

**STATE AUDITOR'S REVIEW OF
THE VERMONT ECONOMIC PROGRESS COUNCIL'S
IMPLEMENTATION OF ACT 71 OF 1998**

June 1998 – February 2000

I. PURPOSE

The Office of the State Auditor has conducted a compliance and internal control review of the Vermont Economic Progress Council's (VEPC or the Council) implementation of Act 71 of the 1998 Session ("Economic Advancement Tax Incentives"). The review was initiated as a result of suggestions by various legislative committees, individual legislators, and other Vermont citizens.

II. AUTHORITY

This review was conducted pursuant to the State Auditor's authority contained in 32 V.S.A. §§163 and 167, and was performed in accordance with the U.S. General Accounting Office's Government Auditing Standards and as part of the State Auditor's annual audit of the State's General Purpose Financial Statements.

III. SCOPE and METHODOLOGY

The scope of this review included compliance with relevant provisions of Act 71 and related statutes and regulations, as well as a review of the Council's internal control systems. This review focused on the business tax credits referenced in §5930a(b)(2). The period covered is from June 1998 through February 2000.

A review differs substantially from an audit conducted in accordance with applicable professional standards, in that the purpose of an audit is to express an opinion. The purpose of a review is to identify findings and make recommendations so that the reviewed agency, in this case the Council, can better accomplish its mission and more fully comply with laws, regulations and relevant policies and procedures. This review relies upon representations of, and information provided by, the Council and staff. If an audit had been performed, the findings and recommendations may or may not have differed from those presented.

The scope of this review was limited by management's decision not supply this Office with a management representation letter following the conclusion of this phase of the review. Management representation letters are required by government auditing standards (see Statement on Auditing Standards no. 19) and essentially represent that the auditee has provided all information and data requested by the Auditor. This failure to provide such representations is but one example of the many obstacles this Office faced in conducting this review. Accordingly, this report is limited in scope and is based only upon the information actually provided to this Office. This scope limitation means that the Council has not provided us with the standard assurance that would allow the public to reasonably conclude that all relevant information has been provided and considered during the course of this independent review.

Our methodology included a review of relevant State statutes, regulations, and published policies, applications and supporting documents submitted to the Council, minutes and notes from Council meetings, staff summaries and recommendations, output from the cost-benefit model, periodic Council reports to the legislature, periodic reports from the Legislature's revenue analyst regarding the program, correspondence to and from the Council and its staff, interviews with the Chairman of the Council, the Executive Director, the Council's administrative staff person, and discussions with various legislative and executive branch officials.

Note: Some materials submitted to and prepared by and for the Council are deemed confidential by law and others are claimed to be confidential by the Council. We have had access to documents provided by the Council, but are not permitted to reproduce many of them or to disclose the names of individual companies in certain instances. We have adhered to the law and made every effort to accommodate legitimate concerns about public disclosure and claims of confidentiality. As a result, we are unable to cite all of the information available. However, we believe the report provides a fair representation of the materials provided.

However, we do quote from executive session minutes to illustrate how the Council wrestled with the basic criterion for determining eligibility for the tax credits. State law explains, "Minutes of an executive session need not be taken, but if they are, shall not be made public subject to Section 312(b) of this title" [1 V.S.A. §313(a)]. The question we had to face was whether such minutes were exempt from public disclosure when the issues discussed were improperly addressed in executive session. The law provides that a body may enter executive session for the purpose of "[d]iscussion or consideration of records or documents excepted from the access to public records provisions of section 317(b) of this title. Discussion or consideration of the excepted record or document shall not itself permit an extension of the executive session to the general subject to

which the record or document pertains" 1 V.S.A. §313(a)(6). As described in Finding 1.2, the Council went beyond the protection of executive session in its discussions of the applications for credits, making these parts of the minutes ineligible for exemption from public disclosure.

IV. BACKGROUND

The Economic Advancement Tax Incentives (EATI) were adopted in 1998 as part of the Act 60 technical corrections bill. It was intended to provide a tool for the State to stimulate new economic activity and is not dissimilar in principle to statutes in many other states. In part, it was promoted in response to concerns about efforts by other states to lure Vermont businesses with tax credits. The basic premise is straightforward. The State promises to reduce corporate taxes in return for businesses making new investments in Vermont.

The program includes tax incentives for facilities, machinery and equipment, job creation, research and development, training education and workforce development, exports, tax stabilization agreements and property tax exemptions. In addition, the statute authorized VEPC to award expanded sales tax exemptions for energy, building materials, and machinery and equipment. The statute calls for the use of a cost-benefit model to evaluate the fiscal impacts of proposals and requires consideration of certain guidelines related to economic and environmental factors.

A nine-member Council appointed by the Governor administers the program. VEPC is attached to the Department of Economic Development for administrative support. The Council appoints an Executive Director who is an Exempt State employee and employs a staff assistant who is a Classified State employee. There are also twenty-four members from Regional Development Corporations (RDC's) and Regional Planning organizations. The Council uses the RDC's to recruit applicants and assist businesses in preparing applications.

After the Council members were appointed, a consultant was hired to develop the cost-benefit model, which was approved by the Joint Fiscal Committee in October 1998. Subsequently, the Council awarded over \$34 million in credits in the first three months of operation.

At the request of the Joint Fiscal Committee, Thomas E. Kavet (independent consultant and legislative revenue analyst) was asked to prepare a quarterly oversight report on the program. In his first report, Mr. Kavet stated that "after nearly eight years of sustained economic expansion and the economy operating at near full capacity, it is hard to believe that none of the EATI projects would have occurred without

subsidies." He was referring to the 'but for' question, "as in 'but for' the subsidy, would the investment have occurred?"

The aggregate amount of tax credit commitments awarded represent a significant contingent liability to the State, which makes it difficult to estimate future revenues. However, the Legislature, which made minor amendments to the statute in 1999, has not yet addressed this issue, although it is under discussion in several committees.

Mr. Kavet issued two additional oversight reports but was limited by VEPC's refusal to allow him to examine records necessary for his review but considered confidential by the Council. In his reports to the Joint Fiscal Committee, Mr. Kavet raised several issues including the regional distribution of awards, continuing concern about the 'but for' question and the cap, and the lack of monitoring and oversight.

Through December 1999, the Council had awarded almost \$64 million in various tax credits and municipal property tax exemptions with an estimated net fiscal benefit to the State of \$29.5 million. According to the Council, these incentives will produce \$1.4 billion in new economic activity including 7,454 new jobs. Thus far, the Council has not reported any information about adherence to the guidelines by companies awarded credits or any disaggregated data about the return on investment from individual awards.

Several legislative committees, individual legislators and other Vermont citizens have expressed concern about the magnitude of the credits awarded and the lack of any formal assessment process. The State Auditor has undertaken this review in response to these concerns and as part of our annual audit of the State's General Purpose Financial Statements.

V. FINDINGS – INTERNAL CONTROL AND COMPLIANCE

"Internal control is a process – effected by an entity's board of directors, management, and other personnel – designed to provide reasonable assurance of achievement of objectives in ... financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations." Internal control consists of five interrelated components including control environment, risk assessment, control activities, information and communication, and monitoring. As the findings below will demonstrate, the Council does not have adequate internal controls and in some cases is not in compliance with the statute.

1. THE 'BUT FOR' TEST

FINDING 1.1

VEPC failed to establish sufficient internal controls to provide reasonable assurance of compliance with the law, which requires application of an effective 'but for' test in order to ensure that the cost-benefit model accurately measures the fiscal costs and benefits associated with the tax credits.

DISCUSSION: The statute requires the use of a cost-benefit model to "measure the present value of the anticipated direct and indirect fiscal benefits ... against ... the direct and indirect fiscal costs associated with" the tax credits. A critical assumption of the cost-benefit model is that the economic activity under consideration is new and would not have occurred without the tax incentives. Therefore, the Council must apply a 'but for' test to "determine that 'but for' the incentives, the economic activity would not otherwise have happened or would have happened in a significantly different and less desirable fashion." The Council's application of the 'but for' test is deficient. This represents a serious internal control failure and may have cost the State substantial "tax expenditures" for economic activity that might have occurred without them.

According to VEPC, "legislative intent is clear that [the] 'but for' must be met in order for a project to be considered for tax incentives." To address the 'but for', applicants are required to submit a letter from the CEO describing "how the incentives played a role in your decision making process." In addition, the Council sometimes questions applicants at the meetings.

It has always been understood that the cost-benefit model cannot, and was not designed to, answer the 'but for' question. According to the Legislature's revenue analyst, "it is important to note that no mechanical model can definitively screen or conclusively answer [the 'but for'] question." The Council's own consultant wrote that "the benefit/cost model is not capable by itself of addressing the 'but for' component of the ... application process."

Nevertheless, the 'but for' test is essential to the model approved by the Joint Fiscal Committee. The Council's consultant explained that "the method in which the benefit/cost model evaluates ... applications implicitly assumes that the applicant's project activity is incremental to the state's economy." The Legislature's revenue analyst stated that "the subjective judgment rendered on this difficult question with respect to each applicant will be one of the most critical assumptions underlying any cost-benefit model output. If the investment would have occurred without an incentive, it is obviously not in the interest of the state to provide a subsidy, and the applicant should be denied."

