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Memorandum

To: Steve Klein, JFO, House Commerce and Senate Economic Development Committees

From: Tom Kavet

CC: Sara Teachout, JFO

Date: February 23, 2015

Re: Draft Economic Development Initiatives, per (dr req 15-818 – draft 1.1) 1/28/2015-DPH08:10AM

Background

As requested, I have summarized comments and estimated public costs associated with selected provisions included in the subject draft legislation, broadly purposed as supporting economic development. A number of these measures have been introduced and considered in previous legislative sessions. Virtually all involve increased public expenditures, some of which are substantial or even without expenditure limit. While some will advance important public policy objectives, others are unlikely to achieve intended outcomes and may actually be counter-productive. None of the proposed expenditures includes independent program review or follow-up to measure effectiveness and return on public investment.

– Tourism and Marketing Appropriation

Comments: This additional public expenditure is unlikely to have a measurable impact on Meals and Rooms revenues. It also sets a second, and equally problematic, precedent for triggering an appropriation based on a revenue forecasting variance (the first being the estate tax and higher education fund).

The revenue forecasting process is designed to balance risks across scores of revenue sources and isolated events. When the economy performs better than expected, most individual revenue categories exceed forecasts. Automatic expenditures triggered by stronger than anticipated economic growth, such as this, deprive the legislature of time-relevant choices in allocating these revenues. They pre-suppose future priorities based on present needs. Should there also be an automatic decline if revenues drop below forecasted levels in any given year? The proliferation of this type of expenditure mechanism is not optimal fiscal policy.

The presumed connection between Tourism and Marketing (T&M) expenditures and Meals and Rooms revenues is unsubstantiated by historical data. In the last 42 official state revenue forecasts, not once have T&M expenditures been mentioned or included as a significant variable in any forecasting model by either the Legislative or Administration economists. The reason for this is evident in the below table and the chart on the following page: there is no positive statistical correlation between the two. Since 2005, T&M expenditures have dropped 38% while Meal and Rooms revenues have increased by 26% (see below Table 1). This is most likely due to the fact that taxpayer-financed T&M advertising for the industry is a small fraction of private advertising in this sector. Current taxpayer-financed advertising expenditures for the tourism sector are estimated to represent a mere 3% of total industry advertising expenditures.[1]

The claims of a "13 to 1 return on taxes on the investment in advertising" on the Vermont Tourism and Marketing website[2] are completely without merit, based on a severely-biased analysis performed by an industry consultant in Colorado.[3] A similarly biased UVM study purporting to show a 3.5 to 1 return on investment in Vermont was discredited upon review and comment by JFO and Tax Department economists and was formally withdrawn prior to release. If a 13 to 1 return-on-investment was credible, the entire Vermont Personal Income tax could be eliminated by simply increasing State Tourism and Marketing expenditures by a mere $50 million...

Cost: $510,000

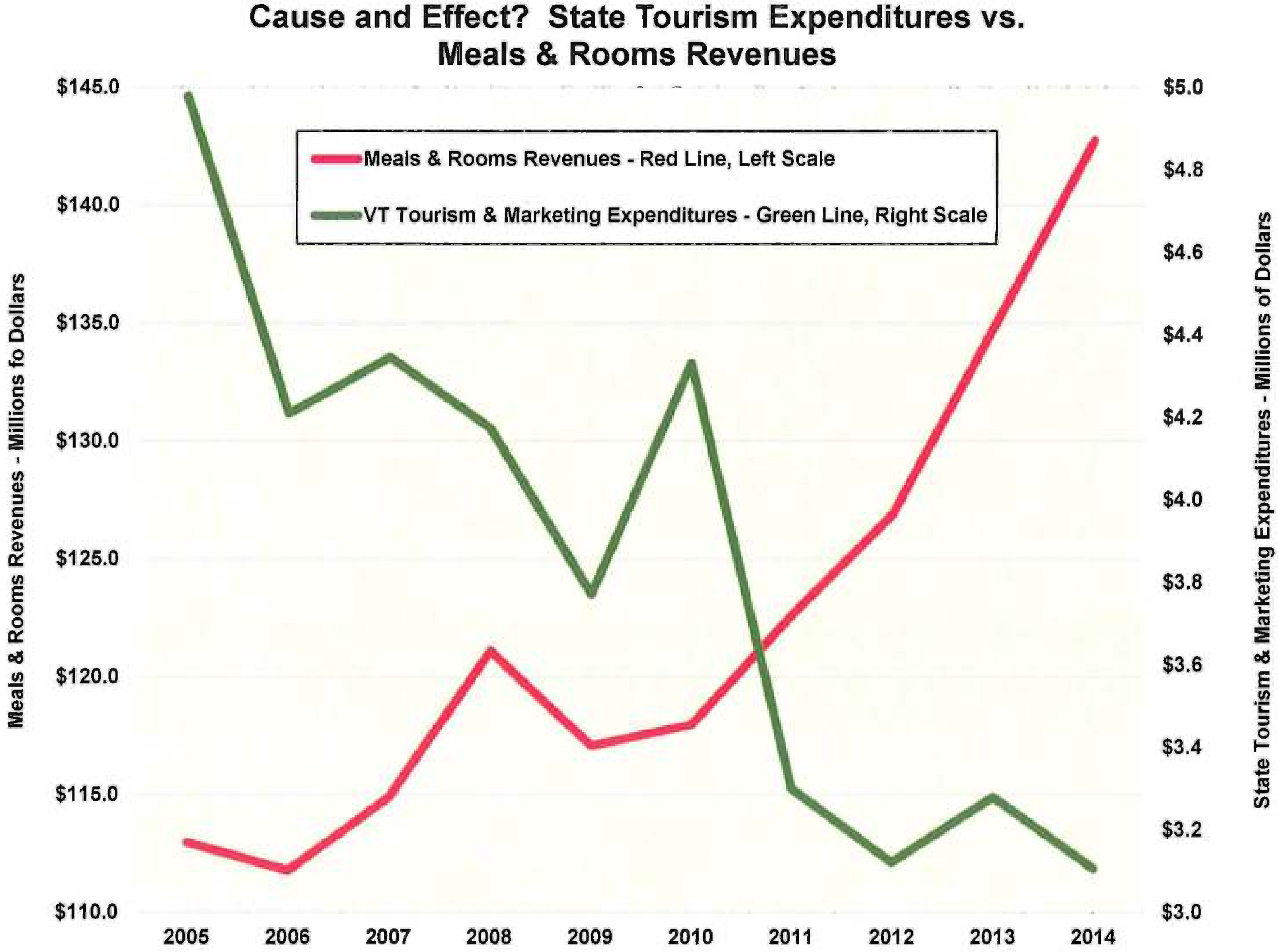
Table 1
Meals and Rooms Revenues vs. Tourism and Marketing Expenditures

