

## **Testimony on the Washington DC CAPCO Program**

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Chairwoman Bowser, Chairman Brown and members of the council, thank you for the opportunity to appear before you to discuss the CAPCO program. My name is Julia Rubin and I am a professor at the Edward J. Bloustein School of Planning and Public Policy at Rutgers University. My research expertise is in developmental venture capital and lending, including the use of equity and debt investments for economic and community economic development. About a decade ago, I and my colleagues Professor David Barkley of Clemson University and Dr. Deborah Markley of the RUPRI Center for Rural Entrepreneurship first researched and wrote about the CAPCO program with funding from the US Department of Agriculture. I have been following the program since then and would like to share with you some of the reasons why I believe the program is both ineffective and extraordinarily expensive.

Today's hearing is taking place as a result of a DC Auditor's report that was very critical of the CAPCO program's implementation. I expect that you will hear a lot of testimony today from the CAPCOs disputing some of the numbers in the Auditor's report, in particular, the Auditor's finding that the program has cost \$76,000,000 to date. I believe the \$76,000,000 figure refers to the total expenditures reported by the CAPCOs to the auditor versus what the CAPCO program would ultimately cost the District. It is my understanding that the program would cost the district \$50,000,000 in lost tax revenue, which still represents quite a large expenditure. When it comes to CAPCOs, it also represents a very poor use of the taxpayers' money.

My primary concerns with this program are not related to the multiple issues that the Auditor found in terms of faulty implementation and oversight of the program. While those are significant and troubling, they can be addressed. What can not be fixed, however, are the fundamental structural flaws of this program, which make it a very, very poor deal for the taxpayers of the District of Columbia.

To understand what is wrong with the CAPCO program, it is helpful to review briefly how normal venture capital works and to compare that to how the CAPCO program works.

### **First, let's look at how normal venture capitalists and CAPCOs raise money**

Normal venture capitalists are financial intermediaries. To be successful, they must first convince wealthy individuals, pension funds, corporations and foundations to trust the venture capitalists with their money, which the venture capitalists will use to make equity investments in privately held companies. The venture capitalists convince these investors to invest with them by demonstrating that they have experience making equity investments and exiting those investments in such a way as to make substantial profits for their investors.

**Now, let's take a look at how CAPCOs raise money.**

CAPCOs do not have to convince potential investors to trust them with their capital. They have to convince states to forego millions of dollars in tax revenue. They do so through extensive and highly effective lobbying. This lobbying is intended to convince the states that they are falling behind their neighboring states in providing capital to local entrepreneurs, and as a result, will suffer in terms of economic development and tax revenues.

Once a state passes CAPCO legislation, the CAPCOs take advantage of their existing relationships with a group of insurance companies to obtain commitments from those companies to invest in the state's program. Because of their existing relationships, the CAPCOs are able to obtain the insurance company commitments very quickly and thus to lock up all the tax credits among themselves. This precludes local venture capitalists from being able to compete for the tax credits. That is why the same handful of CAPCOs have been able to obtain almost all of the tax credits in the nine states that have passed the CAPCO program as well as in the District of Columbia.

**Now let's look at how normal venture capitalists make money versus how the CAPCOs make money.**

Normal venture capitalists receive an annual fee of 2 to 2.5 percent of capital under management to cover their operating expenses. Their primary compensation, however, comes from their being able to keep 20 percent of any profits they earn with their investments. That means that if they don't earn any profits, their income is limited to whatever they receive via the management fee, which accounts for only a small fraction of what a good venture capitalist earns.

Normal venture capitalists make money by investing equity dollars in companies that will grow rapidly and then exiting those investments by selling the companies to other, larger firms or by taking them public. Unless they do this successfully, not only will the venture capitalists not make money for their present investors and for themselves, they also will not be able to convince other investors to trust them with their capital in the future. As a result, normal venture capitalists have a tremendous incentive to select the companies in which they invest very wisely, to insure that they select companies that will grow rapidly. They also have an incentive to provide those companies with any assistance necessary to insure that they become an attractive acquisition for another firm or an attractive stock for the public markets. Otherwise, the venture capitalists cannot make money. By selecting, investing in and providing advice to rapidly growing firms, normal venture capitalists also help to create jobs and grow the economy. If they did not select firms with significant growth potential, the economic impact and job creation that resulted from their investments would be much smaller and potentially only short term.

In contrast, the primary profits for the CAPCOs come not from exiting carefully chosen investments in high growth companies but from decertifying from the CAPCO program once they have invested an amount equal to 100 percent of their tax credit allocation, as allowed under the CAPCO legislation. At that point in time, the CAPCOs can keep all of the taxpayer dollars that they did not lose through the investment process. As a result, the overriding incentive for the CAPCOs is not to make the kind of high quality equity investments that have enabled normal venture capitalists to help grow local economies. The incentive for the CAPCOs is to lend or invest the taxpayers' dollars so as to insure the fastest and safest possible repayment of those dollars.

