Report of the Vermont State Auditor

June 12, 2008

VERMONT EMPLOYMENT GROWTH INCENTIVE

COMPLIANCE AUDIT PURSUANT TO 32 V.S.A. §163(12)(B)

Thomas M. Salmon, CPA
Vermont State Auditor
Rpt. No. 08-08

Mission Statement

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

THOMAS M. SALMON, CPA
STATE AUDITOR

STATE OF VERMONT
OFFICE OF THE STATE AUDITOR

June 12, 2008

The Honorable Gaye Symington
Speaker of the House of Representatives

The Honorable Peter D. Shumlin
President Pro Tempore of the Senate

The Honorable James Douglas
Governor

Dear Colleagues,

The following report is a result of our audit of the Vermont Employment Growth Incentive (VEGI) program as required by 32 V.S.A. §163(12)(B).

The VEGI program is administered by the Vermont Economic Progress Council (VEPC), with support from the Vermont Department of Taxes.

The VEGI program began on January 1, 2007 as a replacement for the previous Economic Advancement Tax Incentives (EATI) program. In enacting the bill the Legislature indicated the program is to support economic development that results in well-paying jobs with benefits, including health insurance. VEGI authorizations are not based on financial need; the program does not require applicants to furnish financial statements, business plans or tax returns.

In its first year with the VEGI program, the Economic Progress Council authorized $9,686,802 in incentives to 13 companies, an average of approximately $750,000 per award. The program helped to bring at least three companies to Vermont. The companies were projected, over the next six years, to create 1,310 qualifying jobs, $60 million in total new qualifying payroll, and invest $116 million worth of new capital investments.

We reviewed a sample of approved VEGI applications from the 2007 calendar year. Because companies did not claim incentives for 2007 activity until late February 2008, our audit does not cover the process used to pay the 2007 incentives. Our next audit on this program will examine the review and payment process employed by the Department of Taxes for support of the VEGI program.

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This is the fifth time this Office has audited Council activities; for the first time we conducted a more in-depth study of the cost-benefit model performance and other calculations which produce the recommended award amount. The cost-benefit model, according to statute, "shall be a uniform and comprehensive methodology for assessing and measuring the projected net fiscal benefit or cost to the State of proposed economic development activities" over the five-year award period.

In our opinion, VEPC is in substantial compliance with the statutes and other regulations governing the program and its administration, but not entirely. There was a policy change made during the year that appears to contravene State law.

We found that in one of the applications we reviewed VEPC used the incorrect background growth rate in its calculations, resulting in $484,000 of additional incentives.

Also, we found that using the applicant's *industry sector* average growth rate in the award calculations, instead of the company's own historical growth rate, can result in subsidizing growth that would occur normally – not incremental growth as the program seeks to encourage. This is an area that should be reviewed by the Joint Fiscal Committee, which approves changes to the cost-benefit model used.

In the new program, companies can receive an "initial application approval" and a "final application approval." Under State law and VEPC rules, the incented activity cannot begin until the final application approval, which, it turns out, can be several months or more after the initial approval. The problem is that companies, once they receive initial approval from the Council, may have to start up a project before their final application approval. Under current rules, the company cannot "count" the expenditures and payroll growth before the final application approval. Not wanting to penalize a company for early investment, VEPC staff determined a policy adjustment was necessary, but did not seek a Legislative or Council approval; initially, the Department of Taxes indicated it will not recognize investments before the final application to be consistent with State law but, in response to a draft audit report, has indicated that there may be a gap in the statute that needs to be resolved.

A critical job of the Council is to review and vote on an applicant's statement that the activity would not happen, or would happen in a significantly different or less desirable manner, "but for" the incentives offered. In other words, is a proposed project likely to occur without the offer of incentives? If it is, any State financial assistance through the VEGI program is an unnecessary expenditure.

As in past audits, we note that this decision is difficult to audit as it relies strongly on the judgment of the Council members. However, we note in the report that VEPC is not using its own "but for" review checklist which covers a range of "due diligence" steps that can be taken to analyze the "but for" arguments of an applicant. We recommend some possible steps to improve this review.

The VEGI program appears to be much simpler to administer than the previous EATI program and focuses squarely on supporting the creation of well-paying jobs with benefits. VEPC staff is working hard with companies to develop project estimates that are realistic and achievable. The new program has a range of fiscal controls which appear stronger than those of the EATI program, including an annual cap of $10 million in awards and clearly defined annual performance targets.

Our next audit, covering the performance of the Department of Taxes in reviewing claims for payment, will provide the Legislature with an overall picture of this program's effectiveness. Currently, the VEGI program appears to be off to a good start. Review of the growth rate issue and more attention to the "but for" decision process are required to ensure this program's success.

Please feel free to contact me to discuss this report at any time. Thank you.

Sincerely,

Thomas M. Salmon CPA

Thomas M. Salmon, CPA
State Auditor

cc: Michael K. Smith, Secretary, Agency of Administration
James Reardon, Commissioner, Department of Finance and Management
Karen Marshall, Chair, Vermont Economic Progress Council
Fred Kenney, Executive Director, Vermont Economic Progress Council
Thomas Pelham, Commissioner, Vermont Department of Taxes
Kevin Dorn, Secretary, Agency of Commerce and Community Development

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Abbreviations

EATI	Economic Advancement Tax Incentives
EPRI	Economic & Policy Resources, Inc.
FY	Fiscal Year
GAGAS	Generally Accepted Government Auditing Standards
GAO	Government Accountability Office
NAICS	North American Industrial Classification System
SAO	State Auditor's Office
SFY	State Fiscal Year
SIC	Standard Industry Classification
VEGI	Vermont Employment Growth Incentive
VEPC	Vermont Economic Progress Council

Introduction

The Office of the State Auditor (SAO) is required to conduct an audit of the Vermont Employment Growth Incentives (VEGI) program biennially. The VEGI program, approved by the Legislature in 2006, formally began January 1, 2007 and replaces the Economic Advancement Tax Incentives (EATI) program under which no further incentives were awarded after December 31, 2006. By developing the VEGI program the Legislature seeks to spur the creation of new, well-paying jobs with good benefits, including insurance.

The predominant differences in the two programs are:

- a reduction of types of incentives available under the VEGI program;
- if a company meets its goals, incentive awards are now in the form of cash payments from the State's payroll withholding revenue rather than tax credits which are utilized only when a company has taxable liability;
- easier administration to determine achievement of economic targets and new jobs, as well as easier tracking and payment of claims presented by applicants;
- more stringent requirements for recipients to meet their stated payroll targets to earn incentives;
- a cap of $10 million has been applied to the annual award amounts; and
- a requirement that new employees hired due to a company's new project are paid 160% of the minimum wage in effect at the time of application.

However, a similarity in the program is retaining the "but for" assessment. This assessment by the Vermont Economic Progress Council (VEPC) is a pivotal assumption in the program. VEPC must consider and assess the veracity of statements made by a company applying to the program that ***but for*** the incentives offered by the program the company's project would not be occurring or would occur in a substantially different or less desirable manner. VEPC will approve or deny an application based on their assessment.

In this audit, the SAO focused its efforts on the administration of the application process and the decision-making procedures for awarding incentives by the Vermont Economic Progress Council during its first year, 2007. See Objectives, Scope and Methodology on page 6.

We also reviewed the program's cost-benefit model and the consistency of its application. As of the inception of the audit fieldwork no claims had been filed nor cash payments made. Therefore, examining the compliance of the Tax Department in reviewing incentive claims and making payments was deferred to the next biennial audit.

Highlights: Report of the Vermont State Auditor

VERMONT EMPLOYMENT GROWTH INCENTIVE: COMPLIANCE AUDIT PURSUANT TO 32 V.S.A. §163(12)(B)

(June 12, 2008   Rpt. No. 08-08)

Why We Did This Audit

Title 32 V.S.A. §163(12)(B) requires that we conduct a biennial audit of the VEGI program in the first quarter of the second year of the program.

What We Recommend

We recommend in this report that, among other actions:

a. VEPC should recalculate an incentive award where new policy contravenes State law.
b. The "but for" checklist developed by VEPC should be used by staff in order to ensure that all information required is obtained.
c. VEPC seek an independent public advocate for reviewing the applicant's "but for" statements and supporting documentation.
d. VEPC recalculate an incentive award where an incorrect background growth rate was used.
e. The Council should maintain the safeguards built into the program to help protect State resources.

Findings

In our opinion, the Vermont Economic Progress Council (VEPC) is substantially in compliance with the statutes, rules and procedures defined for the program. However, we noted several matters of concern.

One of the applicants tested had activity that commenced prior to final approval and that activity was improperly included in the incentive calculation. The relevant statute says that final approval is to occur before the economic activity commences. VEPC adopted a policy change during 2007 that allows the activity to commence prior to final approval. While policy changes are within their authority to make, if it contravenes State law a statutory adjustment must be approved by the Legislature before implementation.

On one application the signers were not the statutorily designated signers and it was not evident that the signatures obtained were authorized to sign.

In one case there was an inconsistent method of calculating the target payroll levels that the applicant must obtain in order to claim incentives. This is contrary to criteria established by VEPC in applying the cost-benefit model.

The "but for" checklist developed by VEPC to obtain information needed for consideration by the Council in confirming the veracity of applicants statements is not being used. This resulted in missing information required in the new procedures implemented in 2006 to improve the "but for" assessment.

The background growth of a company is removed from the total company growth as a way of assuring that a company's normal year-to-year growth is not subsidized, or "incented." Using an industry average growth rate provided higher incentive awards than a company's own growth rate, in the two cases reviewed. Also, the industry background growth rate used on one of the tested applications was incorrect. The consulting economists used outdated data when they calculated the incentive amount.

The individual wage threshold is 160% of the minimum wage in force at the time of the application, but there is no requirement for that percentage to be maintained in subsequent years if the minimum wage increases.

The $10 million cap on incentive awards and the 80% incentive ratio applied to the pre-incentive net fiscal benefit are important safeguards for prudent fiscal management.

Background

In 2006, Act No. 184 created the Vermont Employment Growth Incentive program (32 V.S.A. §5930b) as a replacement to the Economic Advancement Tax Incentive program. Act 184 noted that shortcomings in the EATI program had been identified in the areas of performance measurements and controls, program expenditure controls, State fiscal losses, and adequacy and availability of program information. 32 V.S.A. §163(12)(B) requires a biennial audit of the VEGI program which "shall include a comparative examination of EATI and VEGI with respect to performance measurements, program expenditure controls, [and] the adequacy and availability of program information."

The Vermont Economic Progress Council (VEPC) consists of nine Vermonters appointed by the Governor who vote to approve or deny incentive applications. The Council must ascertain, "to the best of its judgment, that *but for* (emphasis added) the economic incentive to be offered, the proposed economic development would not occur or would occur in a significantly different and significantly less desirable manner."[1] This "but for" test is a provision continued in the VEGI program from the EATI program and is the prime fiscal assumption of the program. Without the Council's approval of an applicant's "but for" statement, an application cannot be considered for incentives.

In calendar year 2007, the Council considered 17 applications for a total of $10,573,510. See Table 1. Of those applications two were denied and two were rescinded after approval by the end of 2007. The net amount of incentives authorized by the end of 2007 was $9,686,802.

Table 1: Vermont Employment Growth Incentive - Authorization Summary

Company Name	*Type of Company*	*Date Considered*	*Authorization Period*	*Status*	*Maximum Incentive Considered*	*LOCATION*	*Type of Project*
Ink Jet Machinery of Vermont	Manufacturer – Inkjet Print Heads	25-Jan-07	2007 - 2011	Active - Final	$336,055	Dorset	Startup Company

[1] 32 V.S.A. §5930a(c)

Company Name	*Type of Company*	*Date Considered*	*Authorization Period*	*Status*	*Maximum Incentive Considered*	*LOCATION*	*Type of Project*
Olympic Precision, Inc/ WIC/Town of Windsor	Research and Development	25-Jan-07	n/a	Rescinded Sept 6, 2007	$474,428	Windsor	Recruitment from out of state
Monahan SFI, LLC	Manufacturer - Filaments	15-Feb-07	2007 - 2011	Active - Final	$791,277	Middlebury	Plant Restart
Qimonda North America Corp.	DRAM R&D	15-Feb-07	2007 - 2011	Active - Final	$229,672	So. Burl	Retain and Expand VT Company
Rehab Gym, Inc.	Physical Rehabilitation Facility	22-Mar-07	n/a	Denied	$255,439	Colchester	Retain and Expand VT Company
Applejack Art Partners	Resellers of Art Prints	3-May-07	n/a	Rescinded Oct 25, 2007	$85,539	Manchester	Recruitment from out of state
Omni Measurement Systems	Manufacturer – Life Support Systems	3-May-07	2007 - 2011	Active - Final	$677,944	Milton	Retain and Expand VT Company
Vermont Timber Frames	Manufacturer – Wood Products	3-May-07	2007 - 2011	Active - Final	$156,126	Bennington	Recruitment from out of state
Battenkill Technologies, Inc.	Research and Development	28-Jun-07	2007 - 2011	Active - Final	$79,054	Manchester	Recruitment from out of state
Burton Corporation	Wholesaler, Designer & Developer - Snowboards	28-Jun-07	2007 - 2011	Active - Final	$1,653,965	Burlington	Retain and Expand VT Company
Energizer Battery Manufacturing, Inc.	Manufacturer - Batteries	26-Jul-07	2007 - 2011	Active - Final	$607,347	St Albans	Retain and Expand VT Company
NEHP, Inc.	Manufacturer – Modular Equipment	25-Oct-07	2007 - 2011	Active - Final	$182,396	Williston	Retain and Expand VT Company
Green Mountain Coffee Roasters	Manufacturer - Coffee	25-Oct-07	2007 - 2011	Active - Final	$1,786,828	Waterbury/ Essex	Retain and Expand VT Company
Mascoma Corporation	Research and Development	25-Oct-07	2008 - 2012	Active - Initial	$1,942,989	White River Junction	Recruitment from out of state
Albany College of Pharmacy	College of Pharmacy	6-Dec-07	2008 - 2012	Active - Initial	$1,048,047	Colchester	Recruitment from out of state

Company Name	*Type of Company*	*Date Considered*	*Authorization Period*	*Status*	*Maximum Incentive Considered*	*LOCATION*	*Type of Project*
Know Your Source, LLC	Call Center	6-Dec-07	n/a	Denied	$71,302	Burlington	Start-up
Tata's Natural Alchemy	Manufacturer – Natural Skin Care	6-Dec-07	2008 - 2012	Active - Initial	$195,102	Whiting/ Shoreham	Start-up

Once an incentive is approved a company must meet the payroll target listed on its application as well as either the jobs or capital investment target or the award will be rescinded. Once the first year targets are met, those for subsequent years have expanded time frames. If the targets are not met within those time frames, future payments will not be made. The Vermont Department of Taxes has the responsibility for comparing a claimant's activity against the targets and tracking the payments to the claimant.

Objectives, Scope, and Methodology

The objectives of our audit were:

1. To assess compliance with all relevant laws, rules and regulations pertaining to the Vermont employment growth incentive (VEGI) program.

2. To review the design and implementation of internal control systems in place for the VEGI program.

3. To make any necessary recommendations for the program to be managed in a more fiscally sound and well-managed manner.

4. To compare the performance measurements and adequacy and availability of information of the VEGI program with the EATI program.

