Grandview Road
Williamstown, Vermont 05679 U.S.A.
Telephone: (802) 433-1360
Cellular: (802) 793-3195
Fax: (802) 433-1480
E-Mail: KAVET@aol.com

Thomas E. Kavet
Economic and Information Systems Consulting

Memorandum

To: Steve Klein

From: Tom Kavet

CC: Joint Fiscal Committee

Date: September 3, 1999

Re: Periodic Legislative Oversight Report: VEPC EATI Program

BACKGROUND

Per the Joint Fiscal Committee meeting of October 13, 1998, I was asked to prepare a regular oversight report on the functioning experience of the new VEPC cost-benefit model and the Economic Advancement Tax Incentives (hereafter, EATI) awards program of which it is a part, with ongoing review of the revenue implications of this program to the State treasury. This is the second such oversight report since the program began in late 1998.

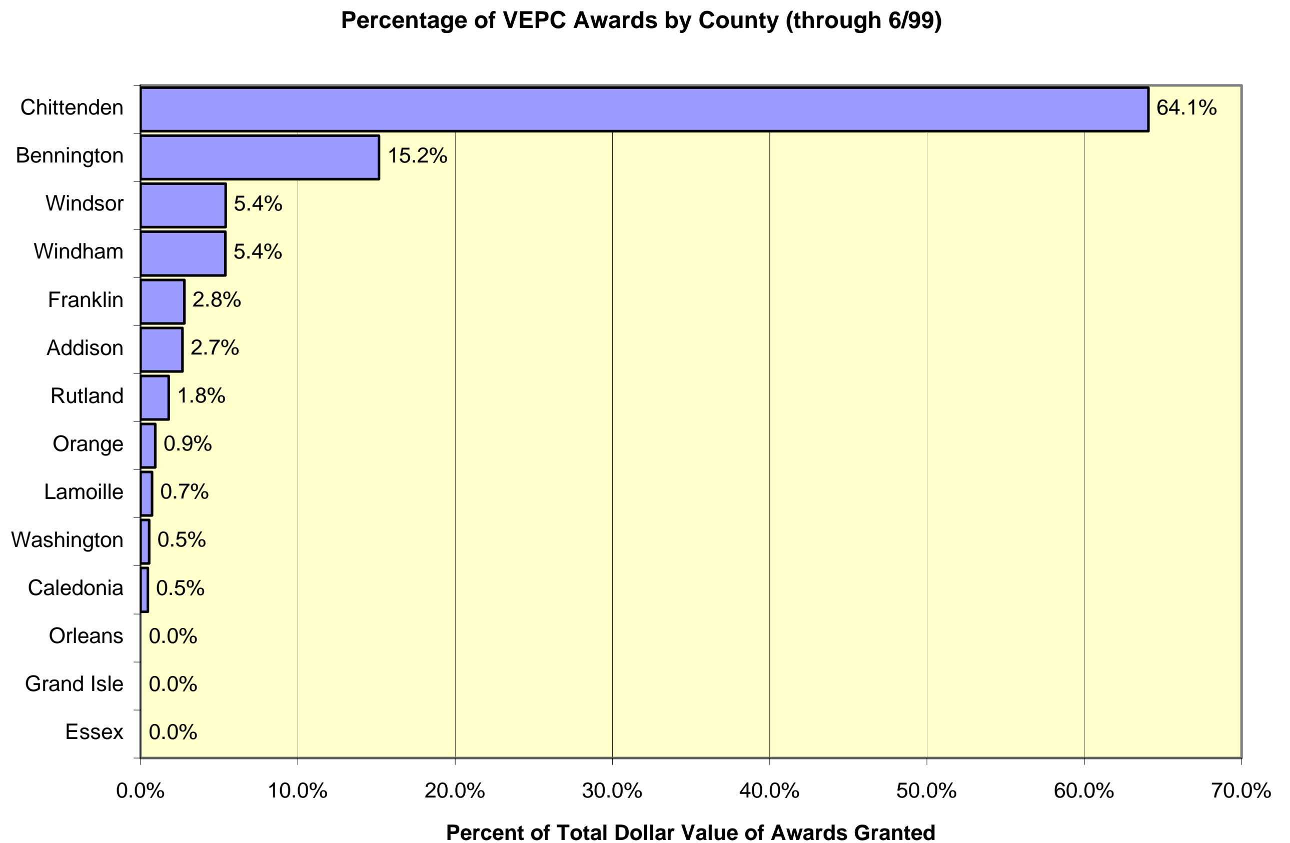
AWARDS GRANTED TO DATE

Through June of 1999, VEPC has awarded more than $51 million in total EATI grants. More than $30 million of these awards were associated with two extremely large new development projects in the Burlington area, IDX and Husky Injection Molding. Since the inception of this program, there have been 67 formal EATI applications submitted to VEPC, of which 58 have been approved in full or part. This represents an 87% approval rate. On a dollar value basis, the approval rate is well over 90%.

Despite VEPC approval of most formal applicants, a number of interested parties have been dissuaded from filing formal applications through informal conversations or “pre-screening” interviews with the VEPC Executive Director and/or RDC representatives. For most of these, it was obvious that the prospective applicant would fail to meet one or more EATI guideline and/or would not be likely to generate net positive results from the VEPC cost-benefit model. Most of these prospects were small service-oriented firms, such as travel agents, restaurants, accounting firms, and attorneys.

REGIONAL DISTRIBUTION OF AWARDS

More than 64% of all VEPC awards to date have been in Chittenden county. Despite regional "discount rates" in the cost-benefit model that are designed to favor counties with relatively high unemployment rates, actual awards have been inversely related to unemployment rates. In fact, the three Vermont counties with the highest unemployment rates (Orleans, Essex and Grand Isle) have received no VEPC grants whatsoever. The six Vermont counties with the highest unemployment rates (the three previously-mentioned counties plus Caledonia, Lamoille and Washington) are also the six counties with the lowest percentage of VEPC awards, accounting for less than 2% of all awards. Of the $51 million in VEPC awards to date, less than $1 million has found its way to the six most economically distressed counties in the State. The below chart illustrates county shares of VEPC awards to date.

