Pennsylvania House Republican Policy Committee
Public Hearing on Ideas to Promote Investment and Spur Economic Growth
Submitted Testimony of Eric Cromwell
Cromwell Schmisseur LLC
July 11, 2012

Chairman Reed and members of the committee, thank you for giving me the opportunity to submit comments on state-led strategies that spur economic growth through capital investment and innovation development. As regional and state economies struggle to expand during this prolonged period of economic turmoil, state policy-makers have new tools in the economic development toolbox to utilize for supporting sustainable economic growth and improved competitiveness in a global economy. Focusing economic development efforts on entrepreneurs and innovators is a smart investment, and we applaud your investigation into new ideas for promoting long term economic growth.

Joining me today is Dan Schmisseur, the other founding member of our consulting firm that specializes in technology-based economic development strategies. Speaking to our backgrounds, we 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. Capital formation, technology transfer, and small business support systems are specific areas of interest and expertise for our firm.

Allow me to begin by stating our belief that innovation-based development strategies can have a positive, even transformational, impact on the Commonwealth of Pennsylvania. Specifically, we believe states are in a unique position to play a leadership role in increasing the availability and accessibility of financial capital for high-growth potential small businesses, which are a significant source of high-skill, high-wage job creation and *wealth creation* in state economies. By aligning with market principles for investing smart, patient capital in Pennsylvania-based companies, policy-makers can design an efficient and effective jobs program that generates comprehensive returns – economic development returns (jobs, new businesses, revenue) *and* financial returns for an "evergreen" program that continues investing in the Commonwealth.

Concept Overview – A Blueprint for Action to Promote Investment

With impressive innovation infrastructure and a regionally-focused support system already in place, Pennsylvania is extremely well positioned to move forward with an innovation development program modeled after an emerging best practice being implemented in the state of Maryland (the program has the working name of InvestMaryland). By learning from program implementations in other states like Maryland and Tennessee, leaders in Pennsylvania can customize a development strategy that meets the unique needs and strengths of Pennsylvania. Maryland learned from an experiment in Tennessee and made significant improvements for their own program's capital deployment processes and economics; Pennsylvania can learn from

Maryland and make additional improvements for a "best yet" model that becomes a new standard for promoting investment.

The premise behind such state efforts is to foster innovation and encourage entrepreneurship by improving the overall business environment for high-growth firms to start and grow. By leveraging the existing support infrastructure in place with the successful Ben Franklin Technology Partners program and simultaneously providing financial capital to profit-oriented venture capital investors for deployment into high-growth potential small businesses, we believe transformational outcomes can be achieved. This dual approach would provide a comprehensive solution for increasing the accessibility of risk capital and business assistance services that can be the difference in a Pennsylvania-based business succeeding or failing.

Furthermore, by providing capital to the Ben Franklin Partners with an economic development mission and to private-sector fund managers with a track record of successful value-add investing in early-stage companies, a smart capital program would be designed to address the areas of greatest need on the financing lifecycle with an "evergreen" investment program.

An Efficient Financing Mechanism

A financing vehicle we recommend is the utilization of deferred non-contingent tax credits. When states are not in a position to finance strategic economic development investments with general fund appropriations, utilizing deferred tax credits can be an attractive alternative – providing capital for investment in Pennsylvania-based small businesses near term while spreading the cost over multiple fiscal years at an acceptable financing cost. Specifically, we recommend leveraging the sizeable annual tax base of insurance premium taxes that can be efficiently monetized for allocation to these specified economic development purposes. The total maximum cost of the program is known upfront, so there will be no fiscal surprises in the future. An important point is that by including a fund-of-funds model alongside an investment in the Ben Franklin Partners, the Ben Franklin Technology Development Authority would have a financial interest in all investments made by the selected fund managers. As such, the anticipated investment returns should be re-invested in these venture development programs for continued support of small businesses in Pennsylvania for years to come.

The InvestMaryland program provides a point of comparison for leaders in Pennsylvania to consider. The state of Maryland assisted in the sale of deferred insurance premium tax credits, and the auction of $100 million in tax credits yielded $84 million in cash for the state's small business investment program (an effective IRR of 5.7% for the cost of capital). As for near-term fiscal impact on the state's budget, the program in Maryland committed $20 million of deferred tax credits per fiscal year (for five years) out of a $34.4 billion annual budget.

There are a few important things to understand about using deferred insurance premiums taxes to finance an innovation development program. First, the financing mechanism works and is capable of pooling capital as demonstrated in Tennessee and Maryland. Second, coordination with state officials in the capital pooling process is recommended, for specific rules and regulations related to insurance taxes need to be understood and addressed to improve the efficiency of the monetization process. Third, it is necessary to have the right people 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.

An additional benefit of the proposed financing mechanism is closer alignment of the marginal fiscal impact on annual budgets with the comprehensive returns anticipated to be generated by the small business investment program. The fiscal impact on the annual budget can be deferred (say for three years), yet investments in high-growth potential small businesses could begin as fast as 6 months after the enabling legislation becomes law.

Case for Acting to Improve Market Efficiencies

As you consider the appropriate framework for an innovative economic development program that is aligned with market principles for venture capital investing, you may be thinking "is there a role for state government to play in capital formation?" In our professional opinion, there are structural issues for how capital is allocated and invested within the private equity asset class that distort the efficient flow of capital across the country and to high-potential companies in locations like Pennsylvania, Maryland and Tennessee.

In reality, geographic location can limit investment opportunities for otherwise "fundable" small businesses, and this is especially notable at the early stages of business formation. By accepting a *strategic but limited role in regional capital formation*, state policy makers can strengthen their state's venture investment community, import financial capital from other markets, and stimulate capital investment in promising early-stage companies with the potential to grow into sustainable industry leaders that anchor regional economies.

Conclusion

In closing, we are encouraged by your leadership in the Pennsylvania General Assembly for exploring public policy solutions for stimulating capital formation and investing in a more prosperous future by supporting innovation. The opportunity before you is to create a program with a number of best practice implications:

1. An efficient financing model with limited fiscal impact that matches anticipated returns;
2. Utilization of existing state entities with experience managing/deploying funds;
3. A competitive capital allocation process for a fund-of-funds program to attract the most capable [private sector] investment managers to invest taxpayer funds;
4. An economic model that provides for re-investment of taxpayer funds in small business.

The conceptual blueprint described today for an innovation-based economic development would be expected to:

- Create high-wage jobs in Pennsylvania;
- Help diversify Pennsylvania's economy into innovation-intensive industries;
- Increase the rate of venture capital investment in Pennsylvania-based companies;
- Generate additional state tax revenue that grows over time;
- Re-invest program proceeds into small businesses as an "evergreen" financing program;
- Support the foundation of sustainable job and wealth creation for improved prosperity

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 potential small businesses – makes good business sense and good political sense. We'd be happy to answer 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. A diverse set of services are available for clients developing technology-based development strategies involving federal, state, regional and local stakeholders with varying scopes of work:

- Public policy guidance for industry leaders and government officials at all levels;
- Principled solutions for 21st century development strategies – specific emphasis on capital formation and entrepreneurial/innovation development programs;
- Opportunity analysis with focus on developing robust innovation ecosystems;
- Financial modeling for government-sponsored economic development programs;
- Effective communication strategies to engage public and private stakeholders;
- Best-practice organizational governance structures and accountability systems;
- Innovative technology transfer strategies for academic and non-academic research institutions with the necessary connectivity to the private sector.