After the audit fieldwork began, all but two of the 2007 awardees that were still eligible filed claims with the Department of Taxes by March 1, 2008. However, we did not review the claims processing actions of the Department of Taxes, which are ongoing. This aspect of the program will be reviewed in a subsequent audit.

In order to verify VEPC compliance with laws, regulations and adopted procedures and to assess the effectiveness of internal controls based on our understanding of the VEGI program, the application process of VEPC and the awarding of incentives by VEPC, we conducted interviews with the Executive Director of VEPC; the VEGI program specialist at the Vermont Department of Taxes; and Economic & Policy Resources Inc. (EPRI), consultants to VEPC. We also reviewed the following documents, among others:

- Statutory references to the program;
- Program information;
- Administrative rules for the VEGI program produced and published jointly by VEPC and the Department of Taxes;
- Applications for the program; and
- *Information Regarding Cost-Benefit Modeling Approval Criterion*, produced and published by VEPC.

We traced the application of procedures to the documentation in the tested applicant files. Further, audit reports issued on the previous EATI program were reviewed.

We reviewed the VEPC files for the selected test applicants to determine whether the applications were complete and timely according to the policies set forth by VEPC and that application of the cost-benefit model was consistently applied. We also reviewed the documentation to verify the due diligence applied by VEPC staff before making a recommendation to the Council. Documentation in the files includes the preliminary or initial application; the final application and all pertinent documentation; correspondence between VEPC and the applicant, EPRI and others; minutes of VEPC meetings; the cost-benefit model calculations, the Finding of Fact and Opinion in Regards to the "But For" Determination, and other information.

Four of the 13 approved applications were selected for testing. Selection of the applicants was based on the application being final, that the authorization period began in 2007 and whether the case was active (not denied or rescinded) as of December 31, 2007. Also considered was a mix of the type of applicant (i.e., startup; recruitment to Vermont; retain and expand existing Vermont company) and a spread of the geographic locations in order to cover various areas of the State.

Further compliance testing included obtaining an understanding of any changes to the cost-benefit model and determining if these changes were appropriately conveyed to the Joint Fiscal Committee as required by 32 V.S.A. §5930a(d). Also determined was the consistency of applying the model to the various applications.

We reviewed the various documents that VEPC has created outlining the program rules, guidelines and procedures, VEPC meeting minutes, statutes and other documents as well as the State of Vermont *Personnel Policy and Procedures* and the *Executive Code of Ethics* which is applicable to the Council members as gubernatorial appointees to assess the effectiveness of the design and implementation of the internal control system.

In order to assess fiscal management we looked at the key factors of the program – the "but for" assessment and the cost-benefit model.

The cost-benefit model is instrumental in the calculation of the amount of incentive awarded. In order for the model to calculate the approximate fiscal costs and benefits associated with applications submitted, various manual inputs are required, among them the selection of the proper North American Industrial Classification System (NAICS) industry code and applicable background growth rate as well as the regional differential adjustment county groupings. We verified that the appropriate code was utilized based on the applicant's industry and recalculated the background growth rate for the four test applicants.

Additionally, we performed the following, among others:

- Read the minutes of the VEPC meetings for all of 2007;
- Attended VEPC meetings;
- Reviewed the memos from the Technical Working Group to the Joint Fiscal Office;
- Observed the cost-benefit model in operation; and
- Consulted with an economist who was a member of the Technical Working Group.

To compare the VEGI program with the EATI program, we reviewed the relevant statutes affecting both programs and conducted interviews with the administrators of the program – VEPC and the Tax Department.

Generally Accepted Government Auditing Standards (GAGAS) require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We performed this audit from January 2008 to March 2008 in accordance with GAGAS, except for the standard that requires that our system of quality control for performance audits undergo a peer review every three years. Because of fiscal considerations, we have opted to postpone the peer review of our performance audits until the next scheduled peer review of our financial audits, which is expected to occur in 2010.

Finding 1
Compliance with Laws, Rules and Regulations

VEPC is in substantial compliance with the laws and regulations that pertain to the Employment Growth Incentive program, but not entirely.

For example, Act No. 184, Sec. 11 of the 2006 legislative session creates an annual cap on the amount authorized each year of $1 million for awards which have a net negative fiscal impact to the State and $10 million on total annual awards. VEPC interprets the annual cap as the maximum amount of money that will be awarded for projects begun in any given year[2]. In 2007, 17 applications were considered for a total of $10,573,510. Of those applications two were denied and two were rescinded by the end of 2007. The net amount of incentives authorized by the end of 2007 for activity beginning in the year 2007 was $6,500,664 which is in compliance with the annual cap of $10 million in total awards for the year. All applications approved in 2007 were projected by VEPC to result in net positive fiscal impacts on the State[3];

[2] For example, VEPC might authorize $12 million in awards in the same year, with $9 million applicable to projects beginning in that year and $3 million applicable to projects beginning in a subsequent year. The $3 million will then reduce the $10 million cap on awards for that subsequent year.

[3] Any fiscal benefit to the State is predicated on "but for" assessment being correct. Validation of the information provided by the applicant is pivotal to the decision made by Council. While VEPC has made a reasonably good effort to assess the validity of the statement, it is impossible to verify that the project would or would not have occurred without the incentives and, thus, it is likely the program represents some net fiscal cost to the State by paying for some economic activity that would have happened anyway.

therefore, no awards went against the $1 million cap for net negative applications.

As another example of compliance, we assessed the timeliness of the Council's approval based on the date of the applications. According to 32 V.S.A. §5930a(b)(3) approval or denial of an application should occur within 60 days of receipt of the complete application. In all tested applications the decisions of the Council occurred on a timely basis.

Despite general compliance with statute and regulations, however, we noted the following matters.

Application Signatures by Corporate Officers

Criteria: 32 V.S.A. §5930b(b)(1) requires that applications shall include specific information, including a statement, to be signed by a company's President, CEO or equivalent, acknowledging the complete or partial reversal of incentives may occur if a company fails to meet the minimum capital investments by the end of the award period.

Condition Found/Cause: In one of the tested applications, signatures for the application and the "but for" statement were obtained from the plant manager and the North America Controller. There was an e-mail in the file from the applicant to VEPC staff that said the controller was not an officer of the company. There is no indication within the application that ensures the controller is a top corporate officer or has the authority to sign in lieu of one. Per the application instructions, the signature for non-Vermont companies must be from a top officer from corporate headquarters. VEPC rules also require signatures from two top company officials, a higher standard than the statute.

Effect: If a company's performance is such that a recapture of the incentive payments is necessary, the State's resources are at risk if the application is signed by personnel not authorized to sign on behalf of the company.

Recommendation: VEPC should include a signed attestation statement on the application that signatories other than the president or CEO are authorized to sign on their behalf.

Date of Project Commencement

Criteria: Per 32 V.S.A. §5930b(b)(2) final application approval is to occur prior to commencement of economic activity. To determine whether any activity occurring prior to the commencement date is considered in the incentive calculation, we compared the activity start date to the final application approval date of selected applications.

Condition Found/Cause: On one application the incented activity began prior to final approval by VEPC. The program allows a preliminary application to be filed which the Council may approve if the "but for" and program guidelines are met. This gives the company an opportunity to include more definitive payroll and employment data since the performance benchmarks of the program are very strict. A final application must be filed and approval given before incented activity commences.

The initial application was filed on May 4, 2007 and approved on May 24, 2007. The final application was not filed until October 5, 2007 with final approval occurring on October 25, 2007. In the letter accompanying the final application, the applicant notes that spending activity has occurred based on the initial approval. Also, a zoning permit application was filed on July 13, 2007 in the town where the activity was to occur. A May 29, 2007 letter from VEPC applicant states that the final application must be submitted prior to the Council meeting that will occur prior to commencement of the economic activity for which incentives were approved. On the final application dated October 5, 2007 the date economic activity was to begin was stated as May 24, 2007. It does not appear that incentives were adjusted for this variance from statute. According to the Internal Audit Supervisor at the Department of Taxes who is responsible for administering VEGI claims, they will follow what the statute says which would be to consider only activity subsequent to the final application as eligible activity for determining whether or not to approve a claim for an incentive payment.

Section 3 of the Administrative Rules of VEPC regarding claiming the incentives states, "To qualify towards meeting the target, a capital investment must have been made after the application approval date…" According to VEPC's Executive Director, there was an informal policy change regarding using a "commencement date" as the activity start date rather than the date of the approval of the final application. The Council did not vote on this policy change, according to VEPC staff. SAO reviewed the minutes of the VEPC meetings in 2007 and confirmed that there was no discussion of this policy change in the minutes. According to the new policy, once the initial approval is given, the "but for" statement is deemed to have been met and economic activity and investments can begin. The start date is no longer subject to the final approval from the Council, according to the new policy. The later filing of the final application makes it more likely that the applicant can meet its targets because they will have better target numbers on the application, staff asserted, despite the policy being apparently at odds with Vermont law.

Effects: When activity is allowed to commence prior to submitting the final application, the Council may have effectively lost the opportunity to revisit the "but for" statement at the final approval stage, if necessary, based on new information about the application. Once an applicant has incurred costs for its project based on the initial approval, the Council may have difficulty disallowing the application without subjecting itself and the State to potential recrimination from the applicant.

Since the policy change was not approved by the Legislature, when the claim is filed by the applicant, the Tax Department plans to process the application based on the final approval date which is a different project start date than expected by the claimant. This could mean that the company does not meet its targets.

Allowing activity to commence prior to the approval of the final application will encourage applicants to file their final applications only in the last quarter of the year when the numbers are substantially set.

This informal policy change appears to be contradicted by statute as discussed above. Policy changes at VEPC are allowed as long as they do not contravene State law; statutory adjustments must be approved by the Legislature before implementation.

Recommendation: VEPC should consult with the Tax Department as to possible impacts of policy changes. In the case above, VEPC should recalculate the incentive award to disallow activity occurring prior to the approval date of the final application so as to be in compliance with statute and do so for all affected applications.[4]

Further, we recommend that VEPC imposes a limit on the time an applicant is given to file the final application after initial approval is given. A 60-day limit will allow a company sufficient time to gather the data it needs to determine its project costs while discouraging a company from waiting until year-end to file the final application in order to assure that its targets are met.

Consistency of Cost-Benefit Model

Criteria: According to 32 V.S.A. §5930a(d) the cost-benefit model shall be "a uniform and comprehensive methodology for assessing and measuring the

[4] In 2008, the Legislature softened the restrictions on claimants by allowing two years to meet the first year targets and eliminating the provision in statute to rescind the award if the first-year targets were not met. This change is retroactive to January 1, 2007.

projected net fiscal benefit or cost to the State of proposed economic development activities."

Condition Found/Cause: We reviewed the consistency of the calculations in the application file selected for testing. We noted a lack of consistency among the four tested applicants regarding the calculation of incented payroll by EPRI due to a calculation error. In three of the applications, the background growth rate was applied against the full-time non-owner payroll, as required by the cost-benefit modeling criteria, to get the dollar amount of background growth in the first year. However, on one application, the background growth rate was applied against incremental qualified payroll targets rather than the full-time non-owner payroll.

The cost-benefit model was developed by Vermont economists with input by the Joint Fiscal Office and was originally adopted in 1998 after review and approval from the Joint Fiscal Committee. In 2006, due to the elimination of the cafeteria-style menu of tax credit options under the old program, the model was adapted to allow for processing of applications in the VEGI program. It calculates the economic impacts to the State of a proposed project outlined on an application. The model is managed for VEPC by an outside consulting firm, Economic & Policy Resources Inc., (EPRI) of Williston, under a State contract. EPRI receives the applicant data from VEPC and provides a report to VEPC on the likely fiscal impact of a proposed project. The assumption in the model that underlies all calculations of net fiscal costs and benefits is that a project has or will pass the "but for" test – that the project will not proceed without the incentive. Included in the model is a calculation of the expected growth rate of the company without the project. This is a company's "background" growth rate. The purpose of the VEGI program is to incent activity that would not otherwise occur; therefore, the anticipated growth rate indicated on the application must be reduced by the background growth.

Effect: The overstatement by EPRI of the amount of payroll considered for the incentive calculation resulted in a higher payroll target that the company needs to meet to claim their award.

Recommendation: The amount was not significant enough to warrant recommendation of recalculation of the incentive award for this applicant. However, verification of the calculations returned by EPRI should be done by VEPC staff to ensure consistent methods are applied.

Wage Threshold

Criteria: According to Guideline No. 2 of 32 V.S.A. §5930a(c), new jobs created should meet or exceed the prevailing compensation level for the particular employment sector. In order for a new job to be considered a qualifying job on the application[5] the minimum annualized Vermont gross wages and salaries paid must be not less than 60% above the minimum wage at the time of the application.[6]

Condition Found/Cause: VEPC interprets this to be the average annualized wage for the year so that companies that boost an individual's pay after a training or probation period to above the qualifying wage will be able to include those jobs in their targets as long as the average wage for the year ends up meeting the qualifying wage level. For example, in 2007 the qualifying wage was $12.05 per hour. If a company hired an individual on January 1st at $11.75 per hour and on July 1st that person began making $12.35 per hour, the wage would average $12.05 per hour for the year. This target amount does not go up. Once a wage qualifies in the first year it must not go below that amount in subsequent years but does not need to go above it.

We found no instances of noncompliance with this guideline. However, the SAO is concerned about the wording in the guideline that allows for the qualifying wage to be at least 160% of minimum wage at the time of the application but does not require the percentage to remain the same for those individual jobs in subsequent years. In the applications, it is not clear if payroll growth after the first year will increase the wages of people hired in the first year, but that could well be the case.

Effect: In 2007 the Vermont minimum wage was $7.53 per hour. The VEGI qualifying wage level for new hires was $12.05 per hour. As of 2008 the minimum wage was raised to $7.68 per hour for a qualifying wage in 2008 of $12.29 per hour. If the wage of the individual who qualified in 2007 remains at $12.05 per hour they will fall below the wage threshold of 160% established in the first year. Their percentage will be only 157%. If the minimum wage increases again in the next year without raising the individuals pay, the percentage will decline further.

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[5] 32 V.S.A. §5930b(a)(20) and 32 V.S.A. §5930b(a)(24).

[6] The threshold may be larger for some companies at the discretion of the Council. (32 V.S.A. §5930b(b)(3)).

Recommendation and discussion: The Legislature should consider revising the statute to require the wage threshold to remain at 160% of the current minimum wage through the entire award period.

Finding 2
Design and Implementation of Internal Control Systems

Internal control is a process designed by management to provide reasonable assurance that a program will meet its objectives, especially in regards to effectiveness and efficiency of operations; reliability of reporting; and compliance with laws and regulations. Internal control is intended to keep performance within what is expected, accepted or allowed.[7]

The various documents provide clear guidance to applicants, staff and other program administrators as to how the program is to be administered.

However, we noted the following matters.

"But for" Checklist

Criteria: According to 32 V.S.A. 5930a(c), "applications that do not meet the 'but for' test are not eligible for economic incentives, and shall not be considered further by the council."

According to VEPC's *"But For" Application Requirements and Procedures* (January 2006), after an application is received and reviewed by VEPC staff, questions should be sent to the applicant that "will help determine the efficacy of the 'But For' statement presented by the applicant." Step No. 5 of the procedures says a "but for" review checklist is to be used. This checklist includes names and contact information on incentives offered by other locations. It also includes data supporting the documentation of significantly different or less desirable outcomes or financial need. These are the required, not optional, items.