Period (FY basis)	Meals & Rooms Revenue ($millions)	%CHYA	Tourism & Marketing Expenditure ($millions)	%CHYA
2005	112.956381	4.1%	4.978637	
2006	111.766588	-1.1%	4.209458	-15.4%
2007	114.892087	2.8%	4.346500	3.3%
2008	121.099755	5.4%	4.174127	-4.0%
2009	117.056476	-3.3%	3.771138	-9.7%
2010	117.965475	0.8%	4.332153	14.9%
2011	122.628019	4.0%	3.299810	-23.8%
2012	126.873783	3.5%	3.121010	-5.4%
2013	134.790908	6.2%	3.279123	5.1%
2014	142.741758	5.9%	3.105665	-5.3%
2005 to 2014	**29.785377**	**26.4%**	**(1.872972)**	**-37.6%**

[1] Based on the 2007 Economic Census, U.S. Census Bureau
See: http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=BES_2002_00I101&prodType=table

[2] See: http://accd.vermont.gov/tourism_and_marketing/colorado_example

[3] The Colorado analysis was performed by Longwoods International, a self-described "marketing, advertising, and public opinion research" firm, that specializes in promoting state tourism advertising. The analysis relied almost entirely on self-created market share data, not available for independent review. It did not consider important variables such as external economic conditions, income, snowfall or weather variation in the analysis. Longwoods states that their research is designed to measure "brand success" and "provide the research you need to show the relationship between destination promotion and economic development." See: http://www.longwoods-intl.com/



1 - Proposed VEGI Program Changes

Comments: The Vermont Economic Growth Incentive program (VEGI) was developed in response to serious program abuses and waste associated with its precursor, the Economic Advancement Tax Incentive (EATI) program. The EATI program cost the State millions of dollars by allowing firms to collect incentive awards despite reducing employment and/or otherwise not meeting promised incentive goals. Amidst calls to eliminate the program entirely, VEGI was developed to replace the EATI program and was designed by a Technical Working Group, consisting of Tax Department, JFO and Administration economists.[4] The goal of this group was to insure that awards were only issued upon completion of promised economic activity, to maximize the State's return on investment from these tax expenditures and to develop administrative protocols that would allow

[4] These included Susan Mesner and Mike Wasserman from the Tax Department, Jeff Carr and Matthew Barewicz on behalf of the Administration and Tom Kavet for the Joint Fiscal Office.

Tax to monitor and track these expenditures (see Appendix A for a copy of the final memo recommending program protocols).

This program has been largely successful as a result of this effort. It is structured, however, so that there is a balance between State costs and potential benefits. This balance includes provisions that qualifying employers provide better than average jobs (as measured by prevailing wage rates), with benefits, so that the State is not paying employers to create jobs which, in turn, may generate further State expense in the form of low income subsidies, such as renter's rebates, child care subsidies, health insurance subsidies, earned income tax credits and others.

