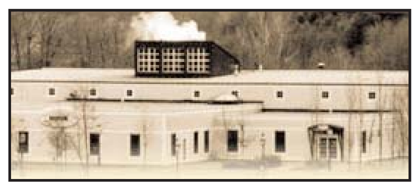
Program Audit

Office of the State Auditor

Promises to Keep





Recommendations to Strengthen the Performance of Vermont's Economic Advancement Tax Incentives Program

Elizabeth M. Ready
Vermont State Auditor

Issue Date: February 4, 2003

Mission Statement

The mission of the State Auditor's Office is to be a catalyst for good government by promoting reliable and accurate financial reporting as well as promoting economy, efficiency and effectiveness in State government.

Message from the Auditor

Using public resources to stimulate job creation is sound economic policy. Most Vermonters would agree that when public dollars are spent in an effort to create jobs - either as a tax break to a growing company, or as an appropriation for workforce training or infrastructure - these dollars must be spent in compliance with the law and in a cost-effective manner that achieves a clear net benefit.

Vermont's Economic Advancement Tax Incentives (EATI) program has become one of the most extensive new initiatives launched by State government in recent years. The program has authorized $80.1 million in business tax credits from its inception in 1998 through December 2002 with the goal of stimulating new economic activity and creating quality jobs.

The Department of Taxes has allowed $24 million in tax credits to be claimed without fully verifying that the promised economic activity has occurred.

The Vermont Economic Progress Council (the Council) has been very responsive to its legislative mandate, processing applications in a timely and efficient manner. It has done much to comply with legislative amendments passed in the 1999-2000 session.

However, the Department of Taxes has allowed $24 million of tax credits to be claimed without fully verifying that the promised economic activity, upon which the credits were based, has occurred.

Fortunately, the new Commissioner of Taxes Richard Mallary has adopted the philosophy of our new Governor who said in his inaugural speech: "Change begins today."

In his response to our findings, Commissioner Mallary states: "The clear legislative intent of Act 71 was to make available certain tax credits for entities that performed specified activities promoting economic development … The Department shall proceed from this point forward on the basis that the language in award letters made all awards conditional, and that the inherent powers of the Department allow it to reduce or deny credits awarded by VEPC." (*See Appendix A for entire statement.*)

Guided by this new approach, the Department of Taxes and the Council will be able to usher in a new era of accountability regarding this program.

Corporate Income Tax on the Decline

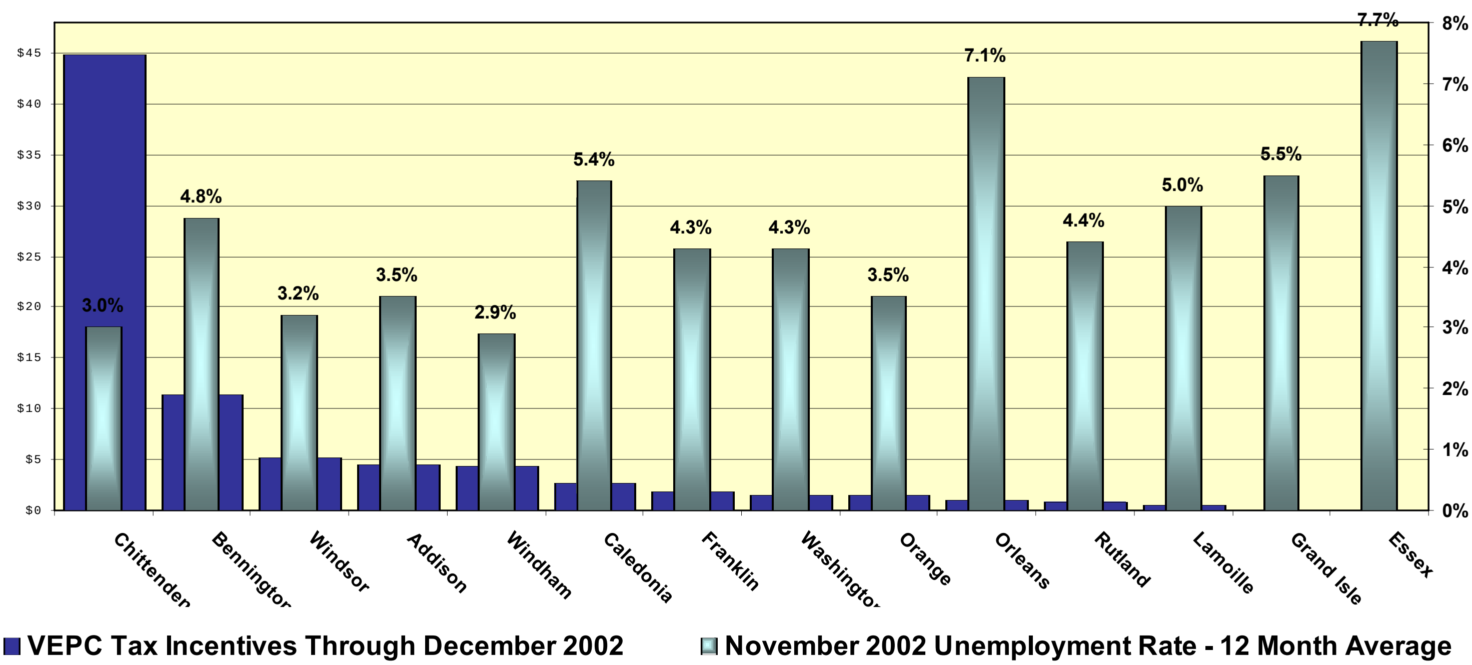
Our findings, and the Department's prudent response, come at a time when fiscal crises beset states from Massachusetts to California. These woes stem partly from the two-decade decline in corporate tax revenues as a share of total State general fund revenues.

