



**Testimony of Ed Lazere, Executive Director
At the Joint Public Roundtable on the Report by the District of Columbia Auditor
On the Certified Capital Companies Program
Committee on Public Services and Consumer Affairs
Committee on Economic Development
April 3, 2009**

Chairman Bowser, Chairman Brown, and other members of the committees, thank you for the opportunity to testify today. My name is Ed Lazere, and I am the executive director of the DC Fiscal Policy Institute. DCFPI engages in research and public education on the fiscal and economic health of the District of Columbia, with a particular emphasis on policies that affect low- and moderate-income residents. I appreciate the opportunity to testify on this important issue.

The report of the DC Auditor on the CAPCO program raises several concerns about the management of this program by the District government. While the issues raised by the Auditor are important, my review of the experience of the CAPCO program in the District and several states suggests that the main problems stem from the basic design of CAPCO programs, not management. My testimony today will highlight how the structure of DC's CAPCO program has resulted in a very costly program that is unlikely to achieve economic development goals in an efficient way. Indeed, CAPCO creates incentives that distract from the goal of supporting solid venture capital investments. For these reasons, DCFPI recommends that CAPCO be eliminated and that alternative economic development efforts be pursued.

The heart of the CAPCO program is a 100 percent tax credit for insurance companies that invest in certified capital companies. That is, insurance companies receive a \$1 tax reduction for every dollar they offer to a CAPCO, even though the funds typically are offered to CAPCOs as a loan. There is a delay between the period the time that the CAPCO investment is made and the time that the tax credit can be claimed, yet even taking this into account, the net present value of the tax credit is likely to be in the range of 75 percent.

In my study of fiscal policy, tax incentives usually cover far less than 100 percent of the costs for which the credit is offered. The federal child care tax credit, for example, covers at most 35 percent of child care expenses. Business tax credits typically are less than 100 percent as well. The 100 percent tax credit offered to insurance companies is very rich.

Economics teaches us that when something has little or no cost, it does not lead to economically efficient decisions. When a restaurant offers free drink refills, for example, we are much more likely to consume too much soda than if we have to pay for another glass. The same logic applies to the CAPCO tax credit. Assuming the CAPCO tax credit has a value equal to 75 percent, it means that an insurance company can invest \$1 at a cost of only 25 cents. That means that the company does not have to be too careful about its investment decision. If the investment only returns 50 cents, for example — a substantial loss from the initial \$1 — it would still work out to a substantial gain after the tax credit is considered.

This is a very simplified analogy and does not exactly represent how CAPCOs operate, but it highlights that the large CAPCO tax credit can generate substantial gains for the companies involved without much effort. When we consider the fact that the investments made by an insurance company usually are in the form of a loan at a reasonable interest rate, it makes a CAPCO-driven investment even more lucrative.

This means that an insurance company investing in a Certified Capital Company does not need to be very concerned about the abilities of the CAPCO. They make a solid return even if the investments do poorly. It also suggests that the main driver of the investment decision is the tax credit, not factors relating to the likely success of the investment. That is bad tax policy and bad economic development policy.

The structure of these investments from the perspective of the certified capital companies also has flaws. CAPCOs typically set aside as much as half of the funds invested in them by insurance companies. Those funds are placed in bonds or other safe investments, and the proceeds are used to pay off the loan from the insurance company. This means that a \$1 million tax credit offered by the District — a \$1 million loss of revenue — creates an investment pool of as little as \$500,000. It would be far more efficient for the District to invest directly in venture capital projects, or in a venture capital company.

Moreover, CAPCO rules allow the certified capital companies to be free of program requirements once they have invested an amount equal to the amount initially received. At that point, the CAPCO is not required to use the funds in a way that address DC economic development goals. Because a CAPCO must set aside half of these funds in a bond fund, then it has an even greater incentive to make investments in ventures that will have rapid returns rather than sound returns. The sooner funds are returned, the sooner new investments can be made and the sooner the investment target can be met. Again, this does not incentivize sound investments.

It is not surprising, then, that reviews of CAPCO programs have found them to be highly inefficient and unsuccessful, including the DC Auditor's assessment of DC's program. For these reasons, it would make sense to eliminate DC's CAPCO program.

Finally, it is worth pointing out that the CAPCO program makes the District an indirect investor in venture capital. Insurance companies get a \$1 credit for a \$1 investment in a CAPCO. DC thus loses \$1 in revenue as a CAPCO gets \$1. But the city has no control over the actual investments, even with rules over the types of firms that CAPCOs can invest in. And the District does not benefit directly from these venture capital efforts. Rather than sharing in profits of successful companies, as a normal equity investor would, DC's only benefits are the taxes paid by successful companies and the jobs created for DC residents. As the Auditor notes, these gains have been modest.

There are a few other relevant observations on DC's CAPCO experience. First, the District does not have a comprehensive economic development strategy. CAPCO appears to have been just another tool added without a clear sense of what it would accomplish or how it would fit with other economic development programs. The fact that DC already had generous tax incentives for new high-technology firms at the time CAPCO was adopted further supports this point. (The high-tech incentives, by the way, also appear to have been ineffective.) The District would benefit from developing an economic development strategy — such as supporting retail development, neighborhood development, small businesses, or development that creates good career ladders for DC residents — and then shaping economic development policies to meet those goals.

I am not an economic development expert and thus cannot make recommendations for alternative investment strategies. But it is clear that there are alternate structures that could

give the District more control over the investments, greater incentives to make sound investments, and more direct benefit from successful investments.

I would like to make one final point about the structure of the CAPCO program. It went into effect in 2004, but companies were not allowed to claim any tax credits until 2009. This is not the usual CAPCO structure. While I have no evidence as to why CAPCO was designed this way, I assume it was done to place the costs of CAPCO (the lost revenue) outside of DC's four-year financial plan window. Doing so would make the official cost of CAPCO be zero, because DC rules require that a program's cost be accommodated in the budget only for four years. It suggests that the District should revise its fiscal impact statement rules to avoid this kind of fiscally irresponsible manipulation.

Thanks again for the opportunity to testify. I am happy to answer your questions.