The program's current design also recognizes the fact that despite requirement of a "but-for" statement by all applicants (attesting that "but-for" the State subsidy, they would not otherwise perform the promised economic activity in whole or part), this attestation is unverifiable. Because the entire fiscal premise of the program rests on this unverifiable assumption, there are important measures built into the program to maximize the possibility of net State benefit from VEGI expenditures of public funds.

There are four broad changes to the current VEGI system that are recommended in the subject legislation. All serve to diminish the public return on investment from this program by lowering standards, eliminating basic fiscal controls or allowing public subsidies when they would not previously have been allowed.

In two locations in the proposed draft legislation (page 10, lines 7-9 and page 14, lines 6-8), wage and benefit standards are significantly lowered. In the first instance, language from one of the 9 core statutory guidelines for the program is deleted, in favor of a lesser standard.[5] In both instances, these changes will serve to diminish the State return on VEGI public expenditures, since the VEGI Cost-Benefit model used to calculate award maximums does not assume that qualifying jobs created through the program will trigger public assistance payments. In both cases, if a $13.00 wage threshold (the current livable wage for two adults with no children) is used, the job holder could qualify for thousands of dollars in annual public assistance and could receive several thousand dollars per year less in income than the current standards. If this change is made, the Cost-Benefit model should also be changed so as to account for this added potential State cost in calculating award levels.

The single Livable Wage rate proposed in these first two changes is only a livable wage for two adults with no children, both of whom are working full time, living together in a rural setting, with an 80% employer healthcare contribution.[6] For all other family configurations, healthcare co-payment levels and geographic locations in the JFO Livable Wage calculations, this wage would be significantly below a livable wage. For example, even if Vermont Health Connect was assumed to be used for healthcare coverage, the comparable livable wage would be $14.12 –

[5] See 32 VSA §5930a(c), at: http://accd.vermont.gov/sites/accd/files/Documents/business/vegi/VEGI_Program%20guidelines.pdf

[6] The "Livable Wage" is the urban/rural average for this family configuration, and thus, is at or above only the rural rate.

closer to the current standard of $14.62 (1.6 times the minimum wage). If the individual lived alone, using Vermont Health Connect for healthcare insurance, the wage would be $18.42 – and with one child, would soar to $26.70, more than double the proposed hourly minimum. These two changes erode the job quality standards that are a central objective of the VEGI program and could cost the State as much as $250,000 to $1 million per year.

The second proposed change is even more far-reaching (pages 16-17, lines 19-3 of the draft legislation). It would essentially eliminate the cap for awards in excess of public benefit calculations by the Cost-Benefit model for 90% of the State (see below Table 2). This could ultimately cost the State tens of millions of dollars and gut any semblance of fiscal control over the program.

The original provision for allowing $1 million in awards that exceed maximum Cost-Benefit model calculations was intended to allow for exceptional projects requiring additional funding – especially in areas of the State that are chronically disadvantaged, such as the Northeast Kingdom. This cap recognizes that such awards can be costly to the State and therefore limits their total amount. During the past 8 years, in no year was even 50% of this cap utilized. Last year, a mere $63,352 was awarded under this subsection. Why this cap now needs to be effectively eliminated is hard to fathom. The below table, utilizing the most current data available, shows that under the proposed changes, 90% of the 20 State labor markets would qualify as subaltern and be immune from the governing cap.

Table 2

Proposed Regional Exclusions from Cost-Benefit Award Controls

Test A		**Test B**		**Final Test: A or B**
Region	*2013 Unemployment Rate*	*Region*	*2013 Average Annual Wages*	*Special Case Exclusions from Cost-Benefit Model Award Controls* ***(90% of all Labor Markets!)***
Vermont	**4.4**	**Vermont**	**42,042**	
Hartford	3.1	Burlington-South Burlington	47,987	
Warren-Waitsfield	3.2	Barre-Montpelier	43,955	
Woodstock	3.3	Hartford	42,762	Barre-Montpelier
Burlington-South Burlington	3.6	Colebrook, NH-VT (Vt only)	41,577	Colebrook, NH-VT (Vt only)
Littleton, NH-VT (Vt only)	4.2	Brattleboro	39,946	Brattleboro
Middlebury	4.3	Rutland	39,668	Rutland
Brattleboro	4.5	Morristown-Stowe	38,001	Morristown-Stowe
Barre-Montpelier	4.6	Bennington	37,943	Bennington
Randolph	4.8	Manchester	37,521	Manchester
Swanton-Enosburg	4.8	Middlebury	37,303	Middlebury
Manchester	4.9	Springfield	37,130	Springfield
Morristown-Stowe	4.9	Randolph	37,009	Randolph
Rutland	5.0	Swanton-Enosburg	36,774	Swanton-Enosburg
Colebrook, NH-VT (Vt only)	5.1	St. Johnsbury	36,342	St. Johnsbury
Bradford	5.2	Woodstock	34,997	Woodstock
Springfield	5.2	Newport	33,773	Newport
Bennington	5.3	Bradford	33,712	Bradford
St. Johnsbury	5.3	Littleton, NH-VT (Vt only)	32,068	Littleton, NH-VT (Vt only)
Newport	6.3	Warren-Waitsfield	31,746	Warren-Waitsfield
North Adams, MA-VT	8.1	North Adams, MA-VT	26,649	North Adams, MA-VT

The third set of changes (page 17, lines 12-13 and page 18, lines 3 – 12) will both diminish the State's benefit from any incentive by allowing extensions of the time period during which the promised activity may occur and encourage applicants to be less conservative in estimating promised economic activity.