The Council's handling of the 'but for' issue has been inconsistent. In the beginning, the Council awarded credits to several companies that had initiated projects before the law was passed and / or before they submitted applications (see Finding 2.3). The fact that major expansions were undertaken prior to the adoption of the law or before the Council began processing applications indicates that the incentives were not essential to the projects. At the very least, an investment made prior to the application creates a presumption against the 'but for'.

There are numerous thresholds and hurdles applicants must overcome to be eligible for the credits (e.g., 'but for', cost-benefit model, jobs, wages, etc.). If the legislature had chosen to simply reduce corporate taxes, it could have done so. The EATI requires the Council to be more discriminating and to apply uniform policies and procedures consistently.

If, on the other hand, some companies made investments based primarily on the needs of the business and simply hoped for favorable action by the Council, that would suggest that the credits were only one of many factors considered and, therefore, not essential.

The Chairman of the Council assured us that, notwithstanding prior expenditures by some applicants, the 'but for' statements were reviewed objectively and rigorously. While the Council can never know the true intentions of company officials, it seems implausible during an economic expansion that all the projects initiated prior to the awards actually needed such incentives. In fact, we found evidence that certain members of the Council were concerned about the 'but for' policy and about individual company statements. For example, notes from the Council's executive sessions contain the following comments:

Notes from the Council's Executive Sessions

The following quotes are from notes taken by Council staff. The veracity of the notes can be inferred from the fact that the staff person who took them was also responsible for the public session minutes, which were rarely revised. Our intention in reproducing these comments is to show the development over time of the Council's approach to the 'but for' question. In each instance cited, the Council voted to award tax credits but we elected not to indicate the public session vote in order to avoid any references that could be used to identify individual companies.

February 25, 1999: Company #1

Council member A "was glad the 'but for' was tightened from last month's questionable application."

Council member B "questioned if the incentives are what drove the project"?

Council Member C "said the decision to move ahead [by the owner] was already made."

RDC rep. 1 "asked if the board is prepared to second guess all the applicant's."

February 25, 1999: Company #2

Council member D "expressed concern that more and more the board is hearing applications that the tax incentives are not the reason a company is proceeding but they are a reason to proceed more quickly."

Council member C "agreed to [Council member D's] statement."

Council member B said that "this 'but for' issue is becoming a moving target as there is no solid definition of 'but for' and no time line associated with when the project starts and how that should relate to 'but for'."

February 25, 1999: Company #3

Council member C said "he needed help understanding the 'but for' issue in this application and wanted to clarify that the company had ordered equipment **before** the incentives bill was passed in the House (emphasis in the original).

Council member B "expressed a concern for the wages issue as they are well below the average wage in [the] county."

The Council voted to approve the payroll tax credit but not the investment tax credit. This is noteworthy because the Council appears to have rejected the applicant's 'but for' for one credit but accepted it for another.

March 25, 1999: General policy discussion

Council staff "stressed the importance of 'but for' and eluded [sic] to the fact that several senators are upset with the way this council has awarded credits."

Council member B stated that "in dealing with the 1998 applications the board was accommodating businesses with the credits awarded and stressed that the council can't do that."

March 25, 1999: Company 4

Council member C asked [for] "help with the 'but for' on this company."

RDC rep. 2 said "the incentives were critical for them ... [and that] they have plenty of opportunity

to go anywhere."

Council member C said, "these owners were [former employees of a local company] so they most likely want to stay in Vermont."

Council member B asked "if the company has already gone ahead with growth."

Council staff "not the building but the payroll."

RDC rep. 2 noted that "the minute legislation for this program passed the RDC's went out and aggressively sold the program. The Governor went to businesses and told them to apply and so did legislators. Every meeting ... higher hurdles [are] being set, and this doesn't help the businesses."

Council member B said, "we can only go so far."

RDC rep. 2 said, "let the RDC's worry about the legislature."

RDC rep. 3 commented that "there was no 'but for' in the legislation [and that] this has been built on since the bill passed, but the administration does not agree with it."

Council member D said, "the 'but for' is something that is being fine-tuned at this point."

Council member E said that "Vermont is competing with other ... states ... and yes we risk a little, but get a lot."

Council member D said, "we can't just approve applications."

Council member C said, "that the council is setting a horrible precedent by compromising on the 'but for'."

Council member F said, "this is a fatally-flawed process. Why doesn't the council deal with legislation and if the legislature doesn't like what we're doing then they will change the laws."

Council's staff said "if you want to put this to the test on the 'but for' issue we will lose the program just on this issue."

Council member F asked "is it the Council's responsibility to keep the council in business"?

As is clear from the executive session notes and correspondence from this period, many of the RDC representatives on the Council were concerned about the handling of the 'but for' issue. One RDC representative wrote, "for those of us that attended last Thursday's VEPC meeting, it was like realizing that our child has lost his/her way. This program is clearly going the wrong way when a ... firm that pays high wages and is revenue positive in the model is tabled due to the incessant 'but for' test. We need to move quickly to get this program back on track before it becomes unworkable for our companies."

A few days later, the Executive Director wrote to the RDC representatives and discussed the 'but for' issue. "Most of you are frustrated because [the 'but for'] is not in the legislation, it may put people in the position of fabricating a response, and credits are just one factor when making a decision to do a project" (emphasis added). He went on to state that "the other side" believed the 'but for' should be applied to every application and that "the Council, being in the middle is trying to find a compromise."

May 11, 1999: General policy discussion [Note: As a result of the continuing confusion about the 'but for' issue, a delegation from the Council and the Department of Economic Development met with Governor. One of the participants described the substance of the meeting.]

Council member B "The Governor keyed in on the quality wage issue and how important that is to the state." [The Governor said] he "broadens the board's authority on the 'but for' issue elaborating by saying if we were just going to go by the book we wouldn't need a council."

Council staff "gave the council the Legislature's perspective, which is not as broad. The way the Legislature sees [it], either the project is in Vermont or it's not, or it takes place or it does not. The Legislature focused on Tom Kavet's letter stating that 70% of business would have taken place in Vermont anyway so the credits were not necessary."

Council member B "restated the Governor's point; we don't need council members if there's a strict 'but for'." He referred to a recent applicant as a good example: "good company with excellent wages but a weak 'but for'."

Council member C said, "if we have a weak 'but for' and a low wage it is a no go. A weak 'but for' and a high wage with other qualities in sync we're OK."

This exchange is critical for two reasons. First, the Governor is reported to have directed the Council to weaken its already questionable policy regarding the 'but for' issue. The Governor's desire to use the EATI to stimulate the creation of high-wage jobs is understandable. However, there seems to be some confusion about the relationship between the 'but for' and the resulting jobs. If an applicant's 'but for' is weak, it means there is reason to believe the company

would create the jobs without the tax credits. If so, any credits awarded represent a potential waste of taxpayer money. The point is, one can't simply separate the 'but for' and the jobs because in the absence of a strong 'but for' the tax credits become nothing more than a transfer payment to companies that create jobs. This is not the purpose of the statute.

Second, the Council should have discussed the 'but for' in public session as required by law (see Finding 1.2 below).

Following the meeting with the Governor, the Council approved the credits for Company #4, which had appeared so problematic before, even though "nothing on the application [had] changed since the last meeting." The Council's modified approach to the 'but for' issue became evident in subsequent meetings. For example:

August 26, 1999: Company 5

Council member C "felt the 'but for' was weak but the strong part was the wages."

Council member D stated "it's a neutral 'but for', but a strong wage case."

September 3, 1999: Company 6

Council member C said, "it seemed to him that [the applicant] is a made in Vermont company and

... that is a weak 'but for'. [He also] "asked about assessment of the 'but for', and questioned if the council suggests companies look at other states in order

for them to put that fact in their application." Council member B said, "there was a weak 'but for' [but] it better met the guidelines thanks to ...

further detail." Council member C said "he didn't see anything from the company saying there was a strong desire to go to New Hampshire."

September 23, 1999: Company 7

Council member C "this program is not totally for the purpose of making sure every business stays in Vermont. What is the purpose of this program?"

Council member E "so we have met or exceeded all the guidelines but we have a weak 'but for'.

September 23, 1999: Company 8

Council member G "reading the letter from [the owner] it seemed that [he] was forced to address

the 'but for' but it wasn't a compelling reason."

Council staff "the council can NEVER get inside the businesses minds to know what they're

going to do or what they're thinking. That isn't the

Council's job." (emphasis

in the original)

Council member G the owner "wants to stay here and protect his employees. He makes a weak

'but for' because he truly wants to stay here."

September 23, 1999: Company 9

Council members A, E & G "all spoke to the angry tone of the letter and said that it isn't the council's responsibility to 'make good' on an experience that the company had

on Act 250 permitting, which was negative."

Council member B "the guidelines were met ... but the 'but for' is just not there."

October 28, 1999: Company 10

Council member B "didn't get the feeling that [the owner] would leave the state. [His] impression

was that the Vermont business would stay as it is and

the growth would occur

elsewhere."

Council member F "how far does the council go ... do we ask for the company to bring back documentation from [another state] saying the company is looking to do

business there?"

Council member C "do we just take their word for it when they say we're going to move out of

Vermont to meet the 'but for'?"

These exchanges among members of the Council illustrate the difficulty of assessing the 'but for' issue. In the face of uncertainty, however, the Council never sought to substantiate the applicant's assertions (see Finding 2.1 below), relying instead on anecdotal information. In most cases when members expressed concern about the 'but for', the Council approved the credits anyway. This informal policy of awarding credits to applicant's with weak or questionable 'but for' statements reflect a failure by the Council to use all means available to protect the taxpayers.