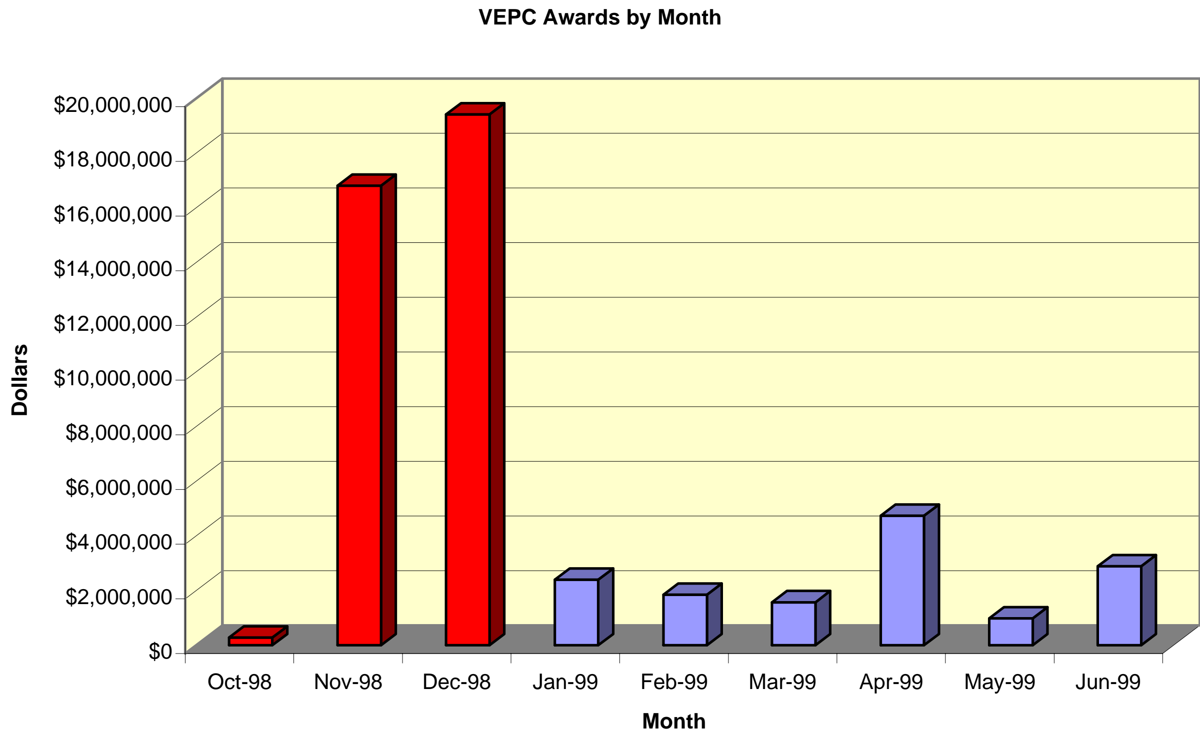


The concentration of VEPC awards in high growth regions represents a major shortcoming of the program as it was originally envisioned and reinforces the sense that much of this activity would have occurred in part or whole without the incentives. It also accentuates concerns about "sprawl" and related development pressures in areas of the State with the lowest unemployment and highest economic growth.

Recommended options that may be considered to remedy this problem include: 1) Imposition of award limits by county or region that favor economically distressed areas, 2) Adjustment of the regional "discount rates" now in effect in the cost-benefit model so as to more aggressively favor distressed areas and/or disfavor high growth areas, and 3) Greater allocation of State economic development personnel and resources to seek out and encourage VEPC applicants and development in distressed areas.