Between 1979 and 2000 corporate taxes nationwide fell from 10.2 to 6.3 percent of total state revenues. In Vermont, this trend was even more pronounced, with corporate taxes dropping from 10 to just 3 percent of general fund revenues. Annual corporate tax receipts in this category fell from $57 million in fiscal year 1999 to just $32 million in fiscal year 2002.

A number of factors contribute to this decline, including lower corporate profits, increased tax avoidance by corporations, lower effective state tax rates, the increased prevalence of state corporate income tax credits and related incentives, and the increased use of S corporations, and other pass-through entities, which reallocate some forms of corporate income to personal income.

Given these trends, it may well be time for Vermont to take a close look at the policies and the performance behind its corporate income tax. Some states are doing just that, and considering a variety of courses.

Distribution of Council-Awarded Tax Incentives Compared to Unemployment Rates by County



NOTE: No companies located in Essex and Grand Isle counties have been awarded tax incentives.

Wisconsin is debating whether to eliminate its corporate income tax and join states like Nevada, South Dakota, Texas, and Washington that are corporate income tax-free. Since Vermont's corporate income tax yields relatively little in revenue, the State could consider eliminating it altogether, thus benefitting all Vermont companies and creating a strong tool for economic development. Such a plan would require careful study.

Other states, including Missouri and New Jersey, are eliminating corporate tax loopholes. New Jersey Governor McGreevey said closing these loopholes would generate an additional $627 million in state revenues.

This report outlines both the success of the current tax incentives program, and the need for improvement. Our recommendations should be considered as part of a larger debate about tax policy in general, and the corporate income tax in particular.

Key findings in our report include:

- The Department of Taxes has allowed $24 million of tax credits to be claimed without fully verifying that the promised economic activity, upon which the credits were based, has occurred;

- These tax credits are, to a greater extent than known before, contributing to Vermont's decline in the corporate income tax as a revenue source to fund education and essential state services;

- The Council's "but-for" test (see page 36 for definition) is a critical program assumption that cannot be verified;

- There is virtually no limit to the amount of credits the Council can authorize in a given year;

- The Department of Taxes does not know if companies are maintaining minimum employment levels in order to earn their credits; and,

- The program is unnecessarily complicated.

Our recommendations include the following improvements:

- The Department of Taxes should verify that the promised economic activity upon which a company's tax credit is based has occurred;

- The "but-for" test should be eliminated as the basis for fiscal cost measurement in the Council's program;

- The Legislature should authorize an annual program cap to lessen the annual risk to the State's treasury and allow the Council to consider the merits of each project based on the nine guidelines; and,