The VEGI Cost-Benefit model recognizes the time-value of public funds awarded and includes this as a part of the award calculation. Any extension of time allowed for the achievement of goals should, therefore, require a recalculation and adjustment of the award amount, or a change in the Cost-Benefit model award protocols to assume a longer benefit period for all awards. Encouraging applicants to be less conservative in activity projections will also cost the State Treasury. If applicants know they may have more time to achieve a promised growth objective, some will apply for larger awards than would otherwise be the case. The current program assumes a balance of activity beyond that promised in order to counter some of the activity that would have occurred in the absence of any incentive. This change negates some of this benefit and could ultimately cost the State more than $1 million per year or more.

The fourth set of proposed VEGI changes adds an enhanced training incentive option that appears to be a simple reallocation of VEGI incentive award funds totaling 25% of job training costs, leveraged by Vermont Training Program (VTP) funds of 75% of job training costs (normally limited to 50%). If there were no request for additional VTP funding as a part of this proposed legislation, there would be no additional cost for this provision. Later in the proposed legislation (page 26, lines 17-20), however, there is a request for an additional $2.5 million in State funding for this function. As discussed in more depth as item #5, herein and below, this change represents $2.5 million per year in additional taxpayer expense. Although there is probably also some additional administrative cost to the Tax Department as a result of this provision, there is a robust recapture clause that protects the State in the event of nonperformance.

Lastly, there is a deletion of the statutory section on VEGI Annual Calendar Year Caps (Sec. 11, page 21, lines 2-21), in favor of a reassignment of the total cap language to another section statute and elimination of the $1,000,000 cap on awards not subject to Cost-Benefit model controls. This downplays the importance of these primary fiscal controls over the program and eliminates one of the caps, as noted above.

Cost: Potentially $10,000,000 to $25,000,000 per year

2 – Angel Investor Tax Credit

Comments: This tax credit has been proposed and enacted in various forms previously in Vermont, but rarely utilized following enactment. The proposed version offers more generous public subsidies to angel investors, thereby shifting some of the investment risk to State taxpayers. While it also offers the possibility of a public return on the investment, this return is nowhere close to the gains that would be realized from an equity position in the investment, consistent with the risk.

In the absence of market failure, the efficacy of state tax credits for angel investors is an open question. Some studies show positive impacts in states that have implemented such policies, but others argue that very few of the factors associated with having a high level of angel investment activity in a state are things that state policy can affect and that tax rates explain very little of the observed variation in angel activity between (and especially, within) states.[7] Angel tax credits are unlikely to have a large impact on job growth or net economic activity, since the State tax credit is a relatively small part of the investment decision. Some argue that it is more important to encourage the formation of angel capital groups – which can augment the effectiveness of individual investors – and effect legal changes to facilitate the participation of lower net worth individuals, through both crowd-funding credits and modified regulation of "accredited investors."[8]

In the event an angel tax credit is pursued, a recent study at Yale University suggests the following guidelines for maximizing the effectiveness of policy implementation:[9]

- Setting clear goals and objectives: concisely defining what industries this tax incentive is targeting and how the success of this incentive will be measured.

- Setting limitations: limiting transferability and refundability of the credit will allow for less abuse of the incentive.

- Making informed policy decisions: creating an evaluation process that can include all current state tax incentives in order to derive whether a program is working compared to others and what might need to be changed to make it more effective. For this to be successful, transparency in the method with which data are collected and stored is crucial to draw clear conclusions.

- Measuring an economic impact: analyzing indicators that are directly affected by this incentive (i.e. jobs created, return on investment, etc.) and how these contribute to performance standards set when the policy was created.

- Forming a monitoring entity: creating a panel or taskforce that focuses on this incentive will provide for an effective system that can focus solely on the AITC and foster community relations.

- Monitoring incentive: creating a cap for the total amount to spend and setting a sunsetting timeline will force states to reevaluate the incentive.

