LATE

LATE

PACIFICAP
GROUP

PACIFICAP GROUP, LLC
820 Mililani Street, Suite 600
Honolulu, HI 96813
Direct: 808.237.5388 Fax: 808.537.2188

February 4, 2009

To: WAMTestimony@Capitol.Hawaii.gov

Testimony for Hearing before the
Senate Committee on Economic Ways and Means
Thursday, February 5, 2009, 9:30 am

State Capitol, Conference Room 211
415 South Beretania Street
Honolulu, Hawaii 96813

Re: Comments Relating to SB 199—Repeal of Tax Credits

Chair Kim, Vice Chair Tsutsui, and Committee Members:

Thank you for the opportunity to submit testimony to provide comments relating to SB 199, relating to the Repeal of Tax Credits.

I am Jeff Au, Managing Director and General Counsel of PacifiCap, Hawaii's largest locally based venture capital firm. Since 2000, PacifiCap affiliates have invested in more than two dozen Hawaii companies, and we have led or co-invested in financing rounds totaling more than $400 million. Our investor base of more than 150 institutional, corporate and individual investors from Hawaii demonstrates the widespread support that our efforts to support local capital formation, economic diversification and innovation have across our community.

I support the repeal of tax credits that have not been effective, if this conclusion to repeal has been reached by objective, substantive cost-benefit analysis based upon empirical data, facts and logic.

However, I strongly oppose the repeal of any tax credit if such repeal is based upon half-truths, misleading headlines and press spin, ignoring and misunderstanding of existing tax law, misguided ideology devoid of facts or logic, or State sponsored studies with misleading conclusions, conducted at taxpayer expense, possibly in violation of State Procurement Laws, more specific details of which I would be glad to provide to you during the question and answer period.

I also respectfully suggest that if after objective, substantive, responsible cost-benefit analysis, it is concluded that certain tax credits should be extended, such extension should pass with a simple majority vote of the Senate and House, and not a two-third supermajority. Some tax credits may be bad, and others may be good, as is the case with all other laws. However, as a general matter, just because a law includes a tax credit does not make it bad per se, and the

Legislature should not start with a negative presumption requiring a 2/3 supermajority to overcome, before looking at the actual and specific details of any tax credit.

I also urge you to avoid "scapegoating" tax credits for the State's current budgetary crisis. While State General Excise Tax ("GET") collections have dropped substantially in recent months, I understand that State Income Tax collections were actually up in the last quarter of 2008. Therefore, tax credits such as the High Technology Business Investment Tax Credit, codified in Section 235-110.9, Hawaii Revised Statutes and commonly referred to as "Act 221" cannot be blamed for the drop in State GET collections since the Act 221 tax credit does not even apply to General Excise Tax.

While the State's budgetary problems are real and serious this year, we have heard the same arguments from the same small number of Act 221 critics, predicting that Act 221 would bankrupt the State in years past, when even with Act 221, the State ended up having budget SURPLUSES of more than $732 million, $493 million and $331 million in fiscal years ending 2006, 2007, and 2008, respectively.

The point here is that Act 221 is NOT the cause of the State's current budgetary problems. To the contrary, Act 221 has been an effective stimulus, which has resulted in far more investment and job creation in Hawaii than the costs of the credits to the State. While the State's current budgetary problems are serious, killing or damaging Act 221 at this point, would be to "jump from the frying pan into the fire."

I respectfully suggest that the better way to balance the State's budget would be to improve efficiency in the collection of more than $1 BILLION PER YEAR in unpaid and delinquent taxes owed the State, which totals several billion dollars, when you include delinquent taxes from past years. Although it may be harder to collect on delinquent taxes in a recession, other states have implemented solutions utilizing new software technologies that have increased tax collections by hundreds of millions of dollars per year.

Since Act 221 became law on July 1, 2001, it has brought out both the best and the worst of our State officials, in analyzing the costs and benefits of Act 221.

On the positive side, the Department of Taxation should be commended on a very comprehensive, substantive and objective study on Act 221, which it published in September 2008. This study concluded that the benefits of Act 221, as of the end of 2007, had far exceeded its costs, with more than $1.2 billion invested in at least 333 Hawaii technology and media companies, which had already spent more than $1.4 billion in Hawaii, had created more than 4,000 employee and independent contractor jobs, which paid more than $228 million in salary and other compensation in 2007 alone. These local high tech and media companies also earned more than $228 million in revenues in 2007 alone. According to this study, all of these benefits, already realized long BEFORE most of these Act 221 companies have reached their full potential, have already far exceeded the costs of credits claimed from 1999 through 2006 of less than $296 million ($437 million including credits claimed from 1999 through 2007).

On the other hand, as recently as this past Sunday, February 1, we had another misleading front page story and headline claiming that Act 221 has "missed the mark" because several film and TV productions were funded by Act 221, when Act 221, as a statutory matter, specifically intended to build Hawaii's film, TV and media production sector, IN ADDITION TO Hawaii's high tech sector. In past years, we have had front page headlines of Act 221 costing $1 Billion, which was "leaked" press without Tax Department approval, when years later, the Tax Department reports the total costs still are far less than $1 Billion.

In 2006, we had the Tax Review Commission issue an RFP to analyze several different tax credits and award the contract to two researchers who had very little experience with Act 221 or tax law generally, one being an accounting professor all the way from the University of West Georgia business college, who has spent very little time in Hawaii, and the other, who personally told me that she wanted to analyze other tax credits (as required by the RFP), but that "They" told her that she could only analyze the Act 221 investment credit (possibly in violation of State procurement laws). The conclusions of this report were remarkable. It concluded that Act 221 was a "blackhole," for which it was impossible to measure the costs and benefits, even though it is impossible to claim an Act 221 investment credit without reporting to the Tax Department how much in credits you are claiming (i.e., the costs), and how much cash you invested (i.e., the benefits). The Tax Director publicly stated that he and his staff was hardly consulted in the preparation of the first draft of the report, while the report itself seemed to quote more (negative) conclusions and interpretations of Act 221 from the Department of Economic Development and Tourism ("DBEDT") than from the Department of Taxation.

In summary, as you and your colleagues move forward in analyzing various tax credits, I respectfully suggest that you follow the following basic principles, which we all should be able to agree upon:

1. Have a ZERO-TOLERANCE policy for political interference, distortions of empirical data with misleading conclusions and violations of State Procurement Laws in the analysis and studies of State Tax Credits.

2. As responsible legislators, base your decisions on primary source empirical data and objective analysis, and NOT just the "press spin" of what you read in the newspaper.

3. Do a Cost-Benefit analysis of various tax credits, and not just a "Cost-Cost" analysis that just looks at the costs and ignores the benefits.

4. Realize that as bad as our economy is right now, it is very possible for you to make it much worse if you repeal or damage those tax incentives, such as Act 221, which has served as effective stimuli to pump hundreds of millions of dollars of cash into our

economy each year, and which has created and continue to maintain thousands of jobs.

5. Use the same and consistent metrics in comparing the cost-benefit impact of tax credits with other government programs. For example, you can compare the capital formation, job creation and economic development benefits of the Act 221 investment tax credit with the results of other State economic development programs, such as those of DBEDT, which I understand spends more than $200 million a year of State money (including special funds).

Thank you very much for allowing me to submit this testimony today.

Respectfully submitted,

Jeffrey K. D. Au
Managing Director and General Counsel
PacifiCap Group, LLC