A clear example of the failure of the Council's 'but for' policy can be seen in the decision to award over \$10 million in tax credits to Husky Injection Molding Systems. A review of correspondence between various officials, as well as Husky's Act 250 filings, shows conclusively that the scope of Husky's plans were well known at least two years before the company and the town applied for the incentives.

Note: The Council also awarded almost \$7 million to the Town of Milton for activities related to the Husky project. However, the municipal tax exemptions are beyond the scope of this review.

When asked about the Husky application during an interview at the State Auditor's office, the Chairman of VEPC said that the company "was not incented [sic] for what was already done [meaning Phase 1], only for what was coming up." However, while Husky's decision as to the timing of the build out is subject to the vagaries of the business, there can be no doubt that the company was preparing for a major investment over a period of years, including construction of up to 4 million square feet in 24 buildings. If they didn't already know, the Council could easily have obtained this information. Based on materials in the public record, the Husky project could never have met the 'but for' test.

The Administration was anxious to assist Husky, as evidenced by a number of communications obtained from various State agencies. However, the desire to secure this large employer did not give license to VEPC (or any other State agency) to circumvent the law. The Administration was free to advocate for the use of taxpayer funds to support the project but such expenditures should go through normal budget process with the consent of the legislature. In the end, VEPC approved incentives for Husky totaling more than \$10 million for a project that was planned to proceed without them.

This is a critical point. According to the Legislature's revenue analyst Tom Kavet, "the determination of whether a project would have occurred without a State subsidy is an entirely subjective judgment made by VEPC and is assumed to be the case in each and every cost-benefit model analysis. It is important to understand that this critical subjective assumption – *that none of the projects would have occurred in whole or part 'but for' the VEPC incentive* – underlies all VEPC claims of program effectiveness and zero (or negative) net cost to the state" (emphasis in the original).

Mr. Kavet went on to say that he found "this assumption, applied by VEPC, to be unrealistic. In light of an 85%+ project approval rate, a preponderance of approved projects in regions of the state with the highest economic growth rates ... and evaluation of macroeconomic data on the State's relative economic performance, it is difficult if not impossible to believe that none of the subsidized projects would have occurred in whole or part except for the presence of VEPC

subsidies. This is not to say that these subsidies have resulted in no public benefits, it is simply that they are not 'free' to the state."

RECOMMENDATION 1.1

The Council should make certain that applicants have met the 'but for' test before awarding tax credits.

FINDING 1.2

The Council discussed policy issues in executive session in violation of the public meeting law [1 V.S.A. §313(1) – (8)].

-

DISCUSSION: The Council is bound by the public meeting law and is limited as to the issues that can be considered in executive session [1 V.S.A. §313(1) – (8)]. On several occasions, the Council discussed policy issues unrelated to specific applications in executive session. This was a violation of §313.

This is troublesome for several reasons. First, the people and their representatives can only be informed about and participate in important public policy decisions if agencies of the State discuss them in open forums. Second, VEPC has statutory authority to grant tax credits worth millions of dollars and these awards have a direct impact on the State's finances, which is partly the responsibility of the Legislature. Finally, the Council was aware that some members of the Legislature, as well as the Legislature's revenue analyst, had expressed concern about the Council's handling of the 'but for' issue. Therefore, the non-exempt issues discussed in executive session should have been part of a public debate.

RECOMMENDATION 1.2

The Council should only discuss broad policy issues in public session and limit its executive session discussions to issues specifically exempted by law.

2. OTHER INTERNAL POLICIES, PROCEDURES AND COMPLIANCE

FINDING 2.1

The Council's procedures regarding its review of 'but for' statements and applicant financial information are inadequate and seriously flawed because no effort is made to substantiate the information submitted by the applicants.

-

DISCUSSION: The Council makes no effort to obtain supporting documentation that would substantiate an applicant's 'but for' statement. Therefore, the Council's decisions are based solely on the personal judgment of the members who have nothing more to go on than the applicant's personal assurance. With large amounts of money at stake, company officials can be expected to put their best foot forward. Although notes from the executive sessions indicate that Councilors sometimes pose thoughtful questions, they rarely, if ever, seek supporting evidence.

In addition, the Council makes no effort to verify applicants' financial information. For example, depending on the relevant tax incentive, the applicant must supply either sales data from the previous year and / or expenditures for payroll, research and development, and workforce training. In some cases, these figures are used to determine the maximum amount of credit allowed based on schedules in the statute. The information is also used for inputs to the cost-benefit model, the results of which are used to determine the amount of the awards. Thus, the data submitted is essential to the review process. During interviews with the Chairman and the Executive Director, both stated that there is no effort to verify information contained in the applications. The decision to accept such data without ensuring its accuracy represents a serious internal control weakness.

The Council's decision not to verify any information is in stark contrast to the elaborate procedures employed by the Department of Social Welfare (DSW) and the Economic Development Authority (VEDA) as they process applications for public assistance and development loans. For example, the joint application used by the Department of Social Welfare for ANFC, Medicaid, Dr. Dynasaur, Vermont Health Access Program, Food Stamps and Aid to the Aged, Blind and Disabled contains a number of requirements:

- Applicants must certify that the information submitted is true under penalty of perjury.
- Applicants must certify that they are not fleeing prosecution or confinement for a felony or violating a condition of probation or parole

- (Note: a comparable requirement for businesses might be certification that the applicant is not in violation of any labor laws).
- Applicants are required to submit their Social Security numbers so that the Department can conduct fraud investigations, exchange information with the Internal Revenue Service to verify income and determine the accuracy and reliability of information submitted to the Department.
 - Falsifying information is a criminal offense and punishable by fines and / or incarceration.
 - Applicants must submit detailed employment records.
 - Applicants must submit detailed information about cash holdings, checking accounts, and assets (land, autos, life insurance policies, etc.).
 - Applicants must inform the state if they have "sold, traded, or given away anything of value in the last two years.

Similarly, the Vermont Economic Development Authority (VEDA) requires applicants to provide considerable information. For example, VEDA requires applicants to furnish business and financial plans (e.g., detailed historical information including CPA-prepared financial statements for the past three years), payroll data for the past three years, and a brief written description of any bankruptcy, receivership, pending litigation, or criminal charges or convictions against the applicant. In addition, VEDA requires a signed statement from the local or regional planning authority with its findings about the project. Finally, the applicant must certify that the information provided is complete and accurate, and authorize VEDA to make "all inquiries necessary to verify the accuracy of the information."

The State has determined that applicants for public assistance and economic development loans should be required to provide extensive personal and / or financial information in order to determine eligibility for benefits or loans. It does not seem unreasonable, therefore, that VEPC should adopt a similar "due diligence" standard in order to satisfy the Council about the 'but for' question. In practice, however, applicants are only required to assert the need.

The following 'but for' statements from various applicants that were the beneficiaries of tax credits reveal how little an applicant has to say to qualify for the program: 1) "the incentives are a critical factor in the decision making process for the selection of the facility;" 2) "but for the availability and utilization of [the incentives], Vermont will not be a competitive place for future investments;" 3) we "would like to stay in Vermont but this is becoming increasingly difficult with the high cost of doing business;" 4) the "incentives ... are among the most important factors in our decision to site this current expansion in Vermont."

Although the Council can never know with certainty, there are other means available to help confirm the applicant's assertions. For example:

- The Council could request an applicant's current or past business plans to determine whether the proposed activity had been considered prior to the application for credits.
- The Council could inquire about whether the company had already arranged project financing, which would suggest they had planned to proceed without the credits.
- The Council could request sales figures for the past five to ten years to determine the company's rate of growth, which might show a trend and a predictable expansion.
- The Council could request historical data about the applicant's investments in machinery and equipment to determine whether some portion of the proposed expenditures are actually part of a routine upgrade or replacement of outmoded or worn out equipment.
- The Council could request audited financial statements.
- The Council could ask applicant's to provide verification that other states have offered tax credits and / or that the companies had seriously investigated locations out of state.

Note: Some applicants have found the 'but for' statements to be a procedural annoyance. One company representative "expressed frustration with the 'but for' stressing that he feels like he has to go to North Carolina or Florida to see what they offer and then come before the council and threaten to leave before he can meet the 'but for'." One council member actually questioned whether applicants were being coached to assert in their applications that other states were offering credits.

We asked the Chairman of the Council if he had ever considered any of the options noted above and he said no. Moreover, he indicated that he didn't think VEPC had the authority to require applicants to submit such information. However, the Council certainly has the right to request such information and it doesn't seem an especially onerous obligation for companies' seeking large tax credits.

One source of readily available information to substantiate an applicant's financial information is the State Tax Department. The Council discussed the possibility of sharing information with the Tax Department at its July 1998 meeting. At that time, Tax Commissioner Haase recommended "using a form that the applicant would sign authorizing VEPC to obtain [tax] information." The Chairman of the Council said he recalled discussions about the practicality of verifying information submitted by the applicants but the Council decided it was more practical to do so "after the fact."