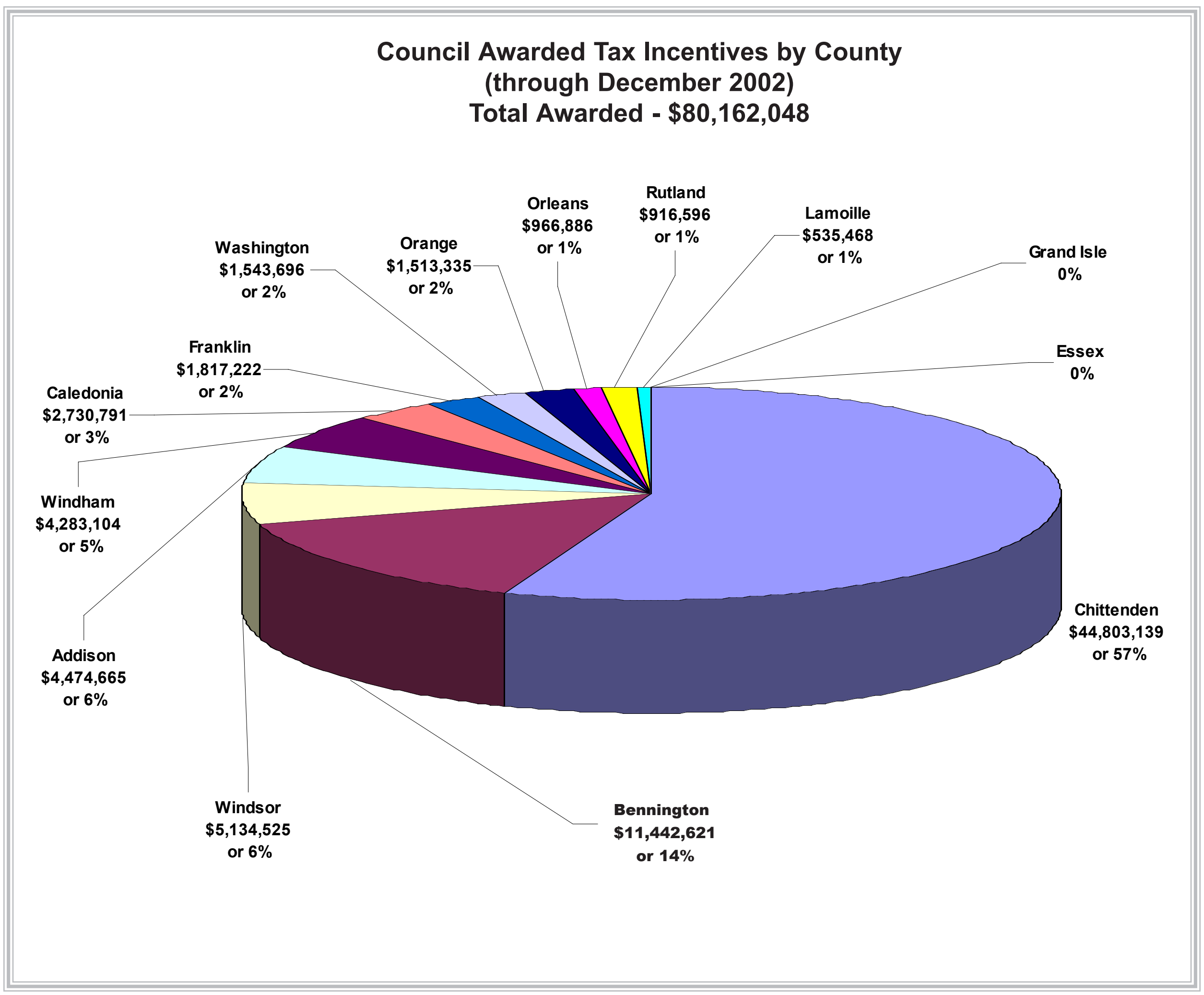
- The program should be simplified to make it easier to administer and for businesses to realize its full range of benefits.

A New Era of Accountability

The Legislature established this economic incentives program with the philosophy that it would be “performance-based.” That is, job creation and economic investments would be accomplished before companies received a tax break.

However, our audit found that the Department of Taxes did not verify the promised economic performance, such as the number of jobs created and the amount of investments made, when companies (or “pass-through” shareholders and partners) claimed their tax credits.

To date, 107 total corporate entity returns (for the 1998-2001 tax years) have resulted in a total of $8,727,876 million in Council-awarded tax credits being applied against a tax liability. None of the 107 claims have been checked to fully verify that a company has created new jobs, maintained its workforce, or made new investments as promised in its application for tax credits.



An additional $15,290,102 in tax credits (for the 1998-2001 tax years) is in “carry-forward status,” which means the Department of Taxes has deemed them to have been earned by companies, but they were not applied because the companies did not have enough tax liability. These credits can be applied to reduce a future tax liability.

We recommend, and the Department of Taxes has agreed to, a new era of accountability to ensure that specific job creation and investment activities are verified, and that credits are allowed or disallowed in a timely fashion.