Perhaps the most extreme example of the questionable quality of CAPCO investments is the Wilshire Capital CAPCO. Wilshire invested a total of \$6.4 million through the end of 2007. However, almost sixty percent of that total was invested in itself. Wilshire placed \$3.8 million in two

companies -- Community Financial Services and Newtek Insurance Agency – that are owned by the same entity that owns the Wilshire CAPCO. Another \$1.9 million, equal to thirty percent of the total dollars that Wilshire invested, went to Mumin Productions, a theater production company that used the investment to stage one play and generated no ongoing jobs.

**The final comparison I'd like to make is between how normal venture capitalists and CAPCOs repay their investors. This is by far the greatest drawback of the CAPCO model.**

Normal Venture Capitalists have approximately ten years to make and exit their investments. By the end of that time span, normal venture capitalists must return to their investors all the capital originally provided by those investors as well as 80 percent of any profits that the venture capitalists have earned on that capital. As I indicated earlier, the other 20 percent of any profits earned the venture capitalists can keep for themselves.

In contrast, CAPCOs return almost none of the investment capital they receive from their equity investors – the taxpayers. Only in the highly unlikely scenario that the CAPCOs generate significant financial returns on their investments, exceeding a 15 percent internal rate of return, does the District of Columbia stand to receive a tiny fraction of the profits.

I think the best way to demonstrate this difference in returns to investors between normal venture capital and CAPCOs is to look at a hypothetical scenario in which the District of Columbia invested \$50,000,000 over four years in three normal venture capital funds versus in three CAPCOs. For purposes of comparison, I have assumed a typical ten year venture capital investment and exit horizon for both normal venture capitalists and CAPCOs. I have also assumed that both the normal venture capitalists and the CAPCOs earn a 20 percent internal rate of return on their investments.

Were that to happen, the normal venture capital funds would return the District's \$50,000,000 investment. The District would also receive 80 percent of the profits generated by those investments, which in this case would be equal to \$69,600,000, for a total return to the District of \$119,600,000 on its \$50,000,000 investment. If the three CAPCOs earned the same 20 percent internal rate of return, they would return none of the District's \$50,000,000 investment. They would, however, return \$4,500,000 of the profits, for a total return to the District of \$4,500,000 on its \$50,000,000 investment in the CAPCOs. In comparison, the CAPCOs would end up with \$132,500,000 in profits. If the CAPCOs generated an internal rate of return of 15 percent or less, they would get to keep 100 percent of the money and the District would receive absolutely nothing back from its \$50,000,000 investment.

**Please keep in mind that any benefits from venture capital in the form of jobs and tax revenue generated would be at least as great if the city invested in a normal venture capital fund vs. giving the money to the CAPCOs.** In fact, the benefits would be much greater because as I pointed out earlier, normal venture capitalists have every incentive to make good investments that generate economic growth and jobs. Otherwise, they do not make any money.

CAPCOs on the other hand, do not have an incentive to invest for maximum economic growth and jobs. Instead, their incentives are to loan or invest their allocation to insure the quickest possible repayment, so they can decertify the taxpayers' money and keep it as profit. Again, **to make money, the CAPCOs do not need to make investments that lead to jobs or growth. They just need to find businesses that will give the money back to the CAPCOs as quickly as possible.**

That is the reason why the IRS immediately recognizes as income to the CAPCOs any funds allocated to them by a state (rather than waiting until the CAPCOs make investments and decertify). The investments are of secondary importance -- simply something that the CAPCOs have to do in order to keep the taxpayers' money

In addition to promising that the CAPCO program would make long-term equity investments in District businesses and bring economic development and job creation to the District, the CAPCO proponents also promised that the program would create and foster a local venture capital infrastructure within the District.

But there is absolutely no evidence that CAPCOs help create and foster a local venture capital infrastructure. Louisiana, where the CAPCO program originated, spent a total of \$631,000,000 on the program from 1989 through 1999. After spending all that money on CAPCOs, Louisiana received less than one tenth of one percent of the venture capital dollars invested in the entire United States in each of the following three years.<sup>1</sup> This is hardly evidence of a vibrant venture capital industry.

Not only does the CAPCO program not help create and foster a local venture capital infrastructure, there is good reason to believe it may actually hurt the local venture capital industry. As I mentioned before, the tax credits allocated through the CAPCO program go almost entirely to a handful of organizations, including Advantage, Enhanced, Wilshire and a couple of others, that travel from state to state lobbying for the program. These organizations have existing relationships with the insurance industry that virtually preclude any other venture capital firms from obtaining access to the tax credits. Because the CAPCOs have to invest the funds quickly and with less concern for the quality of those investments, they tend to flood the market, increasing the prices that other venture capitalists have to pay for their investments. In this way, the CAPCOs may actually hamper the performance and growth of a local venture capital industry.

