nations, and it is our professional opinion that a smart capital program at this critical time would be an important economic development stimulus that makes Pennsylvania more competitive in a global economy. At a time when job creation strategies are essential to putting people back to work and laying the foundation for state economic growth, investing in a program focused on the engine of job and wealth creation – high-growth small businesses – makes good business sense. I'd be happy to address any questions from the committee.

Thank you.

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About Cromwell Schmisseur LLC

Cromwell Schmisseur LLC is a consulting services firm based in Nashville, Tennessee with a focus on innovation-based strategies and enterprise development. Eric Cromwell and Dan Schmisseur founded the firm together to share knowledge of best practices in tech-based economic development after re-launching the Tennessee Technology Development Corporation (TTDC), a legislatively created nonprofit corporation, where they served as President/CEO and Vice President of Strategy respectively. Eric and Dan are recognized experts in the field of technology-based economic development, which is focused on public/private initiatives designed to foster innovation and entrepreneurship in promotion of resilient economic growth.