Commissioner Mallary has shown leadership in laying out a three-point plan to apply the procedures of 32 V.S.A. §5930a (l)(1). (*See Appendix A for entire statement.*) He says the Department will:

- Request the Council to provide it with very detailed performance expectations, as required in 32 V.S.A. §5930a (l)(1)(A) for all credits awarded by the Council prior to July 1, 2000;

- Request that the Council provide the Department with benchmarks, as they do for awards authorized after June 2000 pursuant to 32 V.S.A. §5930a(k), by which it can determine whether there is full or partial compliance with the expectations and determine what portion, if any, of the approved credit should be allowed; and,

- Review future requests for the utilization of credits pursuant to these benchmarks and allow or deny credits on that basis.

Capping the Risk

The so-called “but-for” test, and the cost-benefit model, which relies upon this test, are important components of the tax incentives program because they work together to calibrate the award levels to potential fiscal benefits.

The cost-benefit model assumes the “but-for” test to be true in each and every case. In other words, *all* project benefits flow from and are due to the State tax credit incentive. To attribute the entire stream of future economic benefits that result from an investment to a single factor like a tax credit is not accurate, and cannot be verified.

We believe the “but-for” test should be eliminated as the basis for fiscal cost measurement in this program. Instead, the Legislature should set an overall annual program cap. With a program cap, the cost-benefit model would still be of pivotal importance, in that it could identify and rank subsidies with the greatest potential fiscal benefit. Companies could compete for tax credits, rather than lining up for them as they do now.

Return on Investment

We struggled to answer an essential question during the course of this audit: "*What is the return on investment to the State for the program?*" The statute requires the Council to determine the net fiscal impact of each proposed development or economic investment that is given an incentive.

The true net fiscal impact of this program to date is impossible to pinpoint, because it is predicated on the "but-for" test. The impact can be estimated between a negative $9 million (the approximate amount of tax credits applied to date) and a positive $3 million (the net fiscal benefit to the State treasury as of the end of 2001, according to the Council).

> *"The Department shall proceed from this point forward on the basis that the language in award letters made all awards conditional, and that the inherent powers of the Department allow it to reduce or deny credits awarded by VEPC."*
>
> - Richard Mallary
> Commissioner of Taxes

Because it is likely that some of the program's 113 approved projects would probably have occurred in whole, or in part, *without* the State incentive, an arms-length, independent analysis would likely find the net fiscal impact to the State (since the program began) to be negative.

While not all, nor even most, of Vermont's corporate tax revenue decline (from 1998 to 2002) is attributable to Council-awarded tax credits, our audit revealed the tax credits are a much more significant component of the decline than previously understood.

Conclusion

It is important to consider this audit of Vermont's EATI program in the overall context of the state's fiscal challenges and tax policies, including the significant drop in the corporate income tax.

A number of key issues merit further review by the Legislature and the Administration, and our Office raises them in the hope that they will receive careful research and consideration. They are:

- Should Vermont eliminate the corporate income tax, helping all Vermont businesses and attracting new firms to the State? If so, what fair and equitable revenue sources should be substituted?

- Should Vermont strengthen and restore the corporate income tax as a revenue workhorse to help fund educational and needed government services?

- To what degree can a small state like Vermont “compete” with larger, wealthier states on the basis of tax subsidies to spur new business?

It will be important for the State to evaluate, on an ongoing basis, where the expenditure of limited public funds can have the greatest beneficial impact on economic development. Even in the best of circumstances, economists increasingly recognize that direct business subsidies are among the most expensive ways to achieve employment and economic growth. As state budgets tighten, the costs and benefits of tax incentives programs must be compared with other policy options for creating jobs and economic growth, like workforce training, low-interest loans, and investments in infrastructure such as roads, water and sewer, and telecommunications.

In the meantime, our findings and recommendations, and the Department of Taxes' thoughtful response, promise to improve the State's tax incentives program by strengthening performance verification. In addition, replacing the “but-for” test with a program cap, and simplifying administration would improve the program.

I would like to thank Glen Wright, the Council's chairman, the Council's Executive Director Fred Kenney, former Commissioner of Taxes Janet Ancel, current Commissioner of Taxes Richard Mallary, and the staffs of both the Council and the Department of Taxes for their exceptional assistance and cooperation with this audit. We greatly appreciate their willingness to provide information, answer questions and discuss the issues that ultimately impact all Vermonters.

Sincerely,

Elizabeth M. Ready

Elizabeth M. Ready
State Auditor

February 4, 2003

To obtain additional copies of this report contact:

Elizabeth M. Ready
State Auditor

Office of the State Auditor
132 State Street
Montpelier, VT 05633-5101
(802) 828-2281
1-877-290-1400 (toll-free in Vermont)
auditor@sao.state.vt.us

This report is also available on our website:
www.state.vt.us/sao