In summary:

- The overriding incentive for the CAPCOs is not to make the kind of high quality equity investments that have enabled normal venture capitalists to help grow local economies. The incentive for the CAPCOs is to lend or invest the taxpayers' dollars as quickly as possible, so that the CAPCOs can decertify and keep those dollars as profits.
- Despite the CAPCOs claims, there is absolutely no evidence that CAPCOs help create and foster a local venture capital infrastructure. In fact, there is good reason to believe that the CAPCO program may actually hurt the local venture capital industry.
- Any benefits from venture capital in the form of jobs and tax revenue generated are likely to be much greater if the District invests in normal venture capital funds vs. giving the money to the CAPCOs.
- If the District invested \$50,000,000 in normal venture capital funds that earned a 20 percent internal rate of return, the District would receive back \$119,600,000. If the District gave the \$50,000,000 to the CAPCOs and they generated the same 20 percent internal rate of return, the District would receive back \$4,500,000 while the CAPCOs would earn \$132,500,000 in profits.

It is for these reasons that I began my testimony today by saying that **CAPCOs are an extraordinarily expensive and inefficient way to increase access to capital in the District. I fully believe that the District would get better results if it simply gave a million dollars each to fifty entrepreneurs through a raffle.**

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<sup>1</sup> Source: PriceWaterhouseCoopers MoneyTree Survey of Venture Capital

Finally, I would like to share with you how the CAPCO program has fared in some of the nine states that have adopted it to date.

**Louisiana**, which originated the CAPCO program, commissioned a study conducted by its Department of Economic Development and a leading CPA firm. This study found that the CAPCO program “is expensive and inefficient to the State” and that “the greatest and most immediate beneficiaries of the CAPCO program are the CAPCO companies and their owners.”

The study confirmed that, unlike other venture capital models, CAPCOs are allowed to profit immediately, regardless of the success of the companies in which they are investing.

Louisiana Senate President John Hainkel Jr., who helped create the original 1983 CAPCO, legislation said: “It hadn’t really helped us worth a damn, quite frankly.”

Mike Williams of the Louisiana Department of Economic Development told a reporter investigating the program, “If you’re going to set up something, look at what we did and do the exact opposite.”

**Colorado** originally passed the CAPCO legislation in 2001, allocating a total of \$200,000,000 to the program. The state subsequently successfully diverted \$100,000,000 of that total away from the program.

A legislative audit in Colorado noted that “CAPCO programs are a most inefficient means for the state to raise venture capital” and questioned whether any jobs created were attributable solely to the CAPCO program.

Bob Lee, the head of Colorado’s Office of Economic Development, which administered the program, told a legislative committee that “I think this state would be hard pressed to design a program that cost the taxpayers more and delivered less.”

Then Colorado State Treasurer Mike Coffman, who is now a Congressman, said “It’s a scam...I don’t think there’s anyone who thinks this is a good deal for Colorado, with the exception of those companies who lined their own pockets.”

**Florida** originally passed CAPCO legislation in 1998, allocating \$150,000,000 to the program. According to a 2007 Florida government report, the most current available, the program has created a net gain of 20 jobs in the nine years it has been in effect. That report also found that “Despite legislative intent that the CAPCOs assist the State’s economically distressed areas, there have been no investments reported in the enterprise zones, urban high crime areas, rural job tax credit counties, or nationally recognized historic districts. Also, despite its eligibility being specified in statute, there have also been no investments in the Florida Black Business Investment Board.”

**Missouri** allocated \$140,000,000 to the CAPCO program in 1996. A subsequent state study found 66 percent of the funds generated by the venture capital program there “were not being used for the intended purposes of providing capital for start-up or expanding Missouri businesses.”

A 2004 audit by then Missouri State Auditor Claire McCaskill, who is now a United States Senator, concluded that “The Missouri Certified Capital Company Tax Credit program is an inefficient and ineffective tax credit program” and recommended that “the Department of Economic Development

and the General Assembly let the Missouri Certified Capital Company Tax Credit program expire without authorizing any additional tax credits.”

**Texas** allocated \$200,000,000 to the CAPCO program, starting in 2006. The latest report from the Texas Comptroller of Public Accounts indicates that after investing a total of more than \$22,000,000 in Texas businesses, the CAPCOs had generated a total of 23 jobs, or roughly a million dollars per job created.

In addition to the nine states that have CAPCO programs, the legislation was rejected in at least 12 other states, including Nevada, Iowa, Washington State, Vermont, North Carolina, Rhode Island, South Carolina, Utah, Arizona, Illinois, Kansas, and Michigan.

**In conclusion, the CAPCO program is an inordinately expensive and ineffective way to bring patient capital to the District’s small businesses. My recommendation, like that of the District’s Auditor and of states such as Colorado and Florida that have understood what a terrible deal the CAPCO program is for the taxpayers, is to terminate the program as soon as possible and to do everything you can not to allocate the 50,000,000 in taxpayer dollars to the CAPCOs.**

Thank you again for inviting me to testify this morning. I would be happy to answer any questions you might have.