Additionally, employees and appointees of the State of Vermont are required to "pursue the common good in their official activities, and shall uphold the

[7] Adapted from the Internal Control Integrated Framework of the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

public interest, as opposed to personal or group interests," according to the State of Vermont Personnel Policy and Procedures Manual.

Condition Found/Cause: This checklist was not in any of the test files. Per VEPC's Executive Director, a checklist is not used for the preliminary "but for" review.

We looked for evidence of due diligence by VEPC staff in confirming the veracity of the statements made by the applicants. We also checked town records for two of the applicants to ensure that no construction permits were obtained prior to the application date on the form which could be evidence of a previous decision to do a project without VEGI incentives. Only one of the four tested files had indicated that permits had been obtained prior to the application and those permits were in another state.

However, the project for one applicant resembled the project described in a previous year on a permit application seen at the local Planning Office. As necessary, due diligence in the application review process should include discussions or visits with local planning offices to help determine if a project might likely occur without State incentives.

We then reviewed the documentation related to the "but for" statements in each of the four test applications and compared them to the requirements of the procedure adopted by VEPC in January 2006. Our findings on the list of required documents called for by this procedure are:

- Three of the test applicants stated they had a location decision to make – whether to locate in Vermont or elsewhere. The procedure requires information on other locations, incentives and contact information. Only one of the three provided contact information; one provided general information on other incentives available but no contacts or information specific to which incentive they were applying or had received; and one applicant provided no information on other incentives at all.

- The tested applicant that was not a location decision should have provided data supporting documentation of a significantly different/less desirable outcome or financial need per the requirements of the procedure listed on the checklist. There was no evidence of this in the file.

- The requirements and procedures developed by VEPC also require that a statement of good standing from the Tax Department is obtained. Only one tested applicant had this in their files.

- Also required by the procedures is a Secretary of State listing. Neither of the two established Vermont companies tested had the Secretary of State listing in the file.

The procedure calls for questionnaires to be sent to the applicants to determine the efficacy of the “but for” statements. We noticed e-mail communication subsequent to receiving the documents in all of the tested applications. In two of them, VEPC staff communicated concerns about the wording of some of the narrative descriptions and recommended changes to the wording apparently to avoid giving the impression that the project *will* happen. For example, an e-mail from VEPC staff to the accountant who completed an application states “you should avoid using the term ‘will’ anywhere in the application since that indicates intent regardless of the incentives.” By telling this to an accountant who could file applications on behalf of multiple clients, VEPC may have reduced its ability to effectively identify wording in subsequent applications which might give rise to questions regarding the accuracy of an applicant’s statements regarding the need for an incentive award.

The e-mails show that the applications were reviewed for completeness and discrepancies. However, specific questions pertaining to the veracity of the “but for” statements seemed to be predominantly in reference to discrepancies within the application, where it appears staff could have asked more probing questions about whether a location decision had already been made.

VEPC staff may have received satisfactory evidence to their concerns other than the rewording on the applications but there was insufficient evidence in the files to determine whether the “but for” statement was addressed completely and appropriately before the application was presented to the Council.

Effect: The procedures developed by VEPC are to assure sufficient work is done in assessing the reasonableness and accuracy of the “but for” statements. If steps in the review process are not followed, the risk increases of not detecting in a timely manner that a planned project is likely to occur without incentives. If applicants are guided toward ambiguity about their intentions, the risk of an inappropriate award increases, which would unfairly favor a private interest and be injurious to the public good and finances of the State.

Recommendation: It is in the obvious best financial interest of the State to avoid paying incentives for economic activity that would likely happen without those incentives. The SAO recognizes that VEPC staff must publicize the program and work with a company to complete its application accurately and completely. SAO recommends to VEPC that all the tools available to the staff be used, such as the “but for” checklist.

To this end, we recommend the Council consider the involvement of an independent public advocate for the State reviewing an applicant’s “but for” statements and supporting documentation. The Council relies heavily on the signatures certifying the information is correct while not providing an adequate process for reviewing the statements and data prior to the award. An arms-length, independent assessment, perhaps by a consultant supervised by the Joint Fiscal Office or the State Treasurer’s Office, could provide additional analysis to the Council.

The Council should also consider adopting a policy and process to bill the costs of additional due diligence, when deemed necessary, to a company’s first-year payments through a reasonable “bill back” provision.

We also recommend to VEPC staff that if an applicant gives any indication that the project may occur without the incentive, the due diligence that is performed by VEPC staff should be better documented in the files and the questions and answers communicated to the Council in a timely manner.

North American Industrial Classification System Codes

Criteria: In 2006 the cost-benefit model was updated for annual changes to labor data as well as changes that needed to occur because of the transition from the EATI program to the VEGI program.

Among the updates for the labor data was the use of North American Industrial Classification System (NAICS) codes rather than Standard Industry Classification (SIC) codes to help determine the respective background growth rates used in the incentive calculations.

Condition Found/Cause: We verified the use of the NAICS codes for the selected applicant industries and recalculated the background growth rate.[8] SAO concurs with the NAICS codes listed on the applicant files and saw the evidence in the files that VEPC staff confirmed the codes. However, EPRI used an outdated code when calculating the background growth rate for one

[8] The calculation used by the SAO to determine the background growth rate is a standard rate calculation in Excel. Using this formula resulted in the same rates as calculated by EPRI in all tested cases with the exception of the one under discussion.

applicant. For the 2006 annual update the Vermont Department of Labor had provided combined codes for two of the industries. On April 3, 2007 DOL separated the codes and provided the historical growth detail for each of the codes retrospectively for all years available. However, EPRI used this outdated combined rate rather than the updated information. For a July 2007 application VEPC staff included a copy of the correct data in the file which would have meant using a background growth rate of 4.2%. EPRI used the outdated information for the calculation which resulted in a significantly lower background growth rate of 1.6%. An EPRI representative indicated their reasoning for doing this is two-fold:

1. For consistency in the event two applicants from the same industry apply in the same year, and

2. They only perform *annual* updates to the data going into the model citing a lack of economic feasibility in doing otherwise.

The SAO disagrees with this reasoning. We believe that consistency should be applied in the methodology for applying the model. However, the data going into the model for each applicant differs on a case-by-case basis. VEPC staff indicates that it maintains a spreadsheet that parallels the data returned by EPRI as a control check. This control could be added to that spreadsheet. If VEPC had verified the rate using the formula indicated in Footnote 7 they would have noted the discrepancy and had the model run with the correct data.

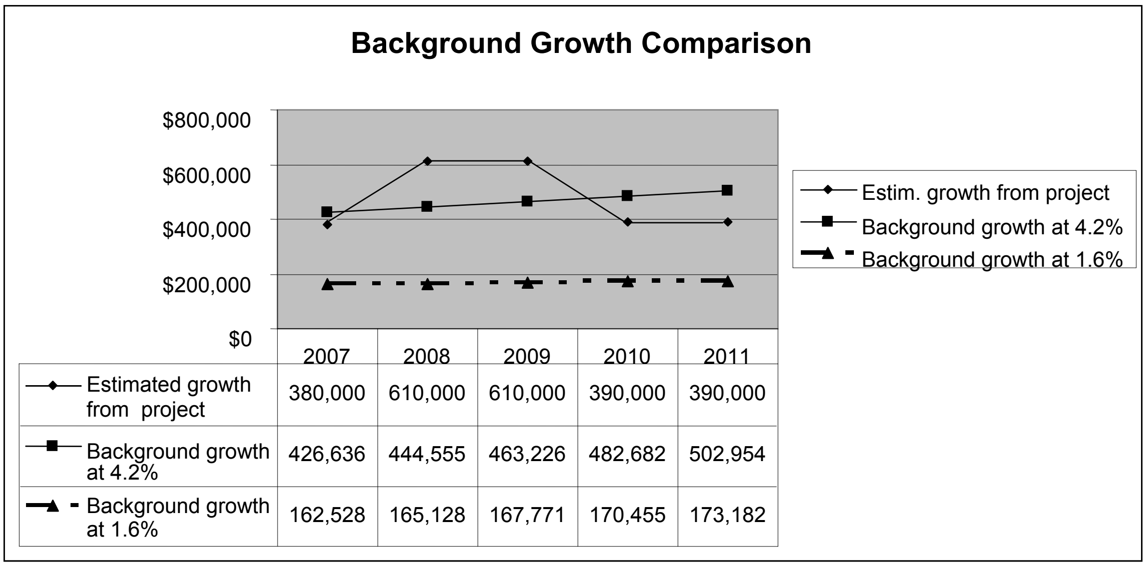
Effect: As demonstrated in Figure 1 below, the payroll growth the company is expected to achieve due to this project does not exceed the actual industry background growth rate in years 1, 4 and 5. Only the years 2 and 3 would be considered as part of the incentive calculation. If the correct background growth rate of 4.2% is used, the payroll targets would be reduced by $444,555 and $463,226 in 2008 and 2009, respectively, to come up with the incented payroll. Instead, VEPC reduced the payroll targets by $165,128 in 2008 and $167,771 in 2009 for a difference of $574,882 just for those two years.

Overall, the understatement of the amount of industry background growth over the five-year period used to calculate the incentive is $1,480,988. Had EPRI used the updated industry growth rate, the applicant's authorized incentive award would have been reduced by $484,289.

Recommendation: We recommend that VEPC should use the correct background growth rate to recalculate the incentive award for this applicant.

Also, VEPC should add recalculating the background growth rate as a control to their verification of the data going into the cost-benefit model per applicant and have the data rerun when an obvious discrepancy occurs.

Figure 1: Comparison of Background Growth (2007-2011)



	2007	2008	2009	2010	2011
Estimated growth from project	380,000	610,000	610,000	390,000	390,000
Background growth at 4.2%	426,636	444,555	463,226	482,682	502,954
Background growth at 1.6%	162,528	165,128	167,771	170,455	173,182

Regional Differential Adjustment Factor

Criteria: Guideline No.1 of 32 V.S.A. §5930a(c) states, "Preference should be given to projects that enhance economic activity in areas of the State with the highest levels of unemployment and the lowest levels of economic activity."

VEPC has responded to this by building into the cost-benefit model a Regional Differential Adjustment Factor by which counties are grouped by level of economic performance as follows:

Region 1 (economically underperforming areas)
Caledonia, Essex, Franklin, Grand Isle, Orleans

Region 2 (performing around state average)
Addison, Bennington, Lamoille, Orange, Rutland, Washington, Windham, Windsor

Region 3 (performing above state average)
Chittenden

The counties are assigned a differential factor which is applied to the rate used in the Present Value formula for calculation of the pre-incentive cost benefit.

Assigning the different factors provides a means where preference may be given for projects occurring in areas of the state that are underperforming economically. According to the rules of conduct (No. 10) in the Cost-Benefit Modeling approval criterion, the county groupings should be updated every year.

Condition Found/Cause: The correct regional differential adjustment county groupings code was applied in the incentive calculations. However, per staff at EPRI, the county adjustment groupings are not updated annually. They are only updated periodically unless a significant change occurs in the economic conditions of a region. The latest update was two years ago.

Effect: Ensuring the groupings are current reduces the risk of applying improper discounts to the present value formula. If an improper rate is used, preference may not be given to companies looking to build or expand in underdeveloped areas.

Recommendation: We recommend that VEPC should update the grouping annually or revise its operating guidelines to reflect the correct methodology.

Finding 3
Fiscal Management

32 V.S.A. §163(12)(B) states that the audit shall include recommendations for improved accountability and fiscal controls. Since the program has just completed its first year it is premature to look at VEPC's accountability for the program. This will be deferred until a subsequent audit. However, the fiscal controls and management of the program were assessed. We believe that the controls and safeguards built into the program are important elements for mitigating risk within the program.

Annual Cap Imposed on Awards

Fiscal management of the VEGI program is most acutely guided by two factors – the determination of whether the proposed economic activity would not occur or would occur in a significantly less desirable manner *but for* the incentive received (the "but for" assessment) and the economic modeling, specifically the background growth rate calculation which helps assure that an economic project produces jobs and investments that are <u>above</u> growth levels typically expected.

The evaluation by the Council of the "but for" reasoning given by the applicants is subjective. The Council must, to the best of its judgment, vote on whether or not a planned economic development proposal would happen without incentives or would occur in a significantly different or less desirable manner.

Even though the Council has implemented procedures designed to support the reasonableness of the statements made by the applicants, the review process cannot assure 100% accuracy on this decision. Nor are those procedures necessarily followed as indicated by the internal control discussion of the previous section. Thus, the premise that is supposed to ensure net fiscal neutrality in the program is imperfect.

As even program sponsors acknowledge, some projects might be approved which would have occurred without the incentive support. In light of this possibility, the Legislature has implemented two safeguards in the VEGI program that are designed to help protect the State's resources.

1. An incentive payment is a reduction in revenue that is outside the State's budgeting procedure and outside the Legislature's annual appropriation process. As a fiscal control, the Legislature has imposed an annual cap of $10 million on the total amount of incentives that may be authorized each year.[9]

2. An incentive ratio of 80% is applied to the pre-incentive net fiscal benefit in order to calculate the maximum award amount. This "discount" on all awards helps to offset potential misstatements such as an erroneous determination in the Council's decision that a project would not have

[9]The $10 million cap on total incentives may be exceeded by VEPC with application to and approval from the Emergency Board (2006 Act 184 Sec. 11(c)).

occurred without the benefit of State funds or a wrong assumption in the cost benefit model.

Recommendation: We recommend to the Legislature that these safeguards should be maintained for prudent fiscal management of the State's resources.

Historical vs. Industry-Average Growth Trends

Secondary to the "but for" test as a fiscal control is the calculation of the background growth rate. To help ensure that only incremental job, payroll and capital investments are incented, a company's anticipated rate of growth is reduced by its background growth rate over the proposed project period. In other words, the amount of payroll that qualifies as new full time wages due to this project is reduced by the payroll growth the applicant entity can normally expect. The company's payroll targets over the project period are determined by calculating and deploying the background growth rate correctly.

Example: A company's full-time non-owner payroll is $107,000 in the base year. It expects this number to grow by $38,000 in the next year due to the project described in the application. The background growth rate is 3%. In other words, the payroll would be expected to grow under normal circumstances by $3,210 ($107,000 × 3%). The payroll that would be considered for the incentive calculation is $34,790 ($38,000 - $3,210).

The cost benefit model uses the North American Industrial Classification System (NAICS) industry growth averages for Vermont as collected by the Department of Labor. Using the historical growth rates of individual companies that have Vermont activity, which might be higher or lower than the industry average, is an alternative that has been the subject of much discussion in the past, according to VEPC and its consulting firm.

In order to determine the impact of using a company's historical growth rates, we compared the growth rates of two of the companies within the test selection that were not startup companies and which have years of historical payroll data in the State of Vermont.