MONTHLY FLOW OF AWARDS

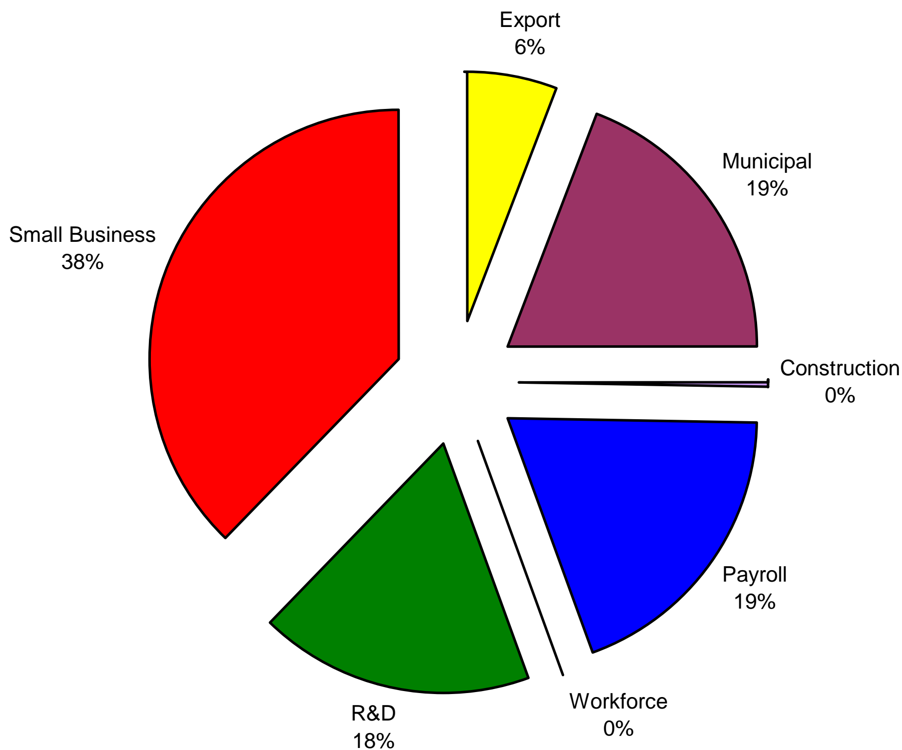
VEPC award activity has slowed dramatically following the first few months after its inception last year. As depicted below, awards between January and June of this year have averaged just over $2 million per month, significantly below the $15-$20 million per month award levels of November and December of 1998. VEPC attributes the high award levels in 1998 to a "backlog" of projects that had been awaiting program implementation. Many of these projects were well underway by the time VEPC evaluated and approved their awards in 1998. This casts considerable doubt on the "essential" vs. supplementary nature of many of the VEPC awards made at this time. While there is insufficient data with which to precisely estimate future annual award flows, current trends suggest about $25-$30 million per year.