Cost: Potentially $1,000,000 to $5,000,000 per year, but without limit

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[7] See, for example a recent pro and con article in the Wall Street Journal, at: http://www.wsj.com/articles/SB10001424052702304459804577283420497271022

[8] See, for example, analysis in the book, "*Fool's Gold*" by Scott Shane, 2008, and an excellent SSTI analysis available on the web at: http://ssti.org/blog/how-effective-are-state-angel-tax-credits

[9] "*Overview of Effective Policy Implementation of Angel Tax Credits*" by Stacy Kanaan, Journal of Science Policy & Governance, Volume 6, Issue 1, January 2015, http://www.sciencepolicyjournal.org/uploads/5/4/3/4/5434385/pa3kanaanformatted_lb.pdf

3 – Strategic Employer Designation

Comments: This initiative (pages 25-26) is an ill-defined supplement to existing business subsidy programs with uncertain total costs. It begs a number of questions:

1) Why are there only 10 firms that may be designated per county? What if some counties have more than 10 good "dollar-importing" economic contributors? What if some have fewer? Why only vary the number of qualifying firms for Chittenden County? Why would Essex and Rutland or Grand Isle and Bennington necessarily have the same number of "strategic" firms?

2) Why are there no job or labor standards applied in designating a firm as "strategic?" Do firms that pay low wages and do not offer benefits have the same economic and fiscal benefit to the State? Is there an objective way to measure the net economic benefit between firms in choosing those in the top 10?

3) There are 5 benefits these strategic firms will receive, but there is no detail regarding the benefit amounts, processes for awarding these benefits, State expenditure sources, costs, or limitations on expenditures. These are all essential in evaluating the fiscal costs of the initiative.

4) One of the benefits mentions "priority authorization" for VEGI subsidies, however, all VEGI awards are processed promptly and there has never been an effective cap constraint on the total awards granted (whenever close, the Emergency Board has always approved cap increases). What does "priority authorization" mean?

The provision to 145 good businesses of new public subsidies they have not requested, is hard to justify in the current budgetary environment. It would be better to focus these needs through a program such as VEGI and target public funds where they are most impactful and needed.

Cost: Potentially more than $10,000,000 per year, but unknown without more detailed program, funding source and operational information

4 – Allocation of VEGI Revenues for Workforce Training

Comments: This provision allocates up to $2.5 million per year in theoretical "revenues" that do not exist. It identifies these as "revenues generated by earnings through the Vermont Employment Growth Incentive." Unfortunately, there are no such "earnings" on any meaningful State balance sheet.

The theoretical revenues reported by VEPC/VEGI are based on assumptions of an infallible "but for" test and a perfect Cost-Benefit model calculation. Neither are infallible or perfect and thus, derivatives from the VEGI approved economic activity paid for with taxpayer subsidies are, at best, close to neutral in terms of net fiscal impacts and possibly negative. They have never been factored into revenue forecasts as net positive events and sometimes, as in the current fiscal year, have been a source of tax revenue estimation reductions.

Every State expenditure is thought by its supporters to be worth the public expense and to return something of equal or greater value to some or all taxpayers. To assume that, because there may be a greater value returned, there is no net fiscal expense to a program is folly. If this were the case, there would be no limit on State expenditures, as each would theoretically return more than it cost.

Imagine, for example, if highway and road expenditures were first run through a cost-benefit model and then costs were deducted from benefits in determining a net expenditure. How much economic activity depends upon roads? Who could get to work? Without them, what would the economic impact be? If the benefits exceed the costs (and they surely would), could we then re-spend these benefits as "revenues generated by earnings through the highway system?"

If there is to be an additional allocation to VTP, it will need to be from an actual revenue source. It is unclear, however, why this additional public subsidy is necessary or beneficial to a firm that has already been incented to perform a specified economic activity in exchange for a VEGI award.

Cost: Potentially $2,500,000 per year

5 – Advanced Manufacturing and Information Technology Programs

Comments: This new program would develop focused workforce training in selected areas of the economy thought to be of particular benefit to the State: "advanced manufacturing and information technology." It seeks to "find jobs for Vemonters in Vermont employers in these sectors."

While job training programs can have significant benefits – and this program would - it is sometimes risky to think the State can best guess those sectors with the highest future growth or greatest potential benefit to the State. Would anyone have funded programs focused on coffee roasting or new ice cream flavors? Probably not, and yet these two sectors have accounted for significant job and income growth in the State.

It is also important to note that the State derives nearly equal economic (if not political) benefit from new jobs filled by out-of-staters. In fact, the VEGI Cost-Benefit model generally assumes (depending upon the sector modelled) that more than half of all net new jobs created by applicants will be fill by in-migrants. This is particularly true with more advanced technology jobs.