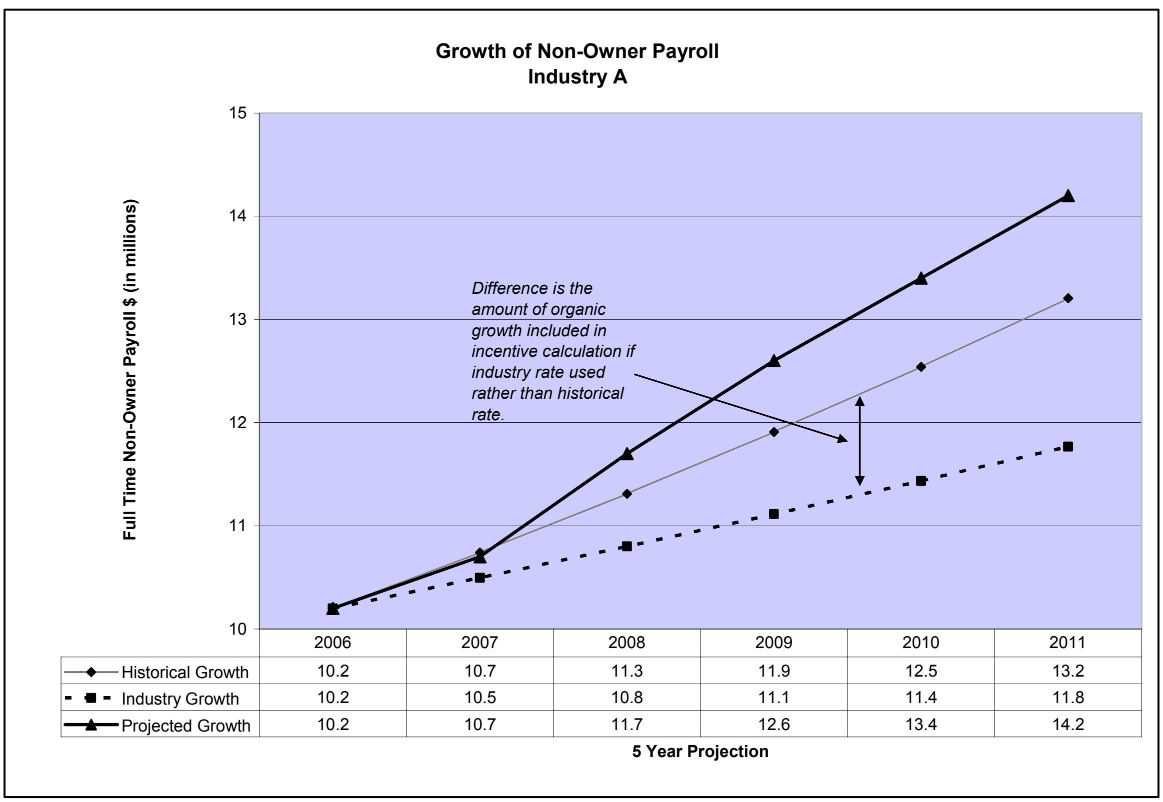
We individually applied both the historical growth rate and industry growth rate to the non-owner full-time payroll on the applications. Next we plotted the resulting data against the projected rate of growth based on the application data to assess the amount of growth included in the incentive calculation that was reasonably expected to occur. See Figures 2 and 3.

The historical growth rate of the companies exceeds industry averages in both cases. (NOTE: The industry rate used by EPRI in the actual applicants' incentive calculations is based on a 15-year period. However, for comparison purposes a six-year average was used as this is consistent with the period of time available for the historical rate calculation.)

<u>Industry A</u>

Figure 2 shows the historical growth for Industry A outpacing the industry growth for the five-year projected period of time. By totaling the annual differences we can see that an additional $4.0 million of growth in full-time non-owner wages was included in the incentive calculation that would be expected to occur, according to historical trends, without the incentives. The amount of qualified payroll to be incented would be reduced by $763,010 ($819,148 using industry average versus $56,138 using historical rates). See Appendix II.

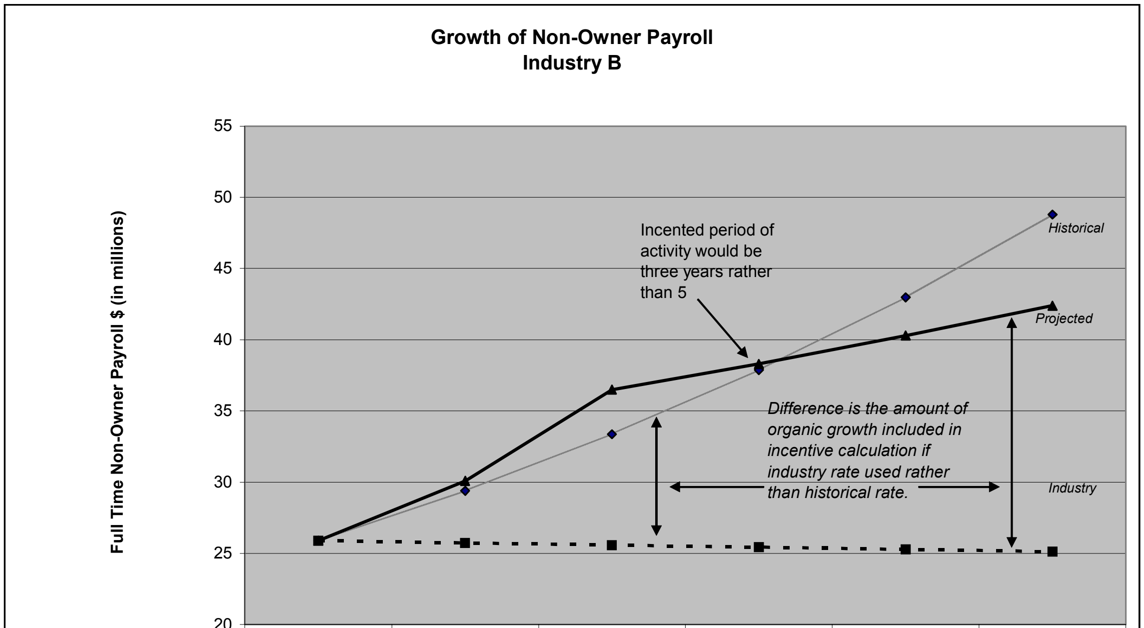
Figure 2: Growth Rate Comparison (Industry A)



<u>Industry B</u>

Figure 3 for Industry B also shows the historical rate outpacing the industry rate for the projected five-year period of time. In this case, the historical rate also exceeds the anticipated growth that is to occur due to this project. Therefore, if the historical rate was used, the 5-year period would necessarily be reduced to 3 years as the crossover point occurs in the third year following the base year. By totaling the annual differences we can see that an additional $65.4 million of growth in full-time non-owner wages was included in the incentive calculation that would be expected to occur according to historical trends without the incentives. The amount of qualified payroll to be incented would be reduced by $10,507,042 ($12,044,067 using industry average versus $1,537,025 using historical rates). See Appendix III.

Figure 3: Growth Rate Comparison (Industry B)



	1					
Historical Growth	25.9	29.4	33.4	37.9	43.0	48.8
Industry Growth	25.9	25.7	25.6	25.4	25.3	25.1
Projected Growth	25.9	30.1	36.5	38.3	40.3	42.4

5 Year Projection

In the cases above, the State reduces incentive amounts by using the historical growth rate of the applicant company.

We believe it would be in the economic interest of the State to use the historical rate where it is higher than the industry rate. In an effort to understand the issue more fully we asked the President of EPRI for historical information surrounding the decision to use industry rates.

> “As I recall, there were proponents on both sides of that issue—industry-wide versus the individual applicant company. In the end, the consensus of all those involved to the best of my recollection was that the individual company approach was problematic because many potential applicant companies would have been just past the start-up phase, and therefore did not have representative histories that could be averaged. The discussion then transpired through the technical development process [and]VEPC

> Board review process where a need was identified to calculate a 5-year or some representative industry average for those applicant companies where there was not enough representative history. Then the point was made – I don't remember by who but it carried the discussion to its conclusion – that if we needed to calculate a 5-year industry average by region, the program ought to use a standard approach for all potential applicant companies so there was a 'level playing field' – for all applicant companies whether large or small, existing or start-up."

Leveling the playing field seems to be inconsistent with legislative intent to not incent normal growth activity of a company. It means all companies within the same industry are expected to grow at the same rate. When a company that is outpacing its peers applies for an incentive, a part of the normal growth of the company which can reasonably be expected to occur is included in the incentive calculation under current rules.

Recommendation and discussion: In the interest of sound fiscal management of the VEGI program and the State's resources, we recommend to VEPC and the Joint Fiscal Committee that a company's historical rate of growth, if higher than industry average, be used in the cost-benefit model when it is available.[10]

Finding 4
Comparative Assessment of VEGI with EATI

In 2005, a Technical Working Group, comprised of Tom Kavet, Consulting Economist to the Joint Fiscal Office; Jeff Carr, Consulting Economist to VEPC; Susan Mesner, Tax Department Economist and Mike Wasser, Tax Department Policy Analyst was asked by members of a legislative committee to review options and make recommendations for a simplified version of the EATI program that addresses the concerns about the program raised by the

[10]It was not difficult for SAO to obtain historical payroll information. Through cooperation from the Vermont Department of Taxes we easily obtained the payroll data from the earliest year on file and the base year (the year before the VEGI application). From those two figures the company's growth rate was calculated. It would not be necessary to cause additional burden on the applicant to get the information on a year-by-year basis through the application process.

SAO, by the Legislature and various branches of the administration, including VEPC and the Tax Department.

According to this Technical Working Group, the resulting VEGI program should not represent any greater fiscal expense to the State; should "emphasize job growth, more directly link company performance to award payouts, minimize subjective award revisions by eliminating deferral and mitigation and minimizing the need for recapture."

In our opinion, the VEGI program is much simpler to administer than the previous EATI program and focuses squarely on supporting the creation of well-paying jobs with benefits.

A comparison of the two programs involved first noting the statutory changes and consistencies with the programs. A comparison was also done in the administration of the program and included looking at the following program aspects (see table 2):

Table 2: Comparison of the EATI and VEGI programs

Program Aspect	EATI	VEGI	COMMENTS
Application	One application only.	Provides for a preliminary approval based on an initial application followed by a final approval at a later date, before economic activity commences.	The additional application allows a company to firm certain cost projections in an effort to ensure the first-year targets will be met.
Cap on award amounts	No cap on theoretical net positive projects; $2 million cap on net negative awards.	$10 million annual cap in total; $1 million cap on net negative awards	This cap is the most important fiscal control. Some of this entire cap may represent a real net fiscal cost to the State.
Restrictions on claimants	Deferral provisions built into process.	Stricter. The applicant must meet stated payroll and jobs or capital investment targets in first year or the award is rescinded.	A revision of this penalty was passed by the Legislature in 2008 to allow two years to meet the first-year target and eliminated the requirement to rescind the award if targets are not met. This is retroactive to January 1, 2007.

Program Aspect	EATI	VEGI	COMMENTS
Recapture provisions	Statute provides several requirements that can trigger recapture if not properly followed by companies. (Ex. Failing to substantially comply with all performance expectations; most critically, failure to maintain the minimum threshold for employment levels. (See 32 V.S.A. 5930h(c))	The 2nd and 3rd year targets are given two years following the award year to be met or all remaining awards will be denied. The 4th year target is allowed an additional year to be met (by the end of year 5) or years 4 and 5 awards will be denied. The 5th year target must be met that year in order to receive the award. The payments are recaptured when employment targets drop below 90% of base year levels.	The EATI provisions are long and complicated whereas the VEGI provisions are simpler to understand and to implement and administer. Due to a change in the statute in 2008 (H.888), the 1st year targets now also have two years following the award year to be met.
Deferral provisions	Complex	Eliminated.	Simpler for the Tax Department to track.
Claimant payments versus credits	Awards issued in the form of tax credits that may or may not be used by the claimant depending upon its own level of liability.	Awards issued in the form of a payment out of the State's revenue from withholdings account redeemed in 1/5 installments over a 5-year period.	Statutory language seems to indicate payment is to come from a company's withholding account.
Wages	Company must meet or exceed prevailing compensation level, including wages and benefits, for the particular employment sector. 32 V.S.A 5930a (c)(2).	Qualifying jobs considered for the incentive award are those meeting a wage threshold which must be at least 1.6 times the Vermont minimum wage in effect at the time of the application. VEPC may require a higher threshold.	The bias in the VEGI program is toward companies providing higher-paying jobs.
Calculation of Award Amount	A larger number of income tax credits was available which required VEPC to do additional work to allocate the total award to the various credits selected by the applicant.	Applicants are provided with two incentive amounts – 1) The maximum amount assumes all qualifying employees are hired on 1/1 and 2) the best estimate amount which is based on the project hiring schedule.	The VEGI program is simpler for VEPC. Under EATI improper allocation may not have been reflective of program goals.

Program Aspect	EATI	VEGI	COMMENTS
Regional prioritization factors	Adds a Regional Adjustment county groupings factor to give preference to economically underdeveloped areas.	Adds a Regional Adjustment county groupings factor to give preference to economically underdeveloped areas.	Same under both programs.
Background growth rate	Uses SIC industry average data	Uses NAICS industry average data	This resulted from the Dept of Labor change in reporting industry data.
Data input manually into the cost-benefit model	Significant amount of data had to be manually input into the model.	Excel spreadsheet mirrors the application. Cut and paste data.	The similar formatting reduces the risk of error.

In our comparison, we considered the objectives of the new program:

Objective No.1 - The VEGI program should have equal or less fiscal expense to the State than the EATI program.

The VEGI program has the potential to exceed the average annual fiscal expense to the State over the EATI program due to the method of claimants obtaining the awarded incentives once their targets are met.

The method of claiming awards under the VEGI program is through a cash payment to the claimant of the incentive amount earned in a particular year, payable over five years as long as the claimant continues to maintain the targets met. Assuming the maximum amount of $10 million is awarded each year and all of the claimants' respective targets are met and assuming the program is set to expire on January 1, 2012[11], the maximum amount that can be paid out to all claimants in any year is $7.6 million.[12]

Although there was no cap on the total amount of theoretical net positive incentives awarded under the EATI program, approximately $101 million in tax credits were authorized over the life of the program. The average amount of income tax credits, property tax incentives and sales tax exemptions

[11] 2006 Act 184 Sec 3(c) sets the expiration date of the program at January 1, 2012 unless extended by the General Assembly.

[12] The average amount of payout over the expected life of the program if the maximum amount is awarded each year is $3.8 million.

applied per year over the life of the EATI program was approximately $3.4 million. This was due to the method of claiming the credits available under the old program. Credits awarded may not necessarily be used by the company if the company has no tax liability against which the credits may offset. (NOTE: There continues to be about $14 million in income tax carryforward credits earned by claimants that may or may not be utilized in future years.)

It is unlikely that all the companies given the opportunity to earn incentives in the VEGI program will meet their targets and claim payments of the amounts awarded. At the end of 2007, the awards available to be earned by companies were only $6,500,664. Considering the current unemployment rate, some companies may not be able to meet their employment threshold because they cannot find people to fill the jobs at projected wage rates.

At this point, due to the timing of the audit, it is unclear whether this objective is met. There is a risk that the current program could be more expensive on a year-to-year basis, as long as the key decision to award an incentive is based on the largely subjective, difficult-to-audit, "but for" assessment by the Council.

Objective No. 2 - The program should emphasize job growth.

This objective is met. The emphasis is on wage growth in the company as the incentive is based on payroll growth. However, the claimant must also meet either its job target or capital investment target.

Objective No. 3 -The program should more directly link company performance to award payouts.