Based on a request made last January, VEPC is now providing an annual "theoretical schedule" for claiming these tax credits. Thus far, it shows a fairly even spread of State tax credit liability over the next five years. There is no information, however, on actual credits claimed, since there is no program follow-up procedure now in effect.

DISTRIBUTION OF CREDITS BY TYPE OF AWARD

Per the below chart, most VEPC awards to date have been for Small Business Investment Tax Credits, Payroll Tax Credits, R&D Tax Credits and various awards available to municipalities. It should be noted that the Small Business Tax Credit is actually available (though with a sliding benefits scale) to firms of all sizes. As a result of this, nearly 65% of all "Small" Business Tax Credits awarded to date have gone to four of the largest firms in the State: Husky, IDX, Mack Molding and C&S Grocers.



THE "BUT-FOR" QUESTION AND PROGRAM COSTS

There are two common misunderstandings associated with the VEPC EATI program that have far-reaching implications in assessing the true costs of this program to the State. The first is that if a project is deemed to be "revenue positive" by the cost-benefit model that there can be no cost to the State in providing a subsidy to this project. This is, quite simply, false. If a project would have occurred in the absence of a public subsidy, any subsidy represents a cost to the State, regardless of cost-benefit model calculations.

The second common misperception is that the VEPC cost-benefit model can determine whether or not a project would have occurred without a VEPC subsidy. In fact, it cannot, nor could it be designed to do so.

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 State cost.

I find this assumption, as 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, specific company information associated with several of the largest projects, 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. At this phase of the business cycle, many probably would have occurred in whole or part without State support, with the exception of municipal subsidies necessary for public infrastructure development. This is not to say these subsidies have resulted in no public benefits, it is simply that they are not "free" to the State.

Accordingly, I find the aggregate economic benefits touted by VEPC in their regular program reports to the legislature to be gross exaggerations of likely economic benefits to the State. VEPC currently boasts of more than $1 billion in "economic activity as a result of the incentives program." This claim, as well as those pertaining to "new jobs created," "increased payrolls," "research and development expenditures" and "new tax revenues" are extreme overstatements of the likely impact of this program. $1 billion in economic activity is more than 6% of Vermont's Gross State Product. It is unfathomable that this program has stimulated anywhere near this level of economic activity (and, consistent with this, has yet to make so much as a ripple in the official State economic forecast).

As stated in the last oversight report, depending upon your assessment of whether none, some or all of the projects approved by VEPC would have occurred in whole or part in the absence of EATI subsidies, the cost to the State of this program ranges from a low of a few million dollars per year (per the current cap for non-cost effective grants), to a high of more than $50 million and counting (spread over a period of 5-6 years, with most concentrated in the next 3-4 years thus far).

Without critical follow-up data on award use, it is difficult to estimate annual program costs with much precision. Given current information, however, previous estimates of $7-9 million per year are probably conservative. Although these costs are now built into current revenue and budget projections for FY00 and FY01, program costs could easily exceed double this amount within five years, as annual expenditure commitments accumulate. For example, calendar 2002 currently holds more than $8.5 million in anticipated awards. As additional awards are granted in 1999 through 2002, this number could easily double or triple.

TO CAP OR NOT TO CAP?

The VEPC EATI program is unique in that there is an unlimited potential for additional State expenditure commitments at any time. Expenditure shocks of $10 million, $20 million or more could occur without regard to annual State budgets or revenues. Few, if any, other State programs represent this kind of uncertain revenue and expenditure risk.

Accordingly, some program cap, at whatever level, would seem fiscally prudent and is highly recommended.

Some legislators believe that the original authorizing legislation for this program included a total award expenditure cap. The initial JFO revenue analysis of this program assumed this. Only a few months before beginning operations did VEPC obtain a legal opinion that interpreted the cap so as to exclude any award that passed the cost-benefit model. Based on this, only approved awards that do not pass the cost-benefit model are applied to the VEPC expenditure cap (a miniscule percentage of considered projects).