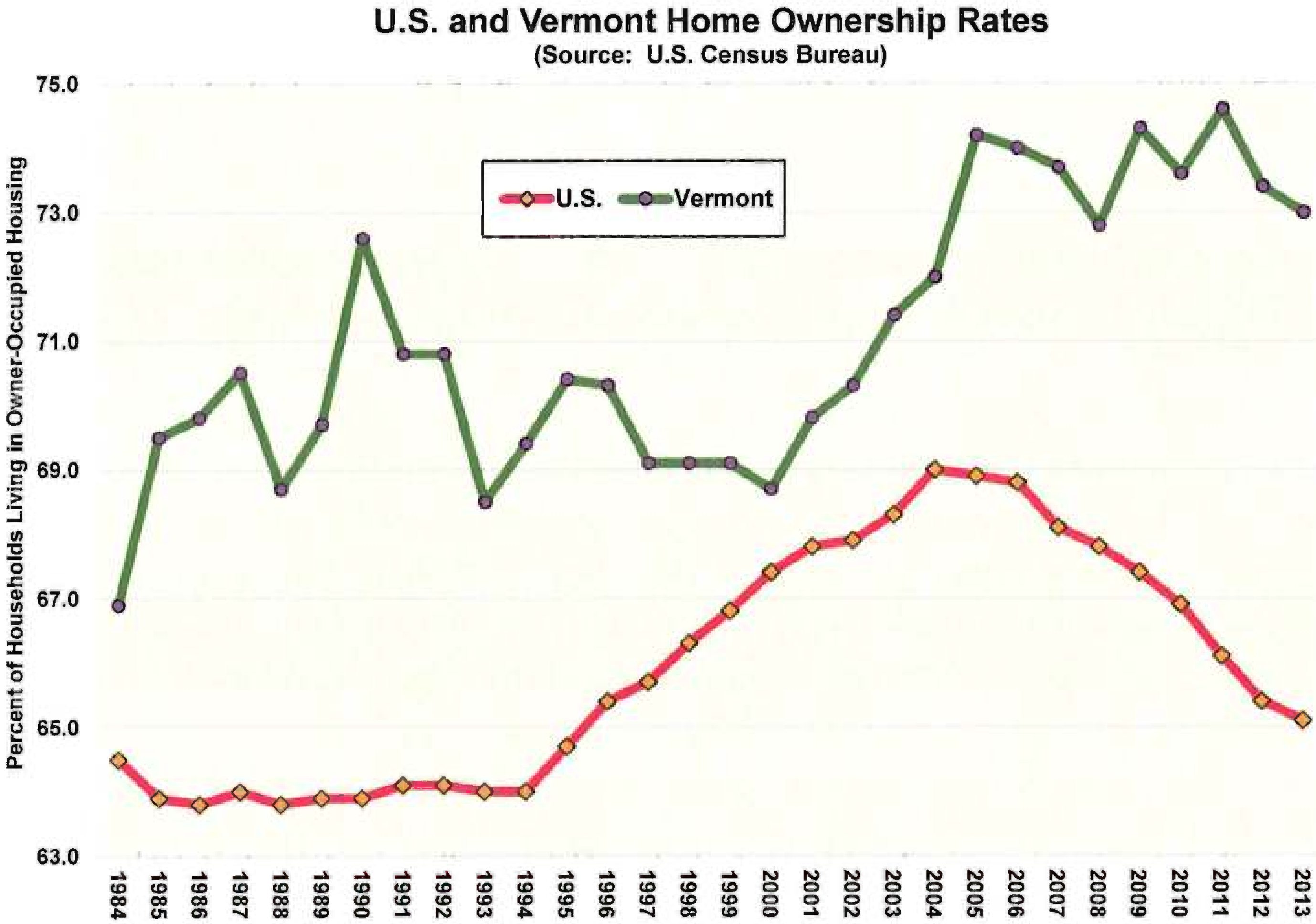
The additional costs associated with this initiative, if any, are unspecified in the legislation, as well as the source of any such additional funding.

Cost: Unknown, pending additional program detail

6 – Tax Credit for Affordable Housing

Comments: Like VEGI awards, Affordable Housing credits are tax expenditures that reduce revenues rather than registering as explicit appropriations. Their cost, however, is no less significant, as growth in Bank Franchise revenue (which is where most Affordable Housing credits appear) has slowed to a crawl as a result.

The changes proposed on pages 27-33 of the proposed legislation are relatively minor, with the exception of a new loan "downpayment assistance program," which provides up to $125,000 per year in downpayment assistance, with a total aggregate limit of $625,000 over 5 years.



Although the U.S. homeownership rate declined dramatically during and since the recent recession, the Vermont rate has remained relatively high. Despite the high rate, housing affordability is a clear issue in the State, especially for first time homebuyers. Although the new downpayment assistance program will only affect a relatively small number of applicants, if loan losses are low, the funding allocation will be leveraged, growing over time.

Cost: $625,000

7 – Vermont Entrepreneurial Lending Program

Comments: The proposed changes to this program (page 34, line 8) removes the $100,000 upper limit on loans to manufacturing businesses and software developers. It is not expected that this will have any net effect on aggregate program cost, but will allow VEDA greater flexibility in loan distribution.

Cost: None apparent

General Recommendations

No matter which, if any, of the proposed economic development initiatives reviewed herein may be pursued, the need for objective oversight and efficacy measurement is critical. The State expenditures associated with many of these measures are substantial public investments. Understanding if they accomplish an actual public good comparable to the expense is essential. Any such review must be independent and objective. Agency self-measurement and review is often little more than an exercise in self-promotion, usually resulting in justification and requests for ever-increasing taxpayer expenditures for the same or similar programs.