This objective is met. The VEGI program is much stricter than the EATI program. A claimant must meet its stated first year target or the award is rescinded. The 2nd and 3rd year targets are given two years following the award year to be met or all remaining awards will be denied. There is no provision for deferral or extension of the time the applicants may have to meet their targets. This makes it simpler for the Tax Department to track results, as well.[13]

[13] In 2008 the Legislature adjusted the incentive ratio to 90% for environmental technology companies, removed the requirement to rescind the award if the first year targets are not met, and relaxed the time the company has to meet the first year performance targets (H.888), retroactive to January 1, 2007. This change does not modify our belief that this objective is met.

Objective No. 4 - The program should minimize subjective award revisions by eliminating deferral and mitigation and minimizing the need for recapture.

As discussed under No. 3 above, the deferral provisions of the EATI program have been eliminated under the VEGI program. A company must meet and maintain its targets over the award period or awards are rescinded. Recapture will occur only if a business to which an award has been paid experiences a 90% or greater drop below the jobs they had at the time of application. Further, since the payout for each year is only one-fifth of the incentive earned for that year, if the company does not maintain or reestablish 100% of award-year levels in subsequent years, no further installment payments will be made.

Since no payment of claims had occurred prior to inception of this audit, we cannot opine on the effectiveness of this objective. We do believe, however, that the provisions in the VEGI program will allow for this goal to be met sufficiently.

Conclusion

The Vermont Economic Progress Council is in substantial compliance with statutes, rules and regulations related to the Vermont Employment Growth Incentive program. However, this report notes that there are issues that should be addressed by the Council:

- policy changes affecting statute that should be brought to the Legislature,
- verifying data on the applications related to the "but for" statements,
- verifying the consistency of calculations and correct input into the cost-benefit model, and
- recalculating incentives where the incorrect data was used.

It is important for Legislators and the general public to recognize that this program does represent some public cost, due to the uncertainty in verifying the critical "but for" assumption. Measures should be taken to strengthen this critical review, such as the appointment of a public advocate to review and participate in the application "but for" review process.

Certain safeguards, such as the 80% pre-incentive ratio and the annual cap of $10 million on the incentive awards, are built into the VEGI program that help protect the State's interests and should be maintained.

To enhance prudent fiscal management of the State's resources in this program, when it is higher than the industry average the historical growth of the company should be used as a background growth rate in the incentive calculations where it is available.

The Legislature should consider amending the requirement for the wage threshold of 160% so it will be maintained each year of the award period rather than just the first year in the event the minimum wage increases.

Overall the changes to the VEGI program from the EATI program will aid in the protection of State resources while pursuing the economic development objectives of the program. The new program ties company performance to receipt of the payment by requiring companies to meet the wage, job and capital investment targets that are the key components of the program's purpose. Further, the program is simpler to administer and the amount of tracking required by the Tax Department has been substantially reduced.

Management's Response and Our Evaluation

The Vermont Department of Taxes and the Vermont Economic Progress Council have each responded to a draft report and we have made some changes based on these comments. The complete responses are included in Appendix IV and Appendix V, respectively.

Date of Project Commencement

We recommended that VEPC should recalculate an incentive award to disallow activity occurring prior to the approval date of the final application so as to be in compliance with statute. The Tax Department's reply was focused primarily on this finding regarding the activity commencement date under the two-phase application process. They recognize that there is an issue with applicants who are allowed to begin economic activity after receiving initial approval but before receiving final approval. However, the Department believes that expulsion of such a company from the program would send an unnecessarily harsh and negative signal to the business and economic development communities in Vermont. The Department discusses an ambiguity or "gap" in the statute and notes that two sections of the applicable statute do not specifically *exclude or allow* for activity to be considered qualifying if it occurs after the "but for" approval but prior to final approval. The Council also addresses this finding in its comments and discusses the problematic nature of the statutory language that indicates final approval is to be given before economic activity may commence. Further, the Council feels that this was a procedural rather than a policy change.

We agree that the two areas of the statute mentioned in the Tax Department's response do not mention the timing of qualifying activity. However 32 V.S.A §5930b(b)(2) states "the Council may provide for a preliminary approval…followed by a final approval at a later date, **before the economic activity commences.**" *(Emphasis added.)* SAO recognizes that to expel this applicant from the program may cause unwanted repercussions. The SAO is not recommending expulsion of the applicant, only adjusting the final award to reflect the activity occurring only after the final approval date. This resolution would ensure fair, equitable treatment of all program applicants.

There were two issues with this particular circumstance that brought us to our recommendations. The first issue was that when the applicant company wrote to the Council to convey its final application the letter stated that activity had commenced based on the Council's initial approval. At this point, VEPC should have reiterated to the company that this activity would not be allowed until the final approval was made. Allowing one company to circumvent the statute creates a situation that is unfair to the other applicants in the program who abide by the rules.

The second issue is that VEPC changed the policy without going first to the Legislature and getting approval for the changes. As we indicated in our discussion, policy changes may be made by VEPC as long as they do not contravene state law; statutory adjustments must be approved by the Legislature before implementation. We believe that this is more clearly a policy rather than just a procedure change as it affects the course of action that the applicant company as well as the Tax Department may take.

The responses from the Tax Department and the Council indicate that they will be working together to seek a program amendment that would define a "bright line" distinction of when qualifying activity can begin. The Legislature did not address this issue in the changes it approved for the VEGI program in 2008; until it does, the Tax Department will be responsible for reviewing claims from this company and adjusting the amounts paid out as necessary.

Response to Council Comment on Finding No. 1: Compliance with Laws and Regulations

The Council agrees with three of the findings directed to them – the Consistency of Cost-Benefit Model, Regional Differential and Application Signature - and indicates that steps have been taken to implement the changes recommended by SAO. SAO appreciates this immediate attention to the issues.

Wage Threshold

We recommended that the Legislature should consider revising the statute to require the wage threshold to remain at 160% of the current minimum wage through the entire award period.

The Council has attempted to "clarify some misinformation" included in the finding directed to the Legislature regarding the wage threshold imposed by 32 V.S.A §5930b(a)(24) by discussing at length the annual wages of a company in the aggregate needing to increase in order to meet its payroll targets. However, SAO's finding was not about aggregate wages; it referred to individual wages. While we recognize that the total payroll of a company will need to increase for it to meet its targets, that payroll could increase through elevating the salaries of higher paid employees at the expense of the lower paid employees who initially came into the program at 160% of Vermont minimum wage.

The Council also states that this would add unnecessary complexity to the program and would be a redundant check on average wage levels. We do not believe there would be additional complexity to the program by requiring the wage threshold to be at 160% of the prevailing minimum wage through the incentive period. It would be the responsibility of the company to ensure that the lowest paid workers in the program that is receiving State funds continue to be paid at 160% of minimum wage. There would also be no redundant check on the wage levels of the workers. It is in the Tax Department's current procedure for handling claims to verify that the wages of the individuals meet the wage threshold. That number would simply be 160% of the minimum wage of the year for which they are claiming an incentive rather than 160% of the base year for the applicant. The point of the recommendation is to ensure that employers receiving State funds to support their growth continue to pay their workers at a higher level.

Response to Council Comment on Finding No. 2: Design and Implementation of Internal Controls

But-For Checklist

Our report noted that a checklist to help VEPC staff evaluate an applicant's "but for" statements was not being used. The Council commented that "once again an attempt is being made to audit a subjective decision." This is true and SAO will remind the Council that the subjectivity of the "but for" decision does not reduce the need for an audit of that decision. Rather, it increases the relevance of a critical review of the basis for the decision. The "but for" reasoning is pivotal to the Council's decision to allow a company to earn an incentive award. SAO recognizes the experience and ability of the members of the Council and appreciates the talent that is necessary for thoughtful consideration of an applicant's "but for" assertions. However, the more subjective a decision is, the more speculation there is as to the biases that may be prevalent within the ranks of the decision makers. Therefore, examination of the Council's subjective decisions is a vital part of this statutorily mandated audit.

The purpose of the checklist when created by VEPC, and the recommendation by SAO to continue its use, is to ensure that pertinent data is obtained, not to create busywork or to replace thoughtful consideration as indicated by the Council's response to this finding. The checklist is considered an important tool for VEPC *staff* to use to obtain the required information to present to the Council. As evidenced by our finding, critical data was omitted from applications that may have influenced the Council's decision if this information had been presented to it as part of the documentation for its review. If VEPC staff had used the checklist that the Council itself created to ensure all the required information is obtained, the omitted data would have been included and a more informed decision could have been possible.

<u>Independent Assessment</u>

We also recommended the Council consider an independent public advocate for the State reviewing an applicant's "but for" statements and supporting documentation.

The Council took exception to the recommendation noting that the subjective decisions are based on reasoned consideration and with positive intent for the people of Vermont.

The recommendation to include an independent public advocate in the Council's process was not intended to imply that the Council takes their responsibilities to the State less seriously than they should. The "but for" decision is vital to a company receiving an award. Review of an applicant's "but for" statements is also critical. In our opinion, it may be an unfair burden to ask VEPC staff, which advertises the program and seeks out and helps companies in the application process, to also provide the council with an independent assessment of an applicant's "but for" arguments.

Utilization of NAICS:

We recommended that the incentive award for one applicant be recalculated using the correct background growth rate.

The Council is concerned that model changes made more often than annually will add to the complexity of the program, not be cost effective and would violate statute.

Adding a step where there is an obvious disparity in information to better calculate an incentive may be adding to the complexity of the program to a minor degree but would be offset by reducing payouts where they are unwarranted.

The Council is also concerned that it would be unfair to other recipients that are in the same industry to have used a different background growth rate if they applied in the same year and that this inconsistency is also a violation of statute. To respond to this comment, we will paraphrase an earlier comment made by the Board in their response to an audit finding. That is that each case is different. Each requires different information that goes into the model based on a company's own information. This reasoning doesn't conflict with applying the model consistently.

The first reason that VEPC cites for not implementing the recommendation for this finding is that it would violate statute which requires that all cost-benefit model changes be approved by the Joint Fiscal Committee. SAO has not suggested that this step be eliminated. VEPC could easily notify the Joint Fiscal Committee of a change in the same manner by which they are notified of the annual changes.

Response to Comment on Finding No. 3: Fiscal Management

Annual Cap and 80% ratio

We recommended that the annual cap of $10 million on the total amount of incentives that may be authorized each year is maintained as well as the 80% incentive ratio that is applied to the pre-incentive net fiscal benefit.

The Council disagrees that the program cap was implemented as a safeguard to protect the State's resources, and feels that it serves to limit the potential for new economic growth. The Council also recognizes that they are not 100% infallible and states that, in addition to the 80% incentive ratio, the cost-benefit model is a safeguard. SAO recognizes that the cost-benefit model can be an effective tool for assuring that the public's dollars yield the greatest possible return. However, the cost-benefit model assumes the growth would not occur but for the incentive. In other words, the assumption is that the "but-for" decision is 100% correct all of the time. The safeguards are, in part, to mitigate the effects of incorrect decisions by the Council that are assumed to be 100% accurate by the cost-benefit model. That the funds paid out to applicants are outside of the budget review process is also relevant here.

Historical Growth vs Industry Average

We recommended that a company's historical rate of growth, if higher than industry average, be used in the cost-benefit model when it is available.

The Council disagrees with this recommendation stating that the use of different rates would be inconsistent and, therefore, violate statute; would put certain companies at a disadvantage; and would impose unnecessary inefficiency and additional cost to the program.

The discussion provided in the findings in regards to the use of the Historical growth rate versus the Industry Average rate is an opportunity to visit a recommendation for improved fiscal management of the program. As we indicated and VEPC reiterated in their comments to this finding, this has been the subject of much discussion when the original program was first implemented. If there has been recent debate of the alternatives this information was not in the memos provided to the SAO by a member of the Technical Working Group. However, SAO feels that this area should be revisited.

An argument that VEPC brings against using the background growth rate is that it would violate the statutory requirement that the cost-benefit model be applied in a uniform manner. Currently, there are different growth rates applied to applicants in the various industries which could be considered inconsistent when using the same logic as VEPC is suggesting. SAO is suggesting using the the industry rate when it is higher than the historical rate or where the historical rate is unavailable.

Another argument against its consideration given by VEPC is that this could favor certain companies over others. Using the industry approach does this as well. The two companies that were used for the examples we discussed in our finding which have significantly greater historical background growth rates than industry rates are large, well-established companies. The examples show how they are being awarded incentives for growth that would be occurring normally in those particular companies.

Using the historical background growth rate would better serve the intent of the General Assembly to not incent a company's normal growth. This message is given clearly in statute and even in the program information written by VEPC. In fact, even in the Council's response to this (page 74) they state that legislative intent is to not provide incentives for the first dollar of desired activity. VEPC indicates that the use of a 15-year rate fulfills this legislative intent but we have shown in our examples how this line of thinking is flawed. The incented activity using industry rates is based on the growth of all applicable companies, rather than solely a company's own growth rate.

Further, there need be no additional burden on the applicant. As stated in the report, SAO used information readily available in the Tax Department's records. There would, however, be some additional work for VEPC in calculating the historical rate. Again, as we have indicated, it is not difficult to do. This, however, should not be a deterrent for the use of a rate that will result in a more conservative use of public funds while still fulfilling the intent of the program.

<u>Comparative Assessment of VEGI with EATI</u>

In this section of the report, we considered the objectives of the new program and assessed whether the objectives have been met. We believe that the objectives have been met in regards to emphasizing job growth and more directly linking company performance to award payouts. We also believe it is premature to opine on the objective to minimize subjective award revisions. We feel that it is unclear whether the objective for the program to have equal or less fiscal expense to the State has been met due to the potential payout in the VEGI program as compared to the EATI program payouts.

The Council disagrees with our opinion that the VEGI program is potentially more expensive than the EATI program, saying that if the economic activity of a company within the VEGI program occurs then the result is that the State earns money. Here again, VEPC is disallowing the risk that the Council can be incorrect in its "but for" assessment by stating that if the activity occurs that earns the incentive, the State makes money. There is no doubt that increased economic activity will bring additional revenue to the State. Our intent is to determine if the program assists only growth that would not otherwise occur or would occur in a substantially different manner "but for" the incentive offered.

We will reiterate the point that was made in our concluding paragraph. It is important for Legislators and the general public to recognize that this program does represent some public cost, due to the uncertainty in verifying the critical "but for" assumption. As evidenced by the average annual amount of dollars expended (or "invested" as the Council distinguishes) in the EATI program versus the potential dollars expended in the VEGI program it is clear that the total affect on the Treasury could be higher in the VEGI program. We recognize that much work has been done by various entities such as the Technical Working Group to reduce the ultimate potential cost to the State for this program. The new controls are better; however, the subjectivity of the "but for" assessment is the same. It would be misleading at this time for us to say that this objective of the new program to be cost neutral or less has been met.

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In accordance with 32 V.S.A. §163, we are also providing copies of this report to the Secretary of the Agency of Administration, Commissioner of the Department of Finance and Management, and the Department of Libraries. In addition, the report will be made available at no charge on the State Auditor's web site, http://auditor.vermont.gov/.