A program cap does not infer that the program is without value or public benefit. It simply recognizes that, like all other State programs (even those that could conceivably be “proven” to be cost–effective by virtue of some cost-benefit model, such as highway development, tourism or lottery advertising, welfare expenditures, etc.), there are expenditure limits based on the availability of State funds and priorities set by elected officials, not departmental employees or mechanical models.

AWARD FOLLOW-UP: ARE CREDITS USED? PROMISES KEPT?

Award follow-up is a basic and critical element now lacking in this program. There should be a regular reporting mechanism via either the Tax Department or a formal and mandatory report by the award grantee stating whether, how much and when an awarded tax credit was taken. Informal telephone surveys with no legal reporting requirement, such as have been used to measure other State business tax expenditures, are inadequate for a program of this magnitude. Without such a follow-up mechanism, there is no way to effectively gauge program effectiveness or cost. It is my understanding that the establishment of a Tax Department reporting linkage with VEPC and/or the Joint Fiscal Office may require some enabling legislation. Consideration should also be given to a periodic independent audit of the program, perhaps by the State Auditor.

Review of compliance with promised economic activity and the eight program guidelines should also be a prominent part of any follow-up procedure.

PROGRAM CHANGES: NEW SUBJECTIVE AWARD DISCOUNTING

The most significant program change over the past six months is a recent and unannounced subjective award discounting process that is now employed at VEPC's discretion to projects that are deemed less than "optimal," but still worthy of some subsidy. These are usually cases in which one or more of the eight project guidelines are only minimally met. In such cases, VEPC may arbitrarily reduce an award level, usually by about 10 to 30 percent, to compensate for this added "risk."

Although this change reduces potential State revenue exposure, it may reinforce concerns about the arbitrary and subjective nature of the program, for which it has been criticized (see *Vermont's Coming Crony Capitalism*, Ethan Allen Institute Commentary, http://www.ethanallen.org/commentaries/crony.html). Any such discounting should be done with clear and consistent procedures, and with open public access to the review criteria and process.

Other program changes include a request that the applicant company CEO or CFO address the "but for" issue in a cover letter included with each application, a more or less standard categorical assessment by VEPC of each applicant's consistency with respect to the eight guidelines (exceeded, met, minimally met, did not meet), and expanded public reporting of summary program statistics (such as those enabling this report and analysis).

PUBLIC SUBSIDIES AND PUBLIC DISCLOSURE

Obtaining information about VEPC applications, operations and awards granted for this legislative review has not been easy. As of this date, critical information in assessing program performance, such as verification of its consistency with the eight

program guidelines has been denied. Access to CEO/CFO letters attesting to the "but for" issue have been refused. As a result of this, a formal request from the Senate Finance Committee has been made to standardize information available to the Legislature (see attached Appendix A).

A great deal more program information could be revealed without compromising confidential applicant information. There should also be complete access to VEPC applications and project deliberations for confidential review by a designated agent of the legislature and/or auditor, such as now exists with confidential Tax Department information. This would allow for a more detailed program evaluation without revealing or compromising confidential information.

MODEL DOCUMENTATION

The cost-benefit model is currently maintained and operated by Economic & Policy Resources, Inc. for the Department of Commerce and Community Development. There have been no significant methodological or other substantive changes to the model since its approval by the JFC in October of 1998. Following my request in January of this year, I received thorough and complete model documentation in June. This will be important in benchmarking and monitoring any significant future model specification changes.

SUMMARY AND RECOMMENDATIONS

The VEPC EATI program has been of value in providing a range of investment incentives to specifically-targeted firms and contributed in many tangible and intangible ways to improving and promoting the State's business image. There are considerable economic benefits from this and most of the supported investments. Despite VEPC assurances to the contrary, however, direct business subsidies such as these are not free and are generally considered to be among the most expensive ways for a state to achieve such economic development.

Without an overall program cap, it is impossible to place an upper limit on future potential State revenue loss from this program. Accordingly, a total annual program cap is highly recommended. This cap should not be more than about 150% of an expected revenue expenditure (e.g., a $12 million cap would be consistent with a revenue expenditure of not less than about $8 million). The cost-benefit model should continue to be an important component of the program in assessing the relative merits of various applicants within the cap and insuring that awards are appropriately influenced by region, rate of return and type of business.