The Pew Charitable Trusts recently prepared guidelines for evaluating economic incentives and maximizing their benefits.[10] Their purpose is to:

- Protect budgets from unexpected tax incentive costs;
- Evaluate all tax incentives on a regular schedule; and
- Inform lawmakers' policy choices with evidence from evaluations

Aside from periodic VEGI review by the State Auditor, there is scant objective review and evaluation of Vermont economic development expenditures performed to the above standards. Doing so would allow legislators to better understand program impacts, eliminate ineffective programs, and make choices between the best of many good initiatives.

There is also no broad strategic framework within which these initiatives can be evaluated. During times of budgetary stress, such as now, there are low-cost or no-cost measures that can meaningfully aid State economic development and should be pursued. In times of greater revenue growth, cost-effective State expenditures can grow and promising pilot programs can be tested. All, however, should be in the context of a cohesive strategic plan that plays to the strengths of the State, amplifying or creating new competitive economic advantages and avoiding or remedying weaknesses. The disparate assemblage of economic development initiatives reviewed herein is evidence that such a plan does not exist.

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[10] For a full list of Pew analyses in this area, see: http://www.pewtrusts.org/en/projects/economic-development-tax-incentives

Appendix A

VEGI Background – Technical Working Group Program Recommendation

Memorandum

To: Senator Hinda Miller, Chair, and Members of the Economic Development Study Committee

From: Technical Working Group: Tom Kavet, Consulting Economist to the Joint Fiscal Office, Jeff Carr and Mathew Barewicz, Consulting Economists to VEPC, Susan Mesner, Tax Department Economist and Mike Wasser, Tax Department Policy Analyst

CC: Steve Klein, Tom Pelham, Fred Kenney

Date: January 17, 2006

Re: Technical Working Group Consensus Recommendations on EATI Options, #3

Following completion of our original task as outlined in our first two memos to the Committee, we have extended our work, per your recent request, to select a single technical option for revision of the VEPC Economic Advancement Tax Incentive (EATI) program. While we agreed that either a modified payroll-based system as proposed by the Tax Department or a "simplified" EATI process more akin to the current program would be technically feasible and could be designed so as to be fiscally neutral relative to the current program, our recommendation for a revised system incorporates aspects of both.

The following is a summary explanation of a revised incentive process that the working group collectively recommends as a permanent replacement for the current EATI program. Because this option emphasizes employment growth, we have informally labeled this as the "Vermont Employment Growth Incentive" (VEGI) option, so as to differentiate it from the other options currently under legislative consideration.

As with our prior recommendations, the below-described system is designed to function as an integrated package. The complexity of the process does not lend itself to alteration and may not function as intended if not enacted in its entirety. Because of this, we suggest close collaboration between Legislative Council and the Technical Working Group in drafting statutory language associated with this recommendation or any variant the Committee may choose. As previously recommended, we also suggest that the Technical Working Group be maintained to assist with implementation and ongoing program oversight so as to avoid some of the technical and operational problems encountered with the original EATI program. Prior to implementation or upon request, we will also prepare a more detailed technical description of this option, and/or any other option desired by the Committee.

Recommended Program Operation and Overview

The recommended VEGI option replaces the current suite of EATI credits with a single incentive based on projected company employment, payroll and capital investment growth. This award basis (payroll and capital investment) represents more than 70% of all EATI awards granted to date. The VEGI incentive would be calculated against incremental additions to payroll beyond background growth and paid out through the personal income tax withholding accounts of authorized companies.

The incentive will be calculated annually using a special VEGI schedule designed to be largely self-enforcing. The new schedule will require current and prior year employment data for real-time performance evaluation against background growth hurdles and retention requirements. No more than one-fifth of incentives earned can be claimed in a given year, so as to ensure that employment thresholds are maintained without the need for subjective, punitive, unpredictable, and potentially controversial recapture and mitigation processes. The working group's cost-benefit model runs revealed that this approach would be significantly more effective at preventing lost revenue to the State in the event of declining employment than the current program's recapture and mitigation provisions.

The VEGI awards would be paid through the personal income tax withholding accounts, as opposed to the current system of credits applied against an authorized company's income tax liability due. This will result in substantial administrative efficiencies achieved by eliminating the need to track carry-forward credits, and eliminate tax incentives at the entity level for pass-through (i.e., S corporations, partnerships, or limited liability companies) and multiple business entities. The new approach will eliminate many of the complexities and potential for abuse historically experienced with respect to pass-through and multiple business entities. The VEGI approach will also enhance fiscal predictability for both applicant companies and the State through the elimination of lengthy carry-forwards and recapture processes.