Appendix I: Risk Matrix

Threats (Risks)	Controls (Procedures) Available: VEPC staff reviews application for reasonableness, accuracy & completeness.	Application is signed b company CEO/CFO and certified as true and correct under penaltes of perjury.	Application has varied data collection to help VEPC staff spot anomalies	Tax dept obtains base payroll and compares to claimant info	VEPC staff can contact applicant if VEPC believes data might be missing.	EPR inc also reviews for completeness, reasonableness, etc.	Line-by-line application instructions, requirements & sample application posted on website	Only official VEGI application, competed by or on behalf of the applicant, is accepted.	VEPC exec director reviews work by admin assistant	Applicants are asked for employment data on related company.	Award rescinded if wages drop below 90% of base year level. Previous payments recaptured	Pmts only made in years where targets are met or maintained.	Additional signature required by VEPC procedures - top corp officer if non-VT company.	VEPC staff checks info on company including internet and Sec of State records.
Applicant														
Non-start-up applicant submits inaccurate information regarding prior wage and employment levels, such as correct "base payroll" -- total Vt gross wages and salaries actually paid to full-time, nonowner employees.	√	√	√	√		√								
Application base payroll will be incorrect if applicant does not provide gross wages and salaries paid to employees who were laid off or terminated within 6 months prior to the date of application.		√			√									
Applicant submits inaccurate information regarding proposed project wages or new employees.	√	√	√		√	√								
Applicant doesn't clearly understand information required for application review.	√		√		√	√								
Applicant submits inaccurate information regarding recent and proposed capital improvements.	√	√	√		√	√								
VEPC staff could incorrectly input application information taken over the phone or by e-mail, etc.	√					√	√	√	√					
Job shifting could occur between related companies to meet the job targets				√						√				
Company doesn't meet payroll, wage or capital investment targets											√	√		
Unauthorized signature on application													√	√

This risk matrix identifies the type of internal control analysis in an internal control audit. It helps to identify issues that can occur and also to identify poor outcomes. This is presented here for informational purposes rather than as an integral part of the audit.

Appendix I: Risk Matrix

Threats (Risks)	Controls (Procedures) Available										
	EPR Inc includes copy of inputted data with cost/ben model report and VEPC reconciles to application	EPR Inc director (Jeff) reveiws work by C/B operatior (Matt)	Uniformly modeled with annually updated five-year model.	Model mimics application - Less manual input	Annual updates given to Joint Fiscal Office	Statement of Good Standing is required.	Tax dept checks all tax accounts before sending payment.	Cost-benefit Model changes are updated annually	EPR Inc notifies VEPC of model changes; Updates communicated to JFC.	Applicants may submit an initial application to obtain approval and an estimate of incentive giving them time to do additional due diligence	Amts are recalculated after each meeting
Cost Benefit Model											
Manual or Excel-copied input of information to the cost-benefit model has inadvertent errors.	√	√									
The wrong regional adjustment rate is applied to an applicants data.	√										
Annual update to the cost-benefit model may cause errors in the spreadsheet resulting in incorrect incentive calculations.				√							
Inconsistent methods are used to calculate incentives.			√	√	√						
Some aspect of the model is changed by model operators without approval.					√						
Applicant is not in good standing with the SOV yet incentive award is given.						√	√				
Basic information used in the cost/benefit model is not updated regularly.					√			√	√		
2 or 3-year project not subjected to 5-year cost/benefit model			√								
Regional adjustment data is not updated regularly - growth not encouraged in underdeveloped area.					√			√			
General Issues											
Applications could dwindle if reputation of program as being too strict in requirement to meet targets, especially first year targets.										√	
Council exceeds annual caps.											√

Appendix I: Risk Matrix

Threats (Risks)	Controls (Procedures) Available: VEPC staff reviews application for reasonableness, accuracy & completeness.	EPR Inc includes copy of inputted data with cost/ben model report and VEPC reconciles to application	Function of the model	Excel template used to calculate results	Applicant must testify before the council to answer verbal questions.	Other state contact information is required.	VEPC staff compares description of incented activity to US Census data.	EPR Inc verifies NAICS code using US Census data.	VEPC staff prepares concurrent calculation on separate shreadhseet	Supplemental information requested from applicant to back up data.	Regional Devel Corp reviews application
Background Growth Rate											
Incorrect NAICS code listed on application.							√	√			
Wrong NAICS code used in model.		√									
15-year average industry Growth Rate is not calculated properly by VEPC consultants.			√								
80% maximum award incentive ratio not applied.		√	√	√					√		
Company specific historic growth rate shows that incented new jobs and wages would fall under normal growth pattern, indicating new jobs would not likely be incremental to the economy.											
But-For Review											
Applicant has already decided to do the project in Vermont but submits ambiguous information in but-for statement to feign interest in non-Vermont location(s).					√					√	√
Applicant has not disclosed all commitments on property selection, permitting, zoning application or other Vermont-positive action as application requires.					√	√					√
No clear statement of how the project would be different without the incentives is submitted by applicant.	√				√						
But-for statements of different applicants are similar, indicating possible coaching of applicants.	√										
General Issues (no controls)											
Activity could commence before final approval date.											
Wage level could fall below 160% of minimum wage after year 1. (Cost/benefit model includes increase in employee wages in years after hire, but company can receive incentive payment based on year 1 wage and is not required to raise wages during award per											
Administration costs of the program could approach or exceed benefits in period of reduced number of applications.											
Economic factors, such as reduced employment rates or recession, unfairly penalize a company who cannot meet targeted growth which would otherwise happen as estimated.											
VEPC makes policy changes affecting statute without authorization from legislature											

Appendix II: Calculation of Payroll to Incent Based on Company Growth - Industry vs Historical (Industry A)

Industry Rate	Base Year	2007	2008	2009	2010	2011	Total
FT Non-Owner Payroll	10,158,000	10,733,000	11,665,000	12,625,000	13,394,000	14,186,000	62,603,000
Incremental Qualified Payroll Targets		380,000	610,000	610,000	390,000	390,000	2,380,000
Background growth rate	2.90%						
Background growth		294,582	303,125	311,915	320,961	330,269	339,847
Payroll to Incent		85,418	306,875	298,085	69,039	59,731	819,148

Industry A

Historical Rate	Base Year	2007	2008	2009	2010	2011	Total
FT Non-Owner Payroll	10,158,000	10,733,000	11,665,000	12,625,000	13,394,000	14,186,000	62,603,000
Incremental Qualified Payroll Targets		380,000	610,000	610,000	390,000	390,000	2,380,000
Background growth rate	5.30%						
Background growth		538,374	566,908	596,954	628,592	661,908	696,989
Payroll to Incent		0	43,092	13,046	0	0	56,138

Payroll to Incent using industry rates	819,148
Payroll to Incent using historical rates	56,138
	763,010

Appendix III: Calculation of Payroll to Incent Based on Company Growth - Industry vs Historical (Industry B)

Industry Rate	Base Year	2007	2008	2009	2010	2011	Total
FT Non-Owner Payroll	25,961,659	30,116,016	36,534,496	38,286,530	40,299,126	42,372,100	187,608,268
Incremental Qualified Payroll Targets		3,375,508	5,515,000	656,000	864,000	864,000	11,274,508
Background growth rate	-0.60%						
Background growth		(155,770)	(154,835)	(153,906)	(152,983)	(152,065)	(212,891)
Payroll to Incent		3,531,278	5,669,835	809,906	1,016,983	1,016,065	12,044,067

Historical Rate	Base Year	2007	2008	2009	2010	2011	Total
FT Non-Owner Payroll	25,961,659	30,116,016	36,534,496	38,286,530	40,299,126	42,372,100	187,608,268
Incremental Qualified Payroll Targets		3,375,508	5,515,000	656,000	864,000	864,000	11,274,508
Background growth rate	13.50%						
Background growth		3,504,824	3,977,975	4,515,002	5,124,527	5,816,338	6,601,544
Payroll to Incent		0	1,537,025	0	0	0	1,537,025

Industry B

Payroll to Incent using industry rates	12,044,067
Payroll to Incent using historical rates	1,537,025
	10,507,042

Appendix IV: Dept of Taxes Response

State of Vermont
Department of Taxes
133 State Street
Montpelier, VT 05633-1401

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STATE AUDITOR

Agency of Administration

OFFICE OF THE COMMISSIONER

May 2, 2008

Thomas M. Salmon, CPA
Vermont State Auditor
132 State Street
Montpelier, VT 05633-1401

Dear Mr. Salmon, Tom

The Department appreciates the efforts of the State Auditor's Office to ensure that the VEGI program is administered in a manner that is in accordance with the statutes and is responsible to the state fiscally. We are confident that adequate controls are in place to ensure that every claim is reviewed thoroughly, and payments will only be issued when it is evident that the company has performed the required growth activities. At the same time, the Department appreciates the need for state economic development authorities to have sufficient tools with which to attract desirable companies and job growth to Vermont.

Despite substantial efforts to explore and address all possibilities presented by the VEGI program, unanticipated situations will undoubtedly arise. The Department looks forward to continued work in further refining administrative and review procedures as the VEGI program evolves. We anticipate this work to be conducted internally as well as in collaboration with VEPC and the State Auditor's Office.

The Department will take the opportunity to respond to one issue that SAO addressed in the 2008 Compliance Audit. This is the issue of an "activity commencement date" raised in the draft report on page 3, paragraph 3, and then described in full detail on pages 11 – 13.

A new feature of the VEGI program is the availability of a two-phase application process. An applicant may apply for approval under the "but-for" criteria in an initial application, then present a final application which would lock in economic projections and target data. The final application is to be approved prior to the commencement of activity. [32 V.S.A. §5930b(2).] This feature was implemented to moderate the strict nature of the program by allowing companies the opportunity to declare targets when they are reasonably certain what the development project will look like.

When the Auditors were gathering information, the Department indicated that it would adhere to the statutes as written regarding what activity would be considered 'qualifying.' Upon close review, there is a gap in statute regarding the timing of qualifying activity. Neither §5930b(a)

VERMONT

www.state.vt.us/tax

Appendix IV: Dept of Taxes Response

("Definitions") nor §5930b(c) ("Claiming an employment growth incentive") specifically exclude or allow for activity to be considered qualifying if it occurs after the 'but for' approval but prior to final approval. The Department and VEPC will jointly seek a program amendment to allow a company to declare an activity commencement date which would be an acknowledged, bright-line distinction of when qualifying activity can begin.

In the first round of claims, instances exist in which a company received initial "but-for" approval, then made the decision to expand in Vermont and began to make capital investments or add jobs prior to final approval. Disallowing activity that occurred prior to the final approval could cause the company to miss its first-year targets and thus be expelled from the program. But the company may be in substantial compliance with VEGI goals and targets, having begun the process of expansion, created good jobs, and added qualifying payroll in excess of its targets.

To expel such a company from the program because it did not wait for final approval before moving forward with its business plan could send an unnecessarily harsh and negative signal to the business and economic development communities in Vermont.

The risk that a company can manipulate its targets by intentionally delaying a final application is minimal. In fact, the intent of the two-phase application was that companies could set realistic, achievable targets. Regardless of whether jobs were added before or after the final approval, no incentive will be granted unless all qualifying activity took place after the but-for approval, and is incremental to both the company and the state economy.

The Department intends in this first year to review each claim on a case-by-case basis for all statutory criteria, as well as the timing of qualifying activity. As mentioned above, we will work jointly with VEPC to seek a correction on this issue, and to identify and address other complications as they arise.

Overall, the Department believes that the state is off to an excellent start with the VEGI program. There are many improvements over the EATI program. In contrast to EATI, significant work has been completed in establishing administrative policies and procedures prior to the start of the program. Doubtless, unanticipated complications will continue to come up, but the Department looks forward to working cooperatively with all stakeholders to address issues and ultimately deliver an economic development tool that will benefit all Vermonters.

Again, we very much appreciate the sustained efforts of your Office to cause this program to be effectively administered.

Sincerely,

Tom Pelham
Commissioner

Appendix V: VEPC Response

VERMONT

Department of Economic Development
Vermont Economic Progress Council
National Life Building – North, Drawer 20 [phone] 802-828-5765
Montpelier, VT 05620-0501 [fax] 802-828-3383
www.thinkvermont.com/vepc

Agency of Commerce and Community Development

May 7, 2008

The Honorable Thomas Salmon
Auditor of Accounts
State of Vermont
132 State Street
Montpelier, Vermont 05633-5101

Dear Mr. Salmon:

Enclosed is the Vermont Economic Progress Council response to the 2008 audit of the Vermont Employment Growth Incentive program.

I want to thank you and your staff for the manner in which this audit was undertaken. Staff was professional, responsive, and committed to understanding a very complicated program. We look forward to working with you to implement the recommendations with which the Council concurs and our future cooperative efforts to improve this important program.

The Council would appreciate having the Highlights and the Response (Summary and Detail) and the attachments included in the published audit report.

Thank you for your consideration.

Sincerely,

Fred Kenney

Fred Kenney
Executive Director

Enclosures

Appendix V: VEPC Response

REPORT OF THE VERMONT STATE AUDITOR

VERMONT EMPLOYMENT GROWTH INCENTIVE PROGRAM

2008 COMPLIANCE AUDIT PURSUANT TO 32 V.S.A. § 163(12)(B)

MANAGEMENT RESPONSE:

VERMONT ECONOMIC PROGRESS COUNCIL

SUBMITTED MAY 7, 2008

HIGHLIGHTS

The Council appreciates the thoroughness of the audit and the professionalism and overall positive approach to the process taken by the Office of the Auditor.

The VEGI program is one of very few tools available to help Vermont attract and grow businesses that provide much needed new jobs and investment. An additional benefit of the program is that it guarantees net new revenues for the state when the economic activity occurs. Increasingly, Vermont competes not only nationally for businesses but also internationally. We must be able to offer incentives - financial as well as intangible support - that will attract appropriate growth and demonstrate a reasonable business environment.

The dichotomy of programs based on economic theory is often the delicate balance between efficiency and equity. Because the VEGI program is new, the program administrators (VEPC and the Department of Taxes), in cooperation with the VEGI Technical Group, made every effort to establish procedures and policies that assure program consistency, equity, efficiency and integrity while protecting the state's interests and fulfilling the program objectives. In the program construction and implementation, great attention was paid to the underlying principles that caused the transition from the old EATI program to the new VEGI program:

- Equal or better fiscal impact
- Direct correlation between the incentive and job growth
- Direct link between performance and earning incentives
- Minimize subjective decisions and need for recapture
- Keep the program simple, efficient, clear and avoid complexity

Unfortunately, in the audit's final comments comparing EATI and VEGI, this last point is ignored and throughout the audit any balance between efficiency and equity seems to be traded for complexity, inequality, inefficiency and added cost.

There are two issues the Council would like to highlight in addition to the responses to the specific recommendations, which are set out below:

Appendix V: VEPC Response

In the Audit's comparison of the EATI and VEGI programs, the Finding incorrectly contends that "There is serious risk that the current program could be considerably more expensive (than the previous EATI program)." Simply put, there is no unknown risk and there is no expense. If applications are approved, the expected activity and resulting revenues to the state are incremental and the level of incentives that might be paid out are as well known as the estimated positive return to the state. The design of the VEGI program, especially when compared to the EATI program, ensures that if incentives are earned, it is because the projected economic activity has occurred, generating new tax revenues for the state. The incentives are paid out in installments ensuring that, from the start, the state is revenue positive.