Measures to focus EATI funding to regions most in need should be developed. These include expenditure caps by county or region, greater emphasis by VEPC and the Agency of Commerce and Community Development in recruiting and steering business investment to these regions, and adjustment of the regional "discount rates"

in the cost benefit model to more aggressively favor distressed areas and/or disfavor advantaged areas.

A formal follow-up of each EATI award should be an integral part of this program. This may be done via the Tax Department, when credits are actually claimed, or as a reporting requirement of the firm receiving the award. Without knowledge of whether, if or when a project award has been used, nor whether it has complied with other program guidelines, it is impossible to assess program effectiveness and potential revenue exposure.

Maximum public disclosure should exist for all non-confidential program information. Access to complete program information should be provided to authorized legislative review and auditing personnel.

Grandview Road
Williamstown, Vermont 05679 U.S.A.
Telephone: (802) 433-1360
Cellular: (802) 793-3195
Fax: (802) 433-1480
E-Mail: KAVET@aol.com

Thomas E. Kavet
Economic and Information Systems Consulting

Memorandum

To: Steve Klein

From: Tom Kavet

CC: Joint Fiscal Committee

Date: February 19,1999

Re: Legislative Oversight Report: VEPC Economic Advancement Tax Incentives – FY99:Q3

Steve,

Per the Joint Fiscal Committee meeting of October 13, 1998, I was asked to prepare a quarterly oversight report on the functioning experience of the new VEPC cost-benefit model and the Economic Advancement Tax Incentives (hereafter, EATI) awards program of which it is a part, with ongoing review of the revenue implications of this program to the State treasury. This is the first such oversight report since the program began in late 1998.

Through January of 1999, this program has awarded about $37.1 million in total grants. More than $30 million of these awards were associated with two extremely large new development projects in the Burlington area, IDX and Husky Injection Molding. Since the inception of this program, there have been 24 EATI applications submitted to VEPC, all of which have been approved in full or part.

Despite VEPC approval of all formal applicants, about 18 interested parties have been dissuaded from filing formal applications through “pre-screening” interviews with the VEPC Executive Director and/or RDC representatives. During these interviews, it was determined that the prospective applicants failed to meet one or more EATI guideline or would not be likely to generate net positive results from the VEPC cost-benefit model. Most of these prospects were small service-oriented firms, such as travel agents, restaurants, accounting firms, and attorneys.

The cost-benefit model is currently maintained and operated by Economic & Policy Resources, Inc. for the Department of Commerce and Community Development. Given the model complexity and professional economic judgement required to properly specify model inputs, VEPC does not foresee operating the model internally

at any time in the near future. Model turn-around time has been good, with most applications processed within a week or two. There have been no important methodological or other substantive changes to the model since its approval by the JFC. I am still awaiting, however, final written documentation on the complete model detail as approved and currently specified.

Given key assumptions underlying the model, the cost-benefit model has shown state fiscal costs and benefits to be fairly closely aligned, as might be expected with direct business subsidies such as these. The total present value of fiscal benefits are estimated by VEPC at about $47 million and total costs at about $37 million. I have requested, but not yet received, an annual breakout of the total cost/benefit stream. It is likely that costs will exceed benefits in the first few years, with net positive benefits occurring in later years. Break-even for currently approved projects may not be realized for 5 or 6 years after initial costs are incurred.

The cost-benefit model has been used by VEPC to both quantify net costs and benefits and, if net benefits are negative, to work with the applicant to reduce the application award amounts, such that net benefits become positive. To date, VEPC estimates that use of the cost-benefit model in this fashion has reduced aggregate awards by nearly $8 million below initial application levels.