An example of the risk associated with the failure to verify financial data can be seen in the processing of one particular application. As required, the company submitted investment figures in the application. This data was used in the cost-benefit model and the Council subsequently awarded the company a total of \$2.7

million in credits. After the Certificates of Eligibility were sent to the company, they informed Council staff that the investment amounts on the certificates were wrong. Apparently, "those numbers represented company wide investments, not investments in Vermont." As a result, the Council's consultant did a second run of the model and found that the company was only eligible for about \$600,000, which was \$2.1 million less than the original award.

The Council, along with all other State entities, should always seek the most efficient and effective means of meeting its responsibilities. But the decision to delay verification of financial information until after awarding credits is a serious internal control failure.

RECOMMENDATION 2.1

The Council should adopt more effective procedures for reviewing and substantiating applicant's 'but for' statements and financial data.

FINDING 2.2

The Council's decisions as to the size of the awards appear to maximize the award rather than the benefit to the State.

-

DISCUSSION: The cost-benefit model employs a sophisticated econometric representation of the Vermont economy in order to estimate the direct and indirect economic and fiscal impacts of a specified investment. "The cost-benefit model shall measure the present value of the anticipated ... fiscal benefits that will inure to the state against the anticipated ... fiscal costs associated with [the] economic advancement incentive[s]" in the statute [§5930a(d)]. Unfortunately, the statute provides no direction to the Council as to the balance between costs and benefits.

For example, a hypothetical investment of \$10 million dollars in a manufacturing business may be expected to generate a total of \$16 million in total direct and indirect economic activity. As a result, the State would receive \$400,000 in new tax revenues over a period of five years – this is the predicted benefit. In theory, therefore, the Council could award up to \$399,999 in tax credits and still be revenue positive by one dollar. The question for the Council is how much of the estimated benefit in new tax revenues should be "spent" (foregone) in order to ensure that the investment occurs? Simply put, how much do we have to give up in credits to gain the benefits and what is the net at the end of the day?

The decision by the Council is subjective and based on a number of variables that differ among the applicants. There is no formula that can be applied consistently. However, there is a core principle that should inform the Council's decisions. The implied purpose of the statute is to maximize the return on investment. Therefore, the Council should always seek to award credits no greater than are necessary to achieve the proposed investment.

As it happens, the cost per dollar of benefit varies considerably. In its January 2000 report to the legislature, the Council provided a summary of its activity to date. At that time, cumulative awards totaled \$63.7 million and "net incremental revenue" was estimated to be \$29.5 million. Overall, this means the State spent \$2.16 to get \$1.00 in net fiscal benefits, a substantial return on investment (assuming the investments would not have been made otherwise and that the benefits actually accrue).

However, we looked more closely at all the individual business awards and found a much different story. For example, we looked at the awards that produced the greatest percentage return on investment. Through December 1999, VEPC awarded tax credits totaling \$15.9 million to seven companies with an estimated net fiscal benefit of \$22.5 million. Thus, for these seven projects, the cost per dollar of net benefit was only \$0.71, less than one-third the overall average and in theory better than a 100% return. As a result, the state earned 76% of the total net fiscal benefits for only 25% of total costs.

On the other hand, during the same period, VEPC "spent" \$47.7 million in tax credits for all the remaining companies to gain only \$7 million in projected net fiscal benefits. For these companies, the total cost was \$6.81 per dollar earned, almost ten times as expensive as the top seven mentioned above. Therefore, VEPC committed 75% of total costs for only 24% of the net fiscal benefits. To illustrate:

- Six companies that each had zero net fiscal benefit received a total of \$7.4 million in credits.
- Eighteen other companies that had less than \$20,000 in net fiscal benefits received a total of \$14.6 million in credits. For this group, there was an aggregate net fiscal loss of \$73,000.

The Council is permitted to award credits to projects that are estimated to result in a net fiscal loss. However, it is not entirely clear that the legislature intended for the Council to award a total of \$21.9 million for an aggregate net fiscal loss of \$73,000.

The point is that the Council exercises complete discretion over the decision about how much of the estimated fiscal benefit to "spend" on each project. Based on our review of the Council's records, it appears that VEPC has often acted to

maximize the award to the companies rather than maximize the fiscal benefit to the State.

One clear example of what appears to have been an abuse of the Council's discretion occurred in May of 1999. During executive session review of an application, a Council member noted that "the application said the company would be happy with \$275,000 but the cost-benefit model calculated an \$800,000 figure. Does the Council approve the company's request or the benefit model's calculation." Another councilor then said that "they EARN the credit and we don't GIVE it to them and he didn't think it mattered" (emphasis in the original).

This is a very significant exchange. The first councilor asked a critical question. That is, if the company only needed \$275,000, why should we spend \$800,000? The second councilor's comment illustrates an unfortunate but common misunderstanding. Just because the credits are based on performance, doesn't mean that the dollar amounts don't matter. The point is that this applicant's investment would be the same regardless of the tax credit offered. Therefore, if they were prepared to make the investment for a credit of \$275,000, anything offered above that amount would not result in greater benefit to the State. In fact, it would be a waste of money and a potential unearned boon to the company's owners – in this case, \$525,000.

Notwithstanding the Council's repeated assertions that it is acting in a fiduciary role for the State, the evidence shows otherwise. During interviews with the Chairman and the Executive Director, both asserted that the cost-benefit model tells them how much to offer in credits. This is not entirely accurate. In fact, the model (and subsequent tax calculations by the consultant) can be used to estimate the amount of credits "available" to make the project break even. That is, how much can the State offer (using the assumptions in the model) to ensure that there is no net cost to the State. However, the Council is not required to offer that amount to the applicant. The Council's decision in most cases to award the maximum amount available is not a function of the model but a conscious policy choice to maximize the award rather than the return on investment.

An example of the Council's perspective on this issue can be found in its response to a bill introduced in the House Ways and Means Committee. The draft bill calls on the Council to "apply a cost-benefit model to determine the relative return on investment to the state and to assist in establishing appropriate award levels for individual applicants." The current statute refers only to the use of the model to determine the anticipated direct and indirect fiscal benefits and costs. It makes no reference to the use of the model output, which the Council uses to award the highest possible amount of credits.

In reply, the Council stated that "VEPC and the Administration do not agree with the changes [proposed]. These changes would limit the effectiveness of the cost-benefit model." In fact, there is no reason to believe the changes would have any

effect whatsoever on the model or the output. What it would do is require the Council to consider the return on investment as a means of judging and comparing applications and measuring the effectiveness of the program. The implication is that the Council should not simply award the maximum amount available according to the model. The Council's response suggests that it would prefer to continue to maximize awards rather than be required to measure return on investment.

RECOMMENDATION 2.2

The Council should meet its fiduciary responsibility to the taxpayers by maximizing the return on investment rather than simply offering the full amount indicated by the cost-benefit model.

FINDING 2.3

On several occasions, the Council has awarded tax credits for economic activity that occurred prior to the company's application. This practice raises serious questions about the Council's finding that 'but for' the credits these projects would not have occurred since they were already underway.

-

DISCUSSION: In several instances, the Council has counted expenditures made prior to a company's application as part of the total planned investment. By doing so, the previous expenditures are included in the calculation of costs and benefits and result in higher awards for the applicants. This practice calls into question the Council's acceptance of the applicant's assertion that the project could not proceed without the incentives. The fact that the project was undertaken prior to the company's application would seem to contradict any affirmative 'but for' statement by company officials in the application.

The Council has taken the position that applications dealing with expenditures made after January 1, 1998 are allowable under the statute. During interviews with the Chairman and the Executive Director, both referred to applications received in late 1998 and early 1999 that included economic activity initiated during the so-called "transition period." They indicated that many businesses had followed the legislature's consideration of the bill and, after passage, had been encouraged to apply.

According to the Executive Director, "if companies moved forward with the expectation that credits would be available, they did not hold this against the company. This does not mean they would get the credit. They were just not screened out." (emphasis added). Furthermore, the Chairman indicated that companies "already doing their projects met the 'but for' if they relied on the passage of Act 71 ... but there were no promises made or other discussions regarding whether or not they would even qualify for the credits."

The Council appears to base its position on the fact that the statute, which was effective for tax years beginning January 1, 1998 [Act 71 of 1998 Session §123(f)], authorizes the Council to award credits for economic activity "in the tax year for which the credit is claimed." The Council assumed this meant it could award activity begun prior to passage of the Act and / or prior to application simply because it occurred "in the tax year for which the credit is claimed." This interpretation is questionable and may have been intended to allow the Council to award companies that otherwise could not pass the 'but for' test.

There are several important issues presented here. First, the 'but for' burden for projects begun prior to the passage of the Act must be significant since there is never any certainty that legislation will pass or whether it will be altered during the legislative process. Moreover, the Legislature only meets for a few months so any company that was hoping to receive credits would not have had to wait very long to find out if the bill passed and in what form.

Second, for those companies that waited until the bill passed, there was still considerable uncertainty about the cost-benefit model, which was not approved by the Joint Fiscal Committee until October, and the way the Council would handle the guidelines.

Third, the credits were never intended to be available to every business that applied since the Legislature created VEPC to process applications and decide which companies would receive the incentives. Therefore, no potential applicant could assume it would receive the credits unless they had received assurance in advance. If such assurances were given (and we've been told they weren't), they would have violated the law. Absent such assurances, it would have been imprudent for a company to proceed if the credits were essential to the project. Therefore, if certain companies proceeded without the credits prior to approval of the bill or the cost-benefit model, it indicates that the incentives were not essential to the project.