Further, the incentive payments are not an "expense," they are an investment. As accountants understand, a balance sheet consists of expenses ***and*** income. One cannot be ignored to favor the other. The VEGI program consists of income and expenses. The new revenue generated to the state coffers by the approved incremental economic activity is the income. The incentive payments and incidental costs to the state caused by the project are the expenses. The balance is shown to be positive in each approval by the program's cost-benefit modeling. If the activity occurs that earns the incentive, the state makes money. If companies receive incentive installments that means they are creating new jobs and making capital investments which generate new revenues to the state due to the increased economic activity. A fraction of the new revenues are paid back to the companies as incentives while another fraction is used to offset additional costs to the state, such as new students in school. However, in the end, the projects generate a much greater level of new revenues than are paid out in incentive installments. ***For the companies that were approved in 2007, the State of Vermont will realize over $8 million in net new revenues after the cost of the incentives***, and we also get about 1000 new, well-paying jobs, $37 million in new payroll and investments totaling over $68 million.

The second issue is the recommendation that a "public advocate" be added to the application consideration process. The voting members of the Vermont Economic Progress Council ***are*** members of the public. We are citizens of Vermont. We have served as volunteers on this board for various terms for over ten years under two different Administrations, four auditors, and an ever-changing General Assembly. As the current members, and on behalf of past members, we take great personal exception to the implication that we do not take our fiduciary responsibility seriously or have the best interests of the State and its taxpayers in mind when deliberating on the But For. Any set of individuals will bring unique perspectives and experience to this decision. It is this diversity of thought that is essential to the integrity of the decisions made by the Council to authorize an incentive. It is time for this statutory provision to be accepted for what it is: a subjective decision based on reasoned consideration of multiple sources of data and information by people of integrity and with positive intent for all citizens of Vermont.

The Council appreciates that the audit mentions the Executive Code of Ethics and the Vermont Personnel Policy and Procedures Manual as these are the standards to which each member and the staff are held. In accordance with these rules, the Council and staff always endeavor to conduct their business in a manner that protects the State and public interest, making decisions that are thoughtful, reasoned, and consistent. The decisions are based on the procedures put in place for the VEGI program and the decisions are documented. It is unfortunate that the audit chose to ignore the steps that have been put in place by the Council to ensure But For integrity and to document those decisions for reviewers such as the Auditor.

Findings and Recommendation Responses:

The audit includes ten Findings and Recommendations, seven directed to VEPC. Regarding the recommendations directed at the Council:

- The Council concurs with three of these recommendations and has already implemented two of them ("Consistency of Cost-Benefit Model" and "Regional Differential"). The other ("Application Signature") will be implemented as soon as the program materials can be updated and reposted on the program website.

- "But For checklist": The Council concurs that certain further steps can and will be taken to strengthen due diligence during the application process. However, the use of a one-size-fits-all But For checklist never was and will not be incorporated in the VEGI process. Instead, the Council will continue to rely on thoughtful deliberation based on the information submitted by the applicant and the steps that were added to the process in cooperation with the Auditor's Office: requiring two company decision-makers to sign applications; requiring one of the decision-makers to testify at a Council meeting; and documentation of the Council's deliberation in a "Finding of Fact and Opinion."

- Two other recommendations ("Utilization of NAICS" and "Use of Historic Growth") cannot be implement because to do so would violate statute, would be counter to previous approvals by the Legislature, would not represent sound economic modeling, and would add complexity, inefficiency, and cost.

- "Date of project Commencement:" VEPC has made administrative changes to the VEGI application and the application process to ensure that only activity that occurs after an established Project Commencement Date is the basis for an incentive. The Council will seek an amendment to the VEGI statute to further address this issue.

The other three Findings and Recommendations were directed at the Legislature or were general comments on the program. The Council either included comments on these issues or has no position on them.

For further detail on the Council's responses to the Audit Findings and recommendations, please refer to the detailed response.

REPORT OF THE VERMONT STATE AUDITOR
VERMONT EMPLOYMENT GROWTH INCENTIVE PROGRAM
2008 COMPLIANCE AUDIT PURSUANT TO 32 V.S.A. § 163(12)(B)
MANAGEMENT RESPONSE:
VERMONT ECONOMIC PROGRESS COUNCIL
SUBMITTED MAY 7, 2008

SUMMARY OF RESPONSES TO FINDINGS AND RECOMMENDATIONS

FINDING 1: COMPLIANCE WITH LAWS AND REGULATIONS

A. **Application Signatures:** The Council will implement a variant of the audit recommendation by requiring an attestation that the person signing the application is a duly authorized representative of the applicant company.

B. **Date of Project Commencement:** The statutory provision allowing for a "Preliminary" and "Final" application approval is flawed in a manner that puts the applicants in a contradictory position that can impair their ability to create new jobs and make investments in Vermont following approval of the But For. The Council has made administrative changes to the VEGI application and application process to ensure that only activity that occurs after an established Project Commencement Date is the basis for an incentive. In the report that is required to be presented to the Legislature later this year, the Council will propose an amendment to the statute.

C. **Consistency of Cost-Benefit Model:** The Council agrees with the Finding that the background growth calculation was performed incorrectly on one application. The Council has implemented the Finding recommendation.

D. **Wage Threshold:** This recommendation is directed to the Legislature. In our detailed response, the Council provides information to clarify some misinformation contained in the Finding and summarizes a response that will be included in the report that is required to be filed with the Legislature later this year.

FINDING 2: DESIGN AND IMPLEMENTATION OF INTERNAL CONTROL SYSTEMS

A. **But For Checklist:** The Finding is based on an outdated document instead of the But For instructions implemented with the VEGI program. The Council concurs that further steps can and will be taken to strengthen due diligence during the application process. However, the use of a one-size-fits-all But For checklist never was and will not be incorporated in the VEGI process. Instead, the Council will continue to rely on thoughtful deliberation based on information submitted by the applicant and the steps that were added to the process, in cooperation with the Office of the Auditor: requiring two company decision-makers to sign applications; requiring the testimony at a Council meeting by one of the company decision-makers who signed the application; and the generation of a "But For Finding of Fact and Opinion" document that is a record of the Council's But For deliberations. The Council will work with the Auditor to ensure greater enforcement of existing due diligence steps and add new steps that will ensure the least potential for error in But For determinations.

B. Utilization of NAICS: The cost-benefit model utilized for the VEGI program is updated annually. This ensures that all applicants are treated uniformly as required by statute. The audit recommendation to update the model as data changes occur throughout the year cannot and should not be implemented because to do so would violate statute, would be counter to previous approvals of the model by the Legislature, would not represent sound economic modeling, would be inefficient, and would add administrative cost to the program.

C. Regional Differential Adjustment: The Council recognizes that the VEGI program materials incorrectly state that placement of each county in the model regions to implement the Regional Differentials will be updated each year. As recommended by the audit finding, the program materials will be corrected to state that the regional differential data will be reviewed each year, but placement will only be updated as required by economic changes.

FINDING 3: FISCAL MANAGEMENT

A. **Annual Cap and 80% Incentive ratio:** This finding incorrectly identifies the Incentive Ratio and the Program Cap as the tools that provide protection to State revenues in the event that incentives are authorized for a project that would have occurred anyway. It is the Incentive Ratio and the ***cost-benefit modeling, especially the background growth calculation***, that provide this protection to the state, not the Program Cap. The Program Cap only serves to limit the potential for new economic growth that can add new, well-paying jobs for Vermonters through the utilization of future revenues generated by the incented projects which the state would not have realized without the approval of the incentives.

B. Use of Historical Growth of Applicant Company vs Industry Average to Calculate Background Growth rates: The current methodology to calculate background growth rates utilizing industry averages was developed in cooperation with economists, including the Legislature's economist, and is the correct, approved methodology. It provides a uniform, verifiable data standard that is applied equally to all applicants. As outlined in our detailed response the audit recommendation to utilize historic company growth, if a higher background growth rate is indicated, cannot and should not be implemented because it would violate statute, would be counter to previous approvals of the model by the Legislature, would not represent sound economic modeling, would be inefficient, and would add administrative cost to the program. Additionally, the recommendation would set up an unfair disadvantage for certain types of companies.

FINDING 4: COMPARATIVE ASSESSMENT OF VEGI WITH EATI:

The Council concurs that the VEGI program is meeting the objectives that prompted the creation of the new program. However, the Finding is incorrect to contend that "There is serious risk that the current program could be considerably more expensive (than the previous EATI program)." First, upon approval, the potential incentive amounts are as well known as the estimated return to the state. Second, there is no "expense." If the activity occurs that earns the incentive, the state makes money. As the companies create new jobs and make capital investments, new revenues are paid to the state due to the increased economic activity. A fraction of the new revenues are paid back to the companies as the incentive while another fraction offsets additional costs to the state, such as new students in school. However, in the end, the projects generate a much greater level of new revenues than are paid out in incentive installments. **For the companies that were approved in 2007, the State of Vermont will realize over $8 million in net new revenues** after the cost of the incentives, and get 1000 new, well-paying jobs, $37 million in new payroll, and investments totaling over $68 million.

REPORT OF THE VERMONT STATE AUDITOR
VERMONT EMPLOYMENT GROWTH INCENTIVE PROGRAM
2008 COMPLIANCE AUDIT PURSUANT TO 32 V.S.A. § 163(12)(B)
MANAGEMENT RESPONSE:
VERMONT ECONOMIC PROGRESS COUNCIL
SUBMITTED MAY 7, 2008

DETAILED RESPONSE TO FINDINGS AND RECOMMENDATIONS

FINDING 1: COMPLIANCE WITH LAWS AND REGULATIONS

A. **Application signatures**: The finding is correct to state that company officials other than the president or CEO have signed VEGI applications. The statute allows for an "equivalent" officer to sign because not all companies have a "president" or "CEO." And, in the case of multistate companies where the applicant is a Vermont division, the top official in Vermont usually is not a president or CEO. The signature requirements of the VEGI application and authorization process put in place by VEPC add further protections for the state beyond the statutory requirement: a single signature acknowledging the potential for recapture due to a shortfall in capital investments. However, the Council will add an attestation that the person signing the application is a duly authorized representative of the applicant company, if that person is not the CEO or president.

Background:

The only signature required by statute for the VEGI program is on a statement acknowledging the potential for incentive recapture due to failure to make all capital investments (V.S.A. 32, §5930b(b)(1)(H)), which states that the application must include:

> ***"(H) A statement signed by the president or chief executive officer <u>or equivalent</u> acknowledging that to the extent the applicant fails to meet the minimum capital investment by the end of the award period, any incentives remaining to be earned shall be limited, and any incentives taken shall be subject to complete or partial reversal, pursuant to subdivisions (c)(10) and (11) of this section." (Emphasis added)***

In compliance with statute, the VEGI application signature form includes the following statement, which incorporates the required acknowledgement regarding capital investments:

> ***"<u>Certification of Understanding</u>: I have read the Administrative Rules of this program and understand that the incentive authorized can only be earned if targets are met, that future installments of earned incentives can be forfeited if employment or payroll levels drop below targets, that***

> ***the total amount of incentive authorized is in part based on the capital investment targets included in this application and that if the capital investment projections are not met the incentive amount may be decreased proportionate to the percent of the capital investment that was not completed, including possible recapture, if required, and that if the applicant company drops employment or payroll below 10% of the employment or payroll levels at the time of application, 100% of the incentives paid will be recaptured."***

This statement, along with several other statements (see attached VEGI application Form G), must be signed for the application to be considered complete. The same signatories must also sign the But For statement. Additionally, if an incentive is authorized, the same people that signed the application must sign the VEGI authorization document, which repeats the ***Certification of Understanding***, including the required language regarding potential recapture due to partial capital investments.

The VEGI application process and rules include the signed statement required by statute and further protects the state by:

- Requiring signed statements regarding application accuracy, truth, completeness, and understanding of program requirements.
- Requiring the same people to sign the But For statement.
- Requiring the same people to sign VEGI Authorization Documents, if incentives are authorized.
- Requiring the signatures of ***two*** company officials (similar to Sarbanes-Oakley requirements), except in the case of a sole proprietorship.
- Requiring signatures from the top Vermont official and a senior official at the company headquarters in the case of multistate companies.
- Requiring one of the company decision-makers, who signed the application, to appear before the Council to testify regarding the application.

The VEGI application rules regarding signatures are as follows:

> ***"Certification and Signatures: The application content and the But For statement must be known to, understood by, and attested to through the inclusion of the signatures, on Forms E and G, of corporate and company officers appropriate for the type of company applying:***

> ***1. If the applicant business is a company that is located in Vermont only, the two highest level officers must sign, such as the President, Chief Executive Officer (CEO) or the Chief Financial Officer (CFO).***
> ***2. If the applicant business is a Vermont division, subsidiary, or otherwise part of a larger multi-state company, the Chief Executive Officer or other highest level executive of the parent company and the highest level Vermont officer must both sign.***
> ***3. If there is an individual majority shareholder, that person may be the sole signatory."***

The application rules and procedures ensure that the appropriate officials of the applicant company, whether they are local or out-of-state, attest to the content of the application, understand the program, the program requirements, and the consequences of not meeting the requirements.

Recommendation: The audit recommendation is that the application include a signed attestation statement that signatories other than the president or CEO are authorized to sign on behalf of the company. The requirement to repay the incentives is not tied to their signature, it is required by law. The signature indicates their acknowledgement of the requirements. The responsibility of the company is not diminished if an equivalent company official other than the president or CEO (as allowed by statute) signs the acknowledgement.

Under current VEGI rules and processes, the statutory requirement is met and actually exceeded. Adding the attestation recommended by the audit will add yet another form for completion and additional process to what was supposed to become a more simplified and more efficient program. However, The Council will add an additional attestation declaring that the person signing the application, if other than the president or CEO, is a duly authorized representative of the applicant company.

B. Date of Project Commencement: The audit Finding is correct to state that certain applications received Final Approval after some economic activity may have begun. The statute provision (32 V.S.A. §5930b(b)(2)) allowing a "Preliminary" and "Final" approval is flawed in a manner that puts the applicants in a contradictory position that can impair their ability to create new jobs and make investments in Vermont following approval of the But For, but before Final Approval.

The two-phase application procedure is new with the VEGI program. By design, the VEGI program demands a greater degree of accuracy in forecasting growth due to the requirement to meet, not just approximate, payroll, employment, and investment targets in order to earn the incentive. The purpose of allowing a Final Application was to allow for the mutually beneficial refinement of the project data. The language of the statute does not require reconsideration of the But For during the Final Application review. It was meant as a means to consider final data to ensure that the applicant and the state can share in the success of the company meeting targets.

The Council conducted a thorough discussion on this issue and has taken administrative steps to amend the program application document and process to ensure that a "bright line" But For date is established with each application. The Council took the steps it could to administratively change the application document and process short of changing policy in a manner counter to statute. To fully implement a change, in consultation with the Auditor and the Tax Department, the Council will propose an amendment to statute in the report that is required to be provided to the Legislature later this year.

Background:
The statute (32 V.S.A. §5930b(b)(2)) states, "the council may provide for a preliminary approval pursuant to the conditions set forth in subsection 5930a(c), followed by a final approval…". The "conditions" referred to are the But For and the Program Guidelines.

[Note: For the sake of clarity, the two phases of approval are actually called "Initial" and "Final" because a separate, informal process has been in existence that provides an estimate to a potential applicant, which is called "Preliminary." Therefore, when we refer to "Initial," this is the same as the term "preliminary" in this provision of statute.]