All of the cost-benefit calculations by VEPC, of course, are based on the critical assumption that the development projects would not have occurred without EATI subsidies. This is sometimes referred to as the "but for question" (as in, "But for the subsidy, would the investment have occurred?"). It is important to understand that if a project would have occurred without a State subsidy, and yet a subsidy is granted, the entire subsidy represents a net fiscal cost, since all benefits would have accrued without the subsidy. During development of the cost-benefit model, this issue was addressed in a memo to the Chair of the Act 60 Oversight Committee as follows:

> *"With respect to the "but for" issue, it is important to note that no mechanical model can definitively screen or conclusively answer this question. We intend to incorporate a range of applicant questions that are intended to discriminate against investments that may occur without an incentive, and will also utilize economic measurements of "background" growth rates for individual sectors and regions that act as "hurdle" or "discount" rates in addressing this issue.*
>
> *There is no substitute, however, for the knowledgeable (and appropriately skeptical), subjective judgment of Council members on this issue. 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.*

As you suggested, some of the largest corporate entities now in the State would probably have qualified under almost any set of mechanical "hurdle rates" and cost-benefit evaluations for current law incentives, and yet these investments occurred without significant State subsidies. In such cases, it is primarily the expert, subjective judgment of the Council that must protect the State treasury from unnecessary loss."

None of the considered projects has been rejected by VEPC on these grounds and all have been assumed to be fully incremental by the cost-benefit model in estimating fiscal impacts. These assumptions are, of course, open to debate.

There may be legal as well as other reasons VEPC has not rejected any applicants on these grounds. Despite the legislative intent elucidated by the Act 60 Oversight Committee during cost-benefit model development, it is not clear that there is adequate statutory language supporting this intent. I have been told by legal counsel to at least one of the EATI applicants that there is a questionable legal basis for denying an award based on the "but for" issue, and that such a rejection could result in a legal challenge. If this is the case, the enabling statute should be clarified, consistent with current legislative intent.

Depending upon your assessment of whether none, some or all of these projects would have occurred in the absence of EATI subsidies, the cost to the state of this program ranges from a low of a few million dollars per year (per the current cap for non-cost effective grants), to a high of more than $40 million and counting (spread over a period of 5-6 years, with most concentrated in the next 2-3 years thus far).

At this phase of the current business cycle, 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 State subsidies. In my estimation, most probably would have occurred, though many of the projects would have been scaled back by at least the amount of the State subsidy (usually a relatively small percentage of total project costs). Although it is impossible to conclusively prove, there is compelling evidence that several of the larger projects were not dependent upon State subsidies at all.

During my initial review of this legislation one year ago, I was advised by the JFO that the total program was capped at no more than $3 million in FY99 and thus concluded that this represented the maximum program exposure to the State. Based on the current operative interpretation of this cap, which now excludes any project deemed cost-effective by the cost-benefit model, I raised my estimate of program exposure to about $5-6 million per year in the most recent official state revenue forecast. Based on this more thorough review of program performance to date, I believe the revenue exposure is probably closer to $7-9 million per year, on average. When I receive more detailed cost/benefit and awards flows by year from VEPC, I will be able to more precisely estimate this by fiscal year.

The use of the cost-benefit model has effectively targeted subsidies to firms in basic (exporting) industries, which generate the greatest employment impact per dollar of state expenditure. The firms receiving awards appear to have met most or all of the eight subjective guidelines for EATI grants. Most of the direct jobs created by the applicant firms will be high quality jobs with pay significantly above prevailing regional wages. It should be noted, however, that in addition to providing high quality job opportunities to existing Vermont residents, the cost-benefit model estimates that well over half of the total jobs created by these developments will be filled by in-migrants. During periods of exceptionally low unemployment, such as Vermont is currently enjoying, even these estimates may be low (see *"Who Benefits from State and Local Job Growth: Migrants or the Original Residents?"* by Dr. Timothy J. Bartik, *Regional Studies*, Vol. 27.4, pp 297-311).

The use of industry background growth and regional discount rates in the cost-benefit model have been important in limiting award size and discriminating against low impact investments. Although use of these background growth rates can screen out many projects that "would have occurred anyway," they should not be seen as definitive in addressing the "but-for" question. This is because a net industry background growth rate is the sum of many individual firms who are expanding, maintaining or contracting their businesses during any given period of time. In order to achieve a given background growth rate, many individual firms must be growing at well above the average rate in order to offset those that are declining or not growing at all. Very few individual firms actually grow at the industry average. If all firms growing at rates above the industry average qualify for and are granted tax incentives, there will be serious tax base erosion and concomitant revenue loss.