RECOMMENDATION 2.3

The Council should not count expenditures made prior to application.

FINDING 2.4

The Council has awarded tax credits for job retention and, therefore, is not in compliance with Section 5930c of the law, which requires that payroll tax credits be used to support only new economic activity.

-

DISCUSSION: One of the primary purposes of the statute is to stimulate job creation. Eligibility for the Payroll Tax Credit is based on increased payroll. Section 5930c (Economic Advancement Payroll Tax Credit) states that a company "may receive a credit against income tax liability ... equal to a percentage of its increased payroll costs (emphasis added)." The importance of this goal is reinforced by the fact that the first Guideline relates to new full-time jobs [§5930a(c)(1)].

The Council itself acknowledged this in its first report to the Legislature by stating that "the intent of the economic advancement package is to support incremental activity in Vermont [and to] stimulate the creation of quality jobs" (emphasis added). The Council's summary of a policy retreat in November of 1999 stated that "job and / or company retention are indirect benefits, the project must involve incremental activity to qualify." (emphasis added). Furthermore, the most recent report to the Legislature states that "Vermont's tax incentive program is one that focuses on new incremental activity, not job retention" (emphasis added).

In fact, the Council has awarded substantial credits to several applicants whose primary goal was job retention rather than the creation of new jobs. For example, one company stated unequivocally that it would close one of its plants if it didn't receive the credits. The company actually acknowledged that they would not qualify for the incentives under the Council's 'but for' policy unless the State considered the potential loss of jobs. They asked the Council to run the cost-benefit model as if the jobs were new in order to determine what the State would lose if the company left. Even though the company was not proposing to create new jobs, they did propose to invest in new machinery and equipment and, according to the Chairman of the Council, this was the basis for the subsequent award.

Another company was initially denied credits because the company didn't meet the 'but for' test. The company later resubmitted its application with a revised 'but for' statement that highlighted the potential loss of jobs and was then granted the credits. One Council member noted that "retention is not what this program is [intended] to incent" but he voted to award the credits anyway.

In the case of another company, the regional RDC representative admitted that "this is a retention project" but the Council awarded the credits anyway. At least two other companies may have been awarded payroll tax credits at least in part because of retention.

There is no doubt that such job losses would be a blow to the workers and the host community, and would have a negative impact on State revenues. However, the EATI was never intended to mimic programs in other states that are increasingly under fire for just this reason. Once the Council opens the door to retention, it is likely to be faced with repeated attempts to exploit the program for these purposes. By granting these awards, VEPC exceeded its authority and violated its own policy.

RECOMMENDATION 2.4

The Council should comply with the law and not award credits for job retention.

FINDING 2.5

On two occasions, the Council approved tax credits for more than was indicated by the model but did not assign the excess to the cap. In one instance, the Council awarded a tax credit even though the Tax Department found the company was not eligible.

DISCUSSION: On two occasions, the Council approved tax credits for more than was indicated by the model but did not assign the excess to the cap.

- The Council voted to award export tax credits to a company that was not eligible according to the Tax Department because it wasn't a 'C' corporation. After being informed of the problem, the Council decided that "the company does not lose the credit they were deemed eligible for, it just will not go into the export tax credit."

Having been told by the Tax Department that the company was not eligible for the credit, the Council's action was taken with full knowledge that it was not considered appropriate. Therefore, the Council appears to have willfully exceeded its authority and granted tax credits in violation of a Tax Department ruling. The Council's decision to call the export tax credits something else means that another credit granted to the applicant was greater than the amount

justified by the model. The Council is not free to ignore Tax Department rulings it finds inconvenient.

The Council reviewed an application from a company that requested both payroll and small business investment tax credits. Using the company's payroll and investment data, the cost-benefit model estimated a payroll tax credit of more than a quarter of a million dollars and an investment tax credit of over a million dollars.

During discussion in executive session, some councilors expressed concern about the comparatively low wages but noted their strong support for the company's planned investments. In the end, the Council decided to award only the investment tax credit. However, the Council added the amount of the denied payroll tax credit to the investment tax credit. That is, the amount of the final award was exactly equal to the sum of both the payroll and investment tax credits as estimated by the cost-benefit model.

Thus, for the public record, the Council denied the payroll tax credit because the wages were low. In fact, however, the Council ignored the cost-benefit model and simply called the whole award an investment tax credit. The Council's decision to call the payroll tax credits something else means that the investment tax credit granted to the applicant was greater than the amount justified by the model.

RECOMMENDATION 2.5

- **The Council should not shift credits between different statutory categories and tax credits should not exceed the amounts determined by the cost-benefit model unless the Council chooses to utilize funds from the 'cap' [Act 71 of the 1998 Session Section 56(b) and Section 96a(b), Public Acts of the 1999 Session].**
- **In the future, the Council should abide by Tax Department rulings regarding applicant ineligibility.**

FINDING 2.6

The Council approved a request by a successful applicant to reassign the tax credit certificates to a new company established to handle real estate liability.

DISCUSSION: An applicant was awarded three tax credits in early 1999. Later that year, the company asked the Council to change the name on the credit certificates to another company established to handle "real estate liability." The Council approved the request.

For each type of tax credit offered under the statute, the Council may award the incentive to the business actually making the required investment (e.g., "its increased payroll costs," "its investments within the state," etc.). The clear intention is to reward the company making the investment with a credit against its corporate income tax liability. In this case, the Council switched the credits to a corporation that, presumably, was not going to make the investment but would just hold the real estate.

Without examining each company's tax records, it is impossible to know what may be the implications of the switch. However, it is entirely possible that there could be an adverse effect on State revenues not envisioned by the Council. For example, if the original applicant did not have substantial tax liability, the credits would not be used and the cost to the State would be low or nonexistent. On the other hand, if the new company had taxable profits, it could use the credits and the State would pay the cost through foregone revenues, even though the credits weren't needed for completion of the project. Conceivably, this could result in an unwarranted tax benefit to the owners of the new company to which they were not entitled.

Note: When reviewing another application, the Council itself acknowledged that that "the credits aren't worth anything unless the company has a tax liability." This supports our view that switching the credits to another company could have adverse tax implications for the State.

RECOMMENDATION 2.6

The Council should no longer approve transfers of tax credit certificates from a successful applicant to another company.

FINDING 2.7

Aside from internal governance, there is no evidence that the Council has adopted any formal policies and procedures to govern its activities.

DISCUSSION: Clearly, the Council has policies and procedures. But if they are not recorded or codified, they must be considered ad hoc and subject to change from one Council meeting to another or from one applicant to another. Although

the statute does not require the Council to follow formal rulemaking procedures, there are sound reasons for doing so. At the very least, the Council should formally adopt policies and procedures in open session.

The statute grants VEPC the authority to "adopt rules under chapter 25 of Title 3 to provide streamlined and efficient procedures for processing and deciding applications" [§5930a(f)]. The Council's first report to the Legislature referred to the adoption of "governance policies and procedures [that are] continually being refined." Although the Council has adopted governance policies, we found no evidence that the Council has adopted any formal policies and procedures regarding the evaluation and disposition of applications.

The Administrative Procedures Act (Chapter 25 Title 3) establishes a process for the adoption of rules that allows for public hearing and comment, including an opportunity for the submission of relevant "data, views or arguments" [§840(c)]. Furthermore, the proposed rule must be reviewed and approved by the appropriate legislative committee [§842], which may object if it finds that the rule is beyond the authority of the agency, contrary to legislative intent, or arbitrary.

This process guarantees openness in government, prohibits arbitrary and capricious decision-making, and ensures that agencies comply with the intent of the legislature. Formal rulemaking is not required and is not always necessary. However, policies and procedures adopted without public or legislative review cannot command the same respect as those adopted formally. This is especially so for a public entity that works with confidential materials and has the power to award large amounts of the taxpayers money. Finally, the adoption of policies and procedures in open session (whether through the APA or not) can result in improvements to the proposed rule as a result of the involvement of the legislature and other interested parties.

RECOMMENDATION 2.7

The Council should formally – and publicly -- adopt policies and procedures related to the applicant review process.

FINDING 2.8

The Council has adopted a governance policy that violates state law governing the exercise of joint authority (1 V.S.A §172).

DISCUSSION:

Article III, Section 5(b) of the Council's governance policies authorizes the Council to take action (i.e., approve credits or contracts) by a vote of a majority of a quorum. This appears to be in conflict with 1 V.S.A. §172 which states that "when joint authority is given to three or more, the concurrence of a majority of such number shall be sufficient and shall be required in its exercise" (emphasis added). In other words, a council with nine members can only take action legally when at least five members (a majority of the total) act together. Therefore, the Council's policy that a majority of a quorum is sufficient is not allowed by §172.

The practical effect of the Council's policy is that as few as three members of the Council could vote to approve tax credits since a quorum is five. This is not that farfetched because only five of the nine councilors attended five of the last ten meetings. Regarding attendance generally, only four of the nine councilors have attended more than 60% of the meetings held to date. Indeed, one member has attended less than half of the meetings (10 out of 21 - 48%), and only one out of the last seven. Three other members have attended barely more than half the meetings to date. As a result, there are usually only five or six members making decisions about tax credits worth millions of dollars.

RECOMMENDATION 2.8

The Council should strike Article III Section 5(b) of its governance policy and comply with 1 V.S.A. §172.