Capital investment when accompanied by job expansion will be included in the overall cost-benefit calculation of the VEGI, and the new schedule will require reporting and tracking of the investment over the five-year authorization period for compliance. If total capital investment at the conclusion of the authorization period is less than the projected 5-year capital investment represented on the VEGI application, the total authorized incentives will be reduced in proportion to any shortfall. To the extent incentives have already been earned and paid out in excess of this adjusted amount, the Tax Department will bill back the withholding accounts for any shortfall. This will create an incentive for companies to provide conservative, realistic data in their authorization applications to VEPC, and will protect against State fiscal loss.

Each year, the VEGI applicants will be required to provide data on current and prior year payroll, capital investment, and job additions as part of their tax return filing as they earn and claim the financial incentives. A critically important aspect of the VEGI approach is the requirement that every incentive recipient reach not less than two of three activity targets (jobs, payroll, capital investment) as represented on their application in each of the first four years of the authorization period in order to earn and utilize incentives. This will ensure consistency with cost-benefit projections and increase fiscal predictability. The Tax Department will implement a new tracking system to monitor not only performance but also eligibility to earn future incentives.

The recommended process would function as follows:

In year 1, if an applicant does not meet two of the three requirements, the incentive authorization will be automatically rescinded. However, one of the required two performance metrics *must* be payroll, which is the major driver of benefits to the state.

If a company meets two of the requirements in year 1 but not in years 2, 3 or 4, the ability to earn and utilize incentives in the year of underperformance will be suspended until the point at which the underperformance is corrected, but for no more than 12 months, after which all earned, unused or prospective VEGI incentives would be rescinded.

In either case, an applicant whose incentive authorizations have been rescinded may reapply to VEPC for a new authorization but will be held to the same standards as if applying for the first time.

The VEGI approach will create limits on how much of the authorized incentive can be taken in any year. A company can earn only the amount represented by the additional jobs projected on its original application in that year (or the balance of the cumulative jobs expected to be added in that year and the previous year under the "two-out-of-three rule"). This measure will prevent abuse and limit risk to the State by compelling applicants to be conservative in arriving at their projections. It will also enhance fiscal predictability for the State.

Joint applications from related entities will no longer be accepted under the VEGI program. This will prevent use of this performance-based tax incentive program by businesses specifically structured to evade or minimize corporate tax liability and will simplify administration.

The effectiveness and theoretical fiscal neutrality of the VEGI approach is reliant upon the following improvements to the cost-benefit modeling procedures: (1) A 20% return to the State will be formalized for all VEGI authorizations in order to create a reasonable and structured return on investment for the program; (2) The fiscal cost-benefit evaluation period will be adjusted from 7 to 5 years in order to align the period of projected benefits to company performance and award payout. This will also avoid potential double counting of benefits in re-application situations; (3) Background growth rate calculations for all VEGI authorizations will be retained but updated to correspond to the latest available data and simplified; and (4) The cost-benefit model will include revised regional factors so as to encourage greater program participation from economically disadvantaged regions of the State.

The Working Group recommends that the property tax stabilization provisions in the existing EATI program be preserved as a "Municipal award" component to the VEGI incentive. Such stabilization awards can be effectively modeled for costs and benefits by deducting these benefits from the corporate award and reallocating a portion of the project benefits associated with the capital investment to the local municipality. No other municipal awards or sales tax provisions under the current EATI program would be offered.

It is clear from the Technical Working Group's review that the adoption of the proposed VEGI option would require the administration of two EATI programs for a period of time—until credit authorizations under the current EATI program are taken or expire. The Group recommends that a mechanism be devised to encourage existing EATI program participants to convert to a prospective new EATI program structure, should the Committee recommend and the legislature adopt a new EATI program structure. If a new program structure is adopted, the Technical Working Group is willing to work with the Committee, VEPC and the Tax Department to devise such a system for conversion. The Group felt that it was premature to make specific recommendations in this regard until the Committee and the legislature decided to move to a specific alternative EATI program structure.

Finally, the Technical Working Group recommends that the process be put in place to facilitate a prospective transition to any new EATI program structure at the earliest possible date. The process needed in this regard would include such items as the review and approval of needed tax forms, changes to the fiscal cost-benefit analysis and scorekeeping procedures, and other technical issues that may arise. A minimum of 3-4 months would be required to implement the proposed option.

In this regard, the Technical Working Group recommends that—just as with the original program development in 1997—that the Legislative Joint Fiscal Committee (after review and comment by the full VEPC Board) be designated as being responsible for final legislative approval of these specific implementation details in the event the legislature adjourns from its current session prior to the implementation date for any restructured EATI program.

The Group believes that the proposed VEGI option represents an effective and substantial improvement over the current EATI program. It will achieve greater simplicity while maintaining the intent and integrity of the program, better protecting the State treasury against loss and abuse if implemented with the technical provisions recommended in their entirety. If ultimately approved by the Legislature, we would also recommend that the Technical Working Group be maintained to oversee implementation of the VEGI program and address further technical issues, associated award conversion options, and related cost-benefit model update issues.

Please let us know if you or other members of the legislature have any questions associated with the above recommendations or would like us to pursue this or other programmatic options further.