While it is probably premature to make conclusive judgements about the efficacy of the regional discount rates employed in the cost-benefit model and VEPC's ability to influence projects in regions where they would truly be unlikely to otherwise occur, both should be critically reviewed in light of the regional distribution of VEPC awards to date. The regional discount rates are designed to favor counties with slower relative economic growth and higher relative unemployment rates. Based on awards granted thus far, however, the opposite has been true: The only counties that have yet to receive any EATI awards are the same counties with the highest unemployment rates in the State: Orleans, Caledonia, Lamoille, Franklin, Grand Isle, and Essex. Though I do not have a complete dollar value break-out from VEPC yet, at least 70% of the value of all awards have been in Chittenden county, which currently boasts the lowest unemployment rate in the State.

The Act 60 EATI program has been valuable in providing flexible investment incentives to specifically-targeted firms and has contributed in many tangible and intangible ways to improving and promoting the State's business image. There are far-reaching economic benefits from this and most of the supported investments. Direct business subsidies, such as these, however, are generally considered to be

among the most expensive ways for a state to achieve such economic development and this program is no exception.

Without an overall program cap, it is impossible to place an upper limit on future potential State revenue loss from this program. Accordingly, I would recommend consideration of a total annual program cap, with perhaps a mechanism for legislative approval of over-cap expenditures for extraordinary individual circumstances. This cap should not be more than about 150% of an expected revenue expenditure (e.g., a $12 million cap would be consistent with a revenue expenditure of not less than about $8 million). The cost-benefit model would continue to be an important component of the program in assessing the relative merits of various applicants within the cap and insuring that awards are appropriately influenced by region, rate of return and type of business.

Please let me know if you or others would like additional information regarding any aspect of this review.

Sincerely,

JFO Summary of VEPC FY99:3rdQ Oversight Report

- *The Economic Advancement Tax Incentive (EATI) program administered by VEPC is currently estimated to cost the State $7-9 million per year, on average, however, more detailed information is required from VEPC to allow precise FY estimates.*

- *All of the benefits estimated by VEPC and the cost-benefit model employed as a part of this program assume that the subsidized projects would not have occurred without EATI subsidies. Given the current economic climate, this seems highly unlikely. The Oversight Report concludes that "…most [EATI projects] probably would have occurred, though many of the projects would have been scaled back by at least the amount of the State subsidy (usually a relatively small percentage of total project costs). …[T]here is compelling evidence that several of the larger projects were not dependent upon State subsidies at all."*

- *More than 70% of the dollar value of all EATI awards have been in Chittenden county, which currently boasts the lowest unemployment rate in the State. There have been no awards made in the six Vermont counties with the highest unemployment rates: Orleans, Caledonia, Grand Isle, Franklin, Lamoille, and Essex.*

- *Most of the jobs created by EATI subsidized projects will be high quality jobs with pay significantly above prevailing regional wages. In addition to providing high quality job opportunities to existing Vermont residents, the cost-benefit model estimates that well over half of the total jobs created by these developments will be filled by in-migrants. Research by one of the most prominent economic development experts suggests that even this may be a low estimate of in-migrant job shares, especially given the State's current low unemployment rate and the concentration of EATI subsidies in counties with the lowest unemployment rates.*

- *The use of "background growth rates" in the cost-benefit model cannot definitively screen out projects that "would have occurred anyway." Because a net industry background growth rate is the sum of many individual firms who are expanding, maintaining or contracting their businesses at any given time, if all firms growing at rates above the industry average qualify for and are granted tax incentives, there will be serious tax base erosion and State revenue loss.*

- *There have been important economic benefits derived from this program, however, direct business subsidies such as these are generally considered to be the most expensive way for a state to achieve such benefits.*

- *There may need to be statutory modifications to the program made if current legislative intent is for these subsidies to be granted only in cases where the investment would not have occurred without the EATI subsidy.*

- *There is no upper limit to the potential cost to the State of this program. For this reason a total program cap is advised so as to limit State revenue exposure.*