3. THE GUIDELINES

FINDING 3.1

VEPC staff does not routinely question or attempt to verify any of the information submitted by applicants regarding the legislative Guidelines. In addition, there are numerous inconsistencies in some of the data provided by the applicants that makes analysis difficult and raises questions about the Council's claims regarding jobs created and wages paid.

DISCUSSION: Section 5930a(c) of the statute requires the Council to "review each application [to evaluate] its overall consistency with the following guidelines:"

1. The degree to which the enterprise creates new full-time jobs that are filled by Vermont residents, not including those jobs or employees transferred from an existing business in the state or replacements for vacated or terminated positions within the applicant business, and provides opportunities that increase income, reduce unemployment, and reduce vacancy rates. New jobs include those which exceed the average annual employment level in Vermont for the applicant business in the preceding two fiscal years;
2. The degree to which the new jobs pay more than the prevailing regional wage, provide employee benefits, and offer opportunities for advancement and professional growth;
3. The creation of positive fiscal impacts on the State, the host municipality and region as projected by the cost-benefit model applied by the council;
4. The degree to which the enterprise uses Vermont resources;
5. The degree to which the enterprise is welcomed by the host municipality, including conformance with appropriate duly adopted town and regional plans, and conformance with all permit and approval requirements;
6. The degree to which the enterprise strengthens the quality of life in the host municipality and fosters cooperation within the host municipality's region;
7. The degree to which the enterprise uses existing infrastructure or is a downtown redevelopment project;
8. The degree to which the enterprise protects or improves Vermont's natural, historical, and cultural resources, and enhances Vermont's historic settlement patterns.

The EATI application requires each company to submit a narrative description of the extent to which the proposed economic activity is consistent with the eight guidelines. The narratives contained in the applications vary considerably in length, level of detail, and use of supporting data. The criteria for some of the guidelines are measurable and can be evaluated objectively. Others require subjective judgments. With few exceptions, VEPC staff has not verified any of the factual assertions contained in the application narrative. For example:

- Guideline 1: "The degree to which the enterprise creates new full-time jobs." This is arguably the most important guideline (along with wages) and reflects the underlying purpose of the statute.

Note: Contrary to common perception, the Payroll Tax Credit does not require the company to actually create a specific number of new jobs. If approved by the Council, a company "may receive a credit ... equal to a percentage of its increased payroll costs" (emphasis

added). Thus, although the company must increase its payroll, there is no requirement how the additional funds must be used. For example, if a company agrees to increase the payroll by \$300,000, it could create 20 jobs at \$15,000, 10 jobs at \$30,000, 6 jobs at \$50,000 or simply increase the wages of some or all of the current employees. In practice, the cost-benefit model assumes there will be new jobs and the potential award is based in part on that assumption. But the output (fiscal impacts) would certainly vary based on the different scenarios presented. Therefore, even though the Council regularly reports on the number of jobs expected to be created by the tax credits, the companies are under no obligation to do so and the Council has no way to determine what was done.

We examined the files of all companies awarded payroll tax credits and found that there are many inconsistencies in the data and that some were significant. In one case, a company reported in the narrative that it expected to create between 100 and 250 jobs (an extremely loose estimate to begin with). The same company indicated 366 new jobs in the application schedule. The consultant used the larger figure in the cost-benefit model calculations even though the discrepancy was noted. The huge difference in the number of potential new jobs has an enormous effect on the predicted fiscal impact and the amount of the award. Although extreme, this is one of many examples of such inconsistencies.

Note: Although the Council has correctly stated that no credits can be claimed unless the company makes the required investments, this does not prevent the Council from reporting what appear to be inflated estimates of the impacts of the program.

Overall, the difference between the number of direct new jobs claimed by the Council (through the Fiscal Impact Reports) and the number reported in the application narratives and / or staff summaries was 1,043 jobs. That is, the Council's consultant (working with data from the application schedules) showed 8,320 new jobs for companies receiving payroll tax credits. A tally from the company narratives showed only 7,277 jobs.

There are several problems presented. First, the applicants have often reported two (and sometimes three) different job creation estimates. Second, there is no record that Council staff made any effort to reconcile the disparate figures and often reported numbers that appear to have no source (Note: The Executive Director stated there were occasional phone calls to and from the applicants about the details of the applications but there are no records of such communications.). Third, the Council's consultant routinely used the

highest figures available even when they were directly contradicted in other portions of the applications.

As a result of these serious internal control failures, the Council's reported figures on expected job creation have only limited credibility. Furthermore, the procedures followed have had the effect of exaggerating the success of the program – both for jobs created and fiscal impacts. At the very least, the Council's procedures were poorly developed.

- Guideline 1: "New jobs include those which exceed the average annual employment level in Vermont for the applicant business in the preceding two fiscal years (emphasis added)." VEPC only requests employment data for one year preceding the date of the application so it is impossible to ensure adherence to this guideline.
- Guideline 1 also states that new full-time jobs may not include "those jobs or employees transferred from an existing business in the state or replacements for vacated or terminated positions with the applicant business." The Executive Director stated that he does not attempt to substantiate the company's assertions and relies on representations made by the applicant. In the alternative, staff could request records from the applicant's human resources office to ensure that the company is not transferring jobs or filling vacated positions.
- Guideline 2: "The degree to which the new jobs pay more than the prevailing regional wage."

Note: The statute provides no guidance as to which regional prevailing wage is the appropriate standard. The Council uses regional prevailing wage by industry (e.g., durable or non-durable manufacturing), which is logical because it compares apples to apples.

Unfortunately, the wage figures reported by many companies suffer from the same types of problems cited above for job creation. First, the use of average wages is problematic because a few high wage jobs can easily skew the average. Second, there are many differences between the figures reported in the application schedules and the applicant's narrative. Third, some companies reported very questionable wage data (e.g., wages doubling in one year, "approximate" wages, etc.). Fourth, very few companies offered a breakdown of the number of projected new jobs by occupational titles. As a result, there's no way to know whether the job mix (and the resulting average wage) for the new jobs will

actually match the current job mix and average wage. Finally, staff made almost no effort to verify any of the wage data.

Using the Council's questionable data from the application schedules (see above) and the subsequent Summary Fiscal Impact Reports, we produced Table 1 below, which shows how the Council's use of aggregate average wages can be misleading. For example, we estimate that the average wage for the projected new jobs for companies that received payroll tax credits is \$37,956. However, a closer look at the data reveals that only about one out of four of the sixty one (61) companies will pay more than the average wage of \$37,956.

Less than half (46%) of all the projected jobs are expected to pay more than the average wage of \$37,956 and almost two thirds of those will be at only three companies. Furthermore, one out of seven new jobs will pay less than \$25,000. That is, the Council awarded \$4 million in credits to thirteen companies to create 1,125 jobs that pay less than \$25,000 per year.

Table 1				
Estimated jobs created by wage range*				
Wage range	Companies		Jobs	
	#	%	#	%
< \$25,000 / yr.	13	21%	1,125	14%
\$25,000 - \$30,000	13	21%	1,181	14%
\$30,001 - \$37,955	18	30%	2,195	26%
> \$37,955	17	28%	3,819	46%
Totals	61	100%	8,320	100.0%
* Figures are for companies that received payroll tax credits.				

We also calculated the projected percentage increase for each company's average wage from the year they applied to the following year. The average one-year percentage increase is about ten percent (10.39%). However, only ten of the sixty-two companies show a rate of increase at that level. In fact, the median rate of increase was only 1.84% (that is, half are higher and half are lower), which reflects a typical cost of living increase. Finally, seventeen companies actually show a lower average wage in the second year.

These figures illustrate the misleading nature of average wages. Furthermore, the Council and other State officials have asserted that the jobs created will have an average wage of about \$48,000. We could find no reliable evidence for this. Moreover, regardless of the actual average wage (which cannot accurately be determined), the Council's failure to report disaggregated wage data leaves the impression that a majority of the new jobs will pay high wages when the data suggests otherwise.

RECOMMENDATION 3.1

The Council and its staff should make every effort to verify information supplied by applicants in the narrative response to the Guidelines and the consultants should take more care in choosing which figures to use in the model.

FINDING 3.2

The method used to rate adherence to the guidelines is flawed due to the failure to verify data submitted and arbitrary because there is no standard for evaluating the more subjective guidelines. In addition, VEPC staff has occasionally rated applicants as having met or exceeded a guideline when the available data does not support such a rating.

-

DISCUSSION: After reviewing the narrative submissions from each applicant, the Executive Director prepares a summary with recommendations to the Council that includes a rating for each guideline (i.e., exceed, met, did not meet). Typically, the staff summary contains either direct quotes or a restatement of

language taken directly from the application. This reinforces our previous finding that no effort is made to investigate or verify company statements. As a result, the ratings are based solely on unverified information provided by applicants. It is to be expected that applicants will present information favorable to their cause but, to the extent possible, the staff rating should be based on an evaluation of facts rather than self-serving statements by companies attempting to secure large tax credits. We found that staff ratings often appear to be entirely arbitrary and not based on consistent standards. For example:

- Guideline 4: "The degree to which the enterprise uses Vermont resources." Many companies submitted lengthy vendor lists but rarely with corresponding data on actual expenditures. Staff rated most applicants as having met or exceeded this guideline based solely on such vendor lists.

There are several problems with this method. First, no distinction is made between non-discretionary purchases (e.g., utilities, post office, lodging & meals, etc.) and discretionary expenditures where the company chose to purchase goods and services in Vermont rather than from out of state. Second, no distinction is made between the use of Vermont raw materials (inputs) and goods and services that are common to all businesses.

Third, and most importantly, without actual expenditures it is impossible to determine what percentage of discretionary expenditures is made in Vermont. As a result, the staff rating is flawed because the vendor lists cannot be used to fairly determine "the degree to which the enterprise uses Vermont resources."

Having reviewed the staff recommendations and applications, we find little to distinguish those rated "did not meet" from "exceed." It is noteworthy that most of the nine (9) applicants rated "did not meet" came early in VEPC's history and did not provide a detailed list of vendors, which became the standard later on (although most of the early applicants did refer to the use of local suppliers). Moreover, the narratives suggest that early applicants assumed that this guideline was meant primarily to highlight the use of Vermont natural resources rather than simply normal business relationships with local suppliers.

On the other hand, only four (4) of the seventeen (17) applicants rated "exceed" actually used Vermont natural resources, which is the most logical and meaningful way to differentiate applicants. The others rated "exceed" simply provided long lists of vendors and, occasionally, aggregate totals but no details. In this regard, they were nearly identical to the forty-seven (47) companies rated "met" or "met but weak."

Interestingly, there is at least one company that actually uses Vermont natural resources but was rated "met" rather than "exceed" only because they didn't provide a complete vendor list. In any case, staff made no effort to obtain more detailed information or to verify the applicant's assertions. In the end, the ratings for this guideline are almost completely arbitrary and provide little, if any, useful information to Council members, the legislature, or auditors.

- Guideline 6: "The degree to which the enterprise strengthens the quality of life in the host municipality." Many applicants submitted lists of charitable organizations to which the companies had made contributions but rarely with corresponding data on actual expenditures. In addition, many applicants stated that employees were encouraged to volunteer in the community and sometimes permitted to do so on paid company time.

Here again, staff uniformly rated most applicants as having met this guideline based solely on such limited information. It is admirable that many Vermont companies donate to local charitable organizations. But the guideline asks "the degree to which the enterprise strengthens the quality of life." Without specific information, it is impossible to answer the question.

For example, what percentage of company profits is donated? Is it fair or appropriate to consider employee contributions of time or money since they are not from the company itself? Are there other ways of measuring contributions to quality of life or, in the alternative, adverse impacts on the quality of life (e.g., pollution, violations of labor law, etc.)? Finally, some of the lists included participation in or contributions to membership organizations whose purpose is to advance the financial interests of the company or similar businesses. While this is understandable it may or may not lead to improvements in the quality of life.

As with Guideline 4 discussed above, there is little evidence to support staff's decision to rate nineteen (19) companies "exceed." Only five (5) of those actually stand out from the others (or from those rated "met"). The rest simply supplied lists of entities to which they (and their employees) contributed money, although most did not provide dollar figures. As noted above, contributions to the United Way (or other similar charities) are admirable but there's no obvious reason why that alone should be considered especially exemplary.

In contrast, the five (5) companies referred to earlier stand apart because they either commit a percentage of corporate profits and / or provide significant support for a fundamental shift in the local /

regional economy (e.g., sustainable agriculture, large number of new jobs in depressed areas, etc.). Other companies awarded a rating of "exceed" are clearly good corporate citizens but are only distinguished from their peers by the sheer size of the company and their ability to give larger sums. Indeed, one big company rated "exceed" provided a total dollar figure that was nominally large but was a miniscule percentage of its annual revenues. This is not say such contributions aren't important to the host community, only that staff should not necessarily rate the company "exceed" based solely on the total dollars contributed.

Once again, the ratings for this guideline are not based on verified data, are mostly arbitrary and provide little, if any, useful information to Council members, the legislature, or auditors.

RECOMMENDATION 3.2

The Council should adopt rules regarding evaluation and rating that ensures a consistent standard is applied and the Council should instruct staff that adequate supporting evidence must be presented to justify a rating of "met" or "exceed."

FINDING 3.3

The Council has awarded incentives to numerous companies whose applications show only limited "consistency" with the guidelines.

-

DISCUSSION: Although the guidelines are not statutory criteria, they reflect the legislature's desire that applicants demonstrate "consistency" with the policy goals expressed in the guidelines. The Council has never reported any individual or aggregate data about the guidelines. The data in the Tables below was derived from VEPC staff summary sheets prepared for each application. We restricted our analysis to businesses awarded tax credits and excluded municipalities. We assigned a numerical score to the staff rating for each guideline.

Did not meet 0

Met but weak 1

Met 2

Exceed 3

An applicant that met all eight guidelines would earn a score of sixteen (8 x 2). As can be seen in Table 2, only 34% of all companies awarded credits achieved a "par" score or better, and this figure is inflated due numerous questionable ratings of "exceed" (see Finding 3.2).

Looking more closely, we found that twenty (20) companies (27%) were rated "did not meet" for two or more guidelines. In addition, nineteen (19) companies were rated "met but weak" for two or more guidelines. Overall, out of 584 cells (73 companies x 8 guidelines), there were 83 ratings of "did not meet" (14%) and 57 ratings of "met but weak" (10%). Therefore, 140 cells (24% of the total) were rated as having not fully met the guidelines (see Table 3).

Table 2		
VEPC Aggregate Guideline Scores* – Total Points by Range		
(for businesses awarded tax credits)		
Total Points - Range	No. of companies	Percentage
0 - 12	18	24%
13 – 15	30	41%
16 ("par")	8	11%
> 16	17	23%
Totals	73	100%
* Numeric scores assigned by the Auditor's staff.		

We then looked at the ratings by guideline. Even with the questionable rating methods used by staff, there were some noteworthy findings:

- 11% proposed little if any FT job creation

- 38% expect to pay less than prevailing wages
- 21% had little if any net positive fiscal benefit to the State
- 20% did not even meet the loose standard established for "uses Vermont resources"

Table 3									
VEPC Ratings by Guideline									
(for all businesses awarded tax credits)									
Guideline		Ratings Assigned by VEPC Staff							
		Did not meet		Met but weak		Met		Exceed	
		#	%	#	%	#	%	#	%
1	Creates new FT jobs	2	3%	6	8%	50	68%	15	21%
2	Pays more than prevailing wages	28	38%	0	0%	14	19%	31	42%
3	Positive fiscal impacts for the State	7	10%	8	11%	56	77%	2	3%
4	Uses VT resources	9	12%	6	8%	41	56%	17	23%
5	Conforms to local plans	6	8%	10	14%	51	70%	6	8%
6	Quality of life	4	5%	6	8%	44	60%	19	26%
7	Uses Existing infrastructure	8	11%	6	8%	53	73%	6	8%
8	Protects historic, cultural & natural resources	19	26%	15	21%	34	47%	5	7%

Totals		14%		10%		57%		17%
--------	--	-----	--	-----	--	-----	--	-----

RECOMMENDATION 3.3

The Council should make every effort to ensure consistency with the Guidelines when reviewing applications.

4. The Cost-Benefit Model

FINDING 4.1

Although intended to provide a means of discounting predicted investments and credits, the use of background growth rates in the model raises several important methodological and policy issues that undermine confidence in the process.

DISCUSSION: In addition to the basic REMI model approved by the Joint Fiscal Committee, the Council decided to apply a discount rate in each calculation based on the background growth rate in the applicant's industry. Thus, if all the widget manufacturers in southern Vermont had grown at an average rate of 1.9% over the past three years, it would be included in the model and become what's known as a "hurdle rate." In theory, it is a good idea to use a hurdle rate but the method chosen has several problems.

First, by definition, the background growth rate is an average of all widget makers including those that have gone bankrupt, stagnated, or grown. It is very unlikely that any one company fits the profile of an average performer in the industry. This is significant because virtually any proposed investment by a growing company will greatly exceed the average background growth rate. For example, a modest size company could probably achieve the hurdle rate by replacing the furniture, fixtures and desktop computers in the executive offices, paving the parking lot and installing energy efficient lighting.

Therefore, if the overall goal is to ensure that the incentives are not used for activity that would have occurred anyway, it would be much more useful to know the applicant's recent history of investments. That is, determine the actual growth rate for the applicant rather than the average background growth rate for the entire industry.

Furthermore, it may be inappropriate to compare a substantial one-time investment by the applicant with a three-year industry background growth rate. In addition to including companies that have made no investments during the previous three years, the background growth rate includes investments by growing companies that have been averaged over the term.

Using the hypothetical situation noted above, assume that widget manufacturers have grown at an average annual rate of 1.9%. But as can be seen in Table 4, it is entirely possible that one company (E) may be growing at a much higher rate than the other companies and the average growth rate for the entire sector may still be 1.9%. Moreover, it would not be surprising that the most successful company would be the one planning a large expansion because it couldn't continue growing at that rate without new facilities and more employees (assuming it had already maximized its productivity with existing labor and equipment). Thus, a substantial investment by company 'E' would greatly exceed the hurdle rate (and therefore qualify for tax credits) but could be seen as a part of a natural evolution of the company.

Table 4				
Background Growth Rate:				
Hypothetical Company Growth Rates and Sector Annual Average				
Company	1996	1997	1998	Company annual average
A	4.0%	0.5%	3.0%	2.5%
B	-15.0%	-3.0%	-8.0%	-8.7%
C	5.0%	3.0%	5.0%	4.3%
D	-2.0%	0.0%	1.0%	-0.3%
E*	21.0%	6.0%	8.0%	11.7%
Sector annual average	2.6%	1.3%	1.8%	1.9%

* The high rate of growth for company E in 1996 reflects a significant investment in the preceding year.

Finally, even successful companies with less robust growth than company E could easily exceed the background growth rate because projects of this nature are usually substantial one-time investments that would almost always exceed the hurdle rate.

RECOMMENDATION 4.1

The Council (in collaboration with its consultant and other qualified economists) should reconsider the methodology used for the background growth rate and seek guidance from the Joint Fiscal Committee as to the most appropriate means of establishing this measure.

FINDING 4.2

A flaw in the cost-benefit model led VEPC to award tax credits to a company with in-state competition. As a result, taxpayer funds were used to assist one company at the expense of another. In addition, the failure of the cost-benefit model to account for the possibility of job losses in the competitor's business means that the predicted net fiscal benefits may have been overstated and that the size of the award was not justified.

DISCUSSION: VEPC approved tax credits for a company whose market is within Vermont. This raises an important issue and illustrates a flaw in the cost-benefit model. If the in-state market were not expanding significantly, one company's growth would have to be at the expense of its competitors. For example, if a company planned to create 20 jobs, the model would discount the predicted benefits due to the expected loss of some jobs at a competitor's business. Therefore, if the net fiscal benefits are reduced, the award should be reduced accordingly. In this instance, the cost-benefit model was not adjusted to reflect the fact that there was in-state competition. As a result, the award was higher than it should have been and the state provided a direct economic advantage to one Vermont company over another.

-

RECOMMENDATION 4.2

The Council should work with the consultant to correct the flaw in the cost-benefit model and ensure that tax credits are not used to create an unfair economic advantage.

5. Monitoring, Assessment and Reporting

FINDING 5.1

The Council has no means of monitoring the fiscal costs and benefits associated with the tax credits and no way of determining whether the companies awarded credits have actually undertaken the planned investments, hired the projected new workers, or adhered to the Guidelines as stipulated in their applications.

-

DISCUSSION: This finding is reflected in the compliance and internal report issued by KPMG and this office, which was part of the FY 1999 Annual General Purpose Financial Statement Audit.

The statute is silent regarding the Councils methods of monitoring the use of the tax credits or the company's adherence to the guidelines. The Council has acknowledged the need for an assessment process but has failed to take any meaningful action. Although the Tax Department is not permitted to share confidential information without specific legislative authority, the Council could have requested applicants to sign a waiver in order to facilitate a review. As was noted above in Finding 2.2, the Council discussed the possibility of sharing information with the Tax Department at its July 1998 meeting but decided against it.

In a subsequent Council meeting, the Chairman relayed a conversation with Tax Commissioner Campbell who said that the Department "doesn't intend to perform detailed audits other than looking at growth." The Council's most recent report to the Legislature stated that "the Tax Department will only review financial information to determine if the investments necessary to claim credits have been made."

As an interim measure, the Council decided to require companies to submit "a report to VEPC describing the economic activity that took place ... [and] how the company complied with eight guidelines" In our view, however, self-reporting by beneficiaries is not an appropriate or adequate means of determining compliance, especially since VEPC never verified any of the applicant's original information.

RECOMMENDATION 5.1

The Council and the Tax Department should develop and implement a monitoring and assessment process and report regularly to the Legislature on their findings.

FINDING 5.2

The Council has failed to meet the reporting requirements of 32 V.S.A. §5930a(j) as amended by §96b(b)(1) and (2), Public Acts, 1999 Session.

-

DISCUSSION: In 1999, the Legislature amended VEPC's reporting requirements. "Beginning with its annual report to the General Assembly in January 2000, and each year thereafter, the Vermont Economic Progress Council shall [include a review] and analysis ... of the degree to which each incentive promotes the policy objectives and goals of the eight guidelines established under 32 V.S.A. §5930a(c) ... [as well as] recommendations as to how to best assess the progress being made toward obtaining the policy objectives and goals of the guidelines, with specific data and information, where possible, of indicators of progress, such as number of jobs that have been created, compensation levels and other job quality indicators, effects on municipal vacancy rates, and the like."

The Council's January 2000 report to the General Assembly contains a short description of the guidelines, several references to the importance of the guidelines, and a brief discussion of the use of a checklist to help applicants understand the guidelines. It also includes the aggregate number of new jobs expected, as well as projected aggregate new payroll.

The report does not, however, contain any "analysis ... of the degree to which each incentive promotes the policy objectives and goals of the eight guidelines" or "recommendations as to how to best assess the progress being made toward obtaining the policy objectives and goals of the guidelines." Other than the aggregate data about predicted jobs and wages (rather than the "number of jobs that have been created" as the statute requires), the report contains no data about the guidelines.

Note: The only wage data in the Council's report was an average imputed from the aggregate payroll and jobs figures. This method is very misleading because it ignores the fact that a majority of expected new jobs would pay less than the average.

RECOMMENDATION 5.2

The Council should comply with the statutory reporting requirements.

6. Other Observations

6.1. Involvement and influence of Regional Development Corporation (RDC) representatives

Section 5930a(a) of the statute provides for the appointment by the Governor of non-voting members designated by RDC's and Regional Planning Commissions. The Council decided at the outset to use the RDC's to recruit applicants from around the state. In most cases, applicants worked closely with the RDC's to develop their application materials. This was a reasonable decision intended to make use of existing resources rather than expand the capacity of the Council staff. However, while the RDC representatives are well positioned to solicit applicants, their role in subsequent Council deliberations may have been much different than originally anticipated by the Legislature.

For example, notes from the Council's executive sessions indicate clearly that the RDC representatives were strong advocates for applications from their regions. Such support is not surprising and, in itself, not a problem. However, as the Chairman indicated in an interview with the Auditor, the primary role of the RDC representatives in executive session was to provide additional information to assist the Council in its deliberations. But information provided by RDC representatives at the meetings is not verified and almost always tends to support the applicant. This doesn't mean the information isn't helpful, it just means that there's no opportunity for Councilors to hear a balanced presentation because no one else is permitted to participate in the executive sessions.

In addition, some RDC representatives were persistent in their efforts to reduce "barriers" to the program which usually meant: 1) advocating for a relaxed 'but for' standard; 2) urging the Council to use the lowest possible prevailing wage (i.e., total vs. industry specific); 3) urging the Council to use the program for job retention; and 4) urging relaxed standards for the guidelines.

In our view, the RDC representatives perform a valuable service on the Council. In their understandable effort to expand the number of companies eligible for tax credits, they have consistently advocated for policies and procedures that may have the effect of weakening the Council's ability to screen applications in a balanced manner. However, in practice it can result in awards that may either waste taxpayer funds (e.g., weak or non-existent 'but for') or disregard legislative

intent by supporting companies whose plans are not consistent with the guidelines.

6.2 Decision not to apply the cost-benefit model to sales and use tax exemptions for the use of electricity, oil, gas and other fuels in the production of goods.

There was a discussion at the July 1998 meeting of the Council regarding the applicability of the cost-benefit model to the sales and use tax exemption for energy [32 V.S.A. §9741(34)]. There is a statement in the minutes that the exemptions "are primarily a continuation of what existed prior to the legislation [and that] because of the conflict in the language, [the Council should] consider a motion stating the cost-benefit model is not applied to the sales and use tax exemptions." Such a motion was made and adopted.

The statute is not clear about this issue but the nature of the conflicting language is such that the Council could just as easily have adopted the opposite interpretation. Section 5930a(d) instructs the Council to apply the cost-benefit model to businesses found to be eligible "for the economic incentives under subsection (b) of this section." Subsection (b) includes the sales and use tax exemptions. However, in a subsequent subsection that prescribes the method for calculating the fiscal benefits and costs of the business incentives [§5930a(d)(2)], the text does not specifically refer to the sales and use tax exemptions.

The decision by the Council not to apply the model to the sales and use tax exemptions means that the Council deliberately excluded these costs (foregone State revenues) from the analysis of a project's fiscal impact on State. Had the exemptions been included in the model, the added costs would have lowered the estimated benefit to the State. That is, the cost of the project (total incentives) would have increased by the amount of the exemption, while the projected benefit would have been unchanged.

6.3 Questionable governance policy

Article VII makes Council members subject to the Executive Code of Ethics (EO 8-91) and further prohibits members from voting on applications if they have had a professional relationship with the applicant during the preceding year (e.g., worked as an employee or consultant, has been an officer or director, etc.). Many of the projects before the Council represent considerable planning by the companies. It is at least conceivable that one or more such projects were under consideration by applicant companies for more than a year prior to their EATI applications. Thus, a Council member who was involved with an applicant one year before an application was filed may well have been involved in or had knowledge of the company's plans. In light of the substantial public funds at issue, it may be that the one-year threshold for separation is not sufficient. There

have been numerous occasions when one or more Council members had to abstain from votes due to real or perceived conflicts of interest. From November 1998 through November 1999 there were 35 abstentions recorded in the Council's minutes. Finally, there is no record in the minutes as to the reasons for each abstention or recusal.

If you would like to obtain a copy of the complete report including all footnotes, please contact the Office of the State Auditor at 828-2281.