According to statute, if an applicant needs to file an Initial Application, the Council must consider the application in regards to the But For and the Program Guidelines. This is the process the Council put in place. The application is considered under the But For and the Program Guidelines and an initial level of incentives is approved, conditioned on the submission of a Final Application. The But For is deemed to have been met, the Guidelines are met to the degree that the applicant can address them with an Initial Application, and the initial incentive amount is based on the data presented by the applicant in the Initial Application. The applicant may have to address the Guidelines further in the Final Application and the data that is provided in the Final Application determines the final incentive amount and sets the applicant's annual targets.

The provision requires that the application be considered under the But For at the time of Initial Application. This makes sense because the intent of the two-phase application process is to allow applicants the opportunity to address the But For prior to detailed project development and commitments that may need to be made if a Vermont site is selected, or to allow for an Initial Approval so that a company can decide between competing states. With an Initial Approval, the applicant is deemed to have met the But For (if the Council approves the application).

If an applicant has met the But For, they cannot be prohibited from proceeding with certain steps they may need to take to ensure that the project might occur in Vermont (permitting, site investigation, design, engineering, initial employment inquiries, etc). When the applicant has been approved under the But For, they have met the most critical criterion of the program to determine whether the activity is incremental. It is then most important to determine when that activity will commence, not whether it commences prior to the date that a Final Application can be considered. Some applicants must undertake certain activities in order to prepare for investment and hiring in Vermont or to make the final determination that Vermont will be the location of the project. These activities often help the applicant better define the project that will occur, including employment, payroll and investment levels, which is the intent of the Initial/Final application process.

Under the current statute it is not clear which date sets the But For "bright line" between hiring and investments that are occurring normally and those that are occurring because of the incentive. Is it the Initial Approval Date or the Final Approval date? Which date should the Tax Department use to determine the baseline for payroll? The language of the provision complicates this matter because the But For must be considered with the Initial Application, but the activity is supposed to begin after the Final Application approval. Because the But For is approved at the time of the Initial Approval, the applicant should be allowed to move ahead with the project, if there is an established "Project Commencement Date."

Another issue caused by this provision is that it assumes that an applicant can hold off on the initiation of all economic activity depending on when a Council meeting can be scheduled. This is the tail wagging the dog. Applicants have many decisions to make and many steps to take to start up, relocate, or expand. When they can commence economic activity that has already been approved for incentives should not be dependent on when the appropriate meeting is scheduled to get Final Approval. Sometimes they have no choice. For example, an option on a building could expire before a Council meeting is scheduled, unless they put down a deposit, thereby starting the investment that was approved for incentives. The purpose of the Final Application is to finalize application data, not to determine when the activity will begin.

The Audit Finding states that the Council loses the ability to revisit the But For if economic activity begins prior to Final Approval and that the Final Application cannot be disallowed without subjecting the Council and the state to potential recrimination from the applicant. The But For can be revisited during Final Application consideration, if the circumstances require. In fact, the current rules and Initial Approval letters state that the Initial Approval is subject to the submission of a Final Application and that the Council retains the right to revisit the But For and Guidelines, if circumstances require, during Final Application consideration. The Council also agrees with the Finding regarding the potential for recrimination by the applicant, but that the potential for it comes from giving an Initial Approval and approving activity under the But For, but limiting the company's ability to implement their project as needed to grow new jobs and make investments in Vermont.

The change the Council implemented was not a policy change; it was a procedural change and a change to the application document. It was required to avoid having two "But For dates" (Initial Approval and Final Approval dates) and to ascertain from the applicant the date the project is projected to commence.

The application document evolved to include a "Project Commencement Date." The applicant must include the date and the data (employment, payroll, and capital investments) that will occur during the year prior to that date. All data for "Year 1" (i.e. activity for which incentives are sought) is only what will occur after that date. Thereby, the Commencement Date becomes the "But For date" or the bright line date dividing activity that is occurring anyway and the activity that will occur because of the incentive. This also provides the Tax Department with one date that is the determinant of the base payroll. With this date declared by the applicant, the application data is much clearer and defined. It is understood by all parties that this is the date after which the project or activity that has been approved for activity will occur. It firmly determines the data that is included in the modeling and incentive calculation for both the Initial and Final Applications.

The process leaves open the ability to reconsider the But For during Final Approval, if necessary. But the result will be a change to the application data. For instance, if some activity that was included after the "Project Commencement Date" actually occurs earlier, it will not be included in the modeling. The cost-benefit model has been and will continue to be rerun with a Final Application to make any adjustments to the incentive and to set the firm targets that must be reached.

The Council agrees that allowing a Final Application to be filed after activity commences may encourage applicants to wait until the later part of the calendar year to file the Final Application. One of the changes we will suggest for the statute is a requirement that Final Applications be filed before the end of the calendar year of the Project Commencement Date. It is not a negative that applicants will be adjusting their Final Applications when they know better what their levels will be for the end of Year 1. That was the whole purpose of having the two-phase process. Imposing a time limit (i.e. within 60 days as suggested by the recommendation) is worse than the current provision. Every situation is different and no particular time period will work for all applicants.

The key issue is commencement of the activity for which incentives are approved. The concern of the Council when the procedure change was made was to ensure the validity of the But For and ensure clarity of the bright line division between regular activity and activity that is occurring because of the incentive.

The problematic clause in the statutory provision is "…before the economic activity commences." The clause is problematic when combined with the beginning of the provision which requires that the Initial Application include a determination of the But For. If that determination is positive for the applicant, prohibiting the commencement of that activity until they can get a Final Application scheduled for consideration can interfere with the creation of new jobs and investments in Vermont that were approved in the Initial Application and are occurring because of the incentive.

This clause is also problematic because it leaves "economic activity" open to interpretation. Is it just hiring? Or is it paying to place job ads. Is it paying a contractor to build a building or does it include hiring a designer or engineer, or placing a down payment on a facility? Some of these activities have to occur before a company can make a final decision to expand or locate in Vermont. Which should be disallowed until the Final Application can be filed and considered? Establishing a bright line date means that such investments are not left to a subjective decision. If they occur prior to the date, they are not activity that can be utilized to calculate the incentive. If they are after the date, they may be eligible.

The Council will consult with the Auditor and the Tax Department on this issue and develop a proposal of amendment to this provision that further protects the interests of the state, maintains the integrity of the But For, and that can be administered and understood easily, while meeting the needs of the businesses that are trying to create new jobs in Vermont because of the incentive. The proposed amendment will be included in the report that is required to be presented to the General Assembly later this year.

C. **Consistency of Cost-Benefit Model:** The finding is accurate as presented and the recommendation has already been implemented by VEPC staff. This incorrect application of the background growth occurred during the formative process of a new program in its first year of implementation when processes and procedures were still being developed. VEPC staff noticed the incorrect application of background growth, brought the issue to the Technical Working Group and the process was corrected for all other early applications with the exception of the application that is the object of this comment. Since full program implementation, the robust development and implementation of processes and procedures during the fiscal cost-benefit modeling have made another occurrence of the type very unlikely.

Recommendation: One of the additional procedures that have been added to the cost-benefit process is the preparation of a separate spreadsheet by VEPC staff to recalculate the incentive amount calculated by the model operator and verify that the correct background growth rate was utilized and that it was applied correctly in the incentive calculation, as recommended by the finding.

D. Wage Threshold: This finding makes some erroneous assumptions and confuses one of the nine program Guidelines with the statutory "Wage Threshold." Since the recommendation is directed to the Legislature, we will limit our comments here to clarification of the issue, and direct our response to the General Assembly in the report to them that is required later this year.

Background:
The VEGI program contains a statutory Wage Threshold for each new, qualifying job (V.S.A. 32 §5930b(a)(24)). Jobs cannot be included on the application as qualifying and will not be calculated by the Tax Department as qualifying when incentives are claimed, unless the job's wage meets this threshold. Statute requires that the "minimum ***annualized*** Vermont gross wages and salaries paid be no less than 60 percent above the minimum wage ***at the time of application***, in order for a new job to be a qualifying job." Therefore, only the payroll generated by the new jobs that meet this wage threshold can be utilized to calculate the incentive. The jobs must also be full-time, permanent and non-owner (See §5930b(a)(20)). The word annualized is highlighted above to emphasize that the methodology utilized to determine if a job meets the wage threshold is not an interpretation as characterized by the Finding, it is required by statute. To ensure that the

same methodology is used to include a job as qualifying on an application and to count it as qualifying in an incentive claim, VEPC and the Tax Department included the methodology, based on statute, in the program rules.

The Finding is correct to state that an employee can start at a wage below the threshold and end up at a wage at or above the threshold and still be considered a "qualifying job." But neither of these wage levels is the determinant as to whether the job qualifies. The calculation is based on the statute and is therefore the total annualized wages divided by the number of hours worked that year. If the resultant hourly wage is above the threshold, the payroll for that employee and the job itself can be counted as qualifying.

The Finding is also correct to state that the wage threshold does not increase as the company progresses through the authorization period (the period of up to five years during which incentives can be earned). This is in accordance with statute (see above: "**at the time of application**"). It is important to remember that the Wage Threshold applies only to new qualifying jobs as they are added each year, not the wages of those new employees as they are employed in subsequent years. However, the Finding is incorrect to state that "it is not clear if payroll growth after the first year will increase the wages of people hired in the first year." If the base payroll for all full-time employees (including the payroll of the new qualified employees) does not increase over the five-year modeling period, the economic impact will be flat or have a negative impact in the modeling. Also, the incentive claim process requires that not only are the new, qualifying jobs added each year as projected, but the base payroll of all full-time jobs (including the wages of the new jobs added the previous year) be maintained or increase each year. Otherwise, the new, qualifying jobs cannot be counted as incremental. Therefore, the wages of the new employees have to at least be maintained. There is also the practical reality that an employer is not going to decrease a new employee's wages in subsequent years and expect to retain that employee.

Further, the Finding is incorrect to refer to this requirement as a Guideline. This is a statutory requirement. Applications are also subject to evaluation to determine the overall consistency of each application with nine guidelines (V.S.A. 32 §5930a(c)). The second of these Guidelines states that the new jobs should…."meet or exceed the prevailing compensation level, including wages and benefits, for the particular employment sector." This is an additional requirement that compares the average wage of all the new jobs to regional and sector data. Guideline 2 is separate and different from the Wage Threshold.

The issue that appears to be central to the Finding is that the Wage Threshold in place at the time of application remains the Wage Threshold throughout the authorization period. The Finding is concerned that an employee's wages, which must meet the Wage Threshold when hired, may not meet it in subsequent years. As discussed above, that cannot be the case and still result in incentives being earned.

The Finding also refers to the fact that if an application is approved in 2008 when the Wage Threshold is $12.29/hour, the same Wage Threshold applies not only to the new jobs added in 2008 but also to the new jobs added in 2010, in order for those jobs to be considered "qualifying." That is the requirement of statute, which is why this Finding's recommendation is directed at the Legislature. We will address, in detail, the reasons the statute should not be changed in this regard in the report to the Legislature required later this year. For now, in summary:

- The Wage Threshold is based on the Vermont Minimum Wage, which is tied to the CPI, and therefore automatically increases each year. At the time of application, neither the applicant, nor VEPC, nor the cost-benefit model operator, nor the Tax Department will know the Vermont Minimum Wage for the subsequent years and therefore would not have the ability to calculate the Wage Threshold to apply for subsequent years.
- Adding an escalating Wage Threshold to each application would add unnecessary complexity to the program at the time of application, during incentive determination, and during the incentive claim process.
- The wages for the new jobs added each year must at least be maintained or increased each subsequent year or the model result will be negatively impacted and, in the claims process, the base payroll requirement will not be met.
- There is also redundant check on average wage levels of the new jobs with a standard that is generally higher than the Wage Threshold because of the Program Guidelines (Guideline2).

FINDING 2: DESIGN AND IMPLEMENTATION OF INTERNAL CONTROL SYSTEMS

A. **BUT FOR Checklist:** Before commenting on the details of this Finding, the Council must comment on the fact that once again an attempt is being made to audit a subjective decision. The Council's interest has always been the implementation of steps that will ensure the greatest potential of a proper But For determination, not steps that just add busy work and require burdensome documentation that will not be relevant to the determination.

The “checklist” that is the subject of this Finding does not exist. The document to which the Finding refers was created as interim instructions under the old EATI program when the Council added new But For procedures in 2006. Those procedures were incorporated into the VEGI program when it was implemented. The But For instructions, procedures and requirements for the VEGI program are documented in the VEGI program rules and in a free-standing document: “Information Regarding the But For Approval Criterion,” which is published and available to everyone (attached). This is the standard against which the Council’s But For determinations should be evaluated, not a document from a previous program.

The use of a “checklist” of evidence to be submitted by an applicant or due diligence to be performed by staff will not make the But For process better or more complete. This is an example of adding process and paperwork without added value. In fact, such a process could result in the evasion of a difficult responsibility. A checklist may be useful in the attempt to audit a subjective decision, but a checklist cannot replace the hard work of diving in, analyzing the relevant issues, speaking with the applicant face-to-face, and thoughtfully deliberating to determine if the applicant has met the statutory requirement.

In the end, a checklist cannot replace the key aspects of the But For process that were developed by VEPC, in cooperation with the Auditor’s office, but are never mentioned in this Finding. In cooperation with the Auditor’s office, the But For process was improved to include the signature requirements that are outlined in the Council’s response to the first Finding in this audit. Additionally, one of the company decision-makers who signed the application must appear before the Council and testify regarding their application and But For statement. Finally, the Council includes in the applicant’s confidential file notes from Executive Session from when the application is considered and a “Statement of Finding of Fact and Opinion” in regards to the Council’s But For deliberation and determination.

The audit Finding mentions that the Council relies heavily on the signatures of the applicants. This is true. As discussed earlier in this response, the signatories are the decision-makers. They are signing attestations as to the accuracy of their statements. But the Council goes well beyond just requiring a signature. The decision-makers must appear before the Council and testify about their application and But For statements. This personal, face-to-face inquiry provides more information and does more to allow for a proper determination than any document or written information. Yet this additional step is never mentioned in the Finding.

A further step in the But For process that was added by the Council to benefit reviewers such as the Auditor is a “Statement of Finding of Fact and Opinion” in regards to the Council’s But For determination. Yet again, the Finding is silent about this. The Finding of Fact and Opinion document states the facts and opinions of the Council based on ***all*** the evidence presented to the Council by the applicant and VEPC staff, including during the testimony to the Council. It documents how the Council came to its determination and shows where consistency of thought and deliberation occurred.

It was disappointing that these key items were ignored by the audit as they have great bearing on the steps the Council has taken to add due diligence and documentation of process beyond the materials provided by the applicants.

The Council appreciates that the Finding mentions the Executive Code of Ethics and the Vermont Personnel Policy and Procedures Manual. In accordance with these rules, the Council and staff always endeavor to conduct their business in a manner that protects the State and public interest, making decisions that are thoughtful, reasoned, and consistent. The decisions are based on the procedures put in place for the VEGI program and the decisions are documented.

The comments in the finding regarding the test applications that were examined provide good examples of how “one size fits all” documentation requirements do not work for the But For. Had the “Finding of Fact and Opinion” for each application been examined, it would have been more evident what additional information and evidence the Council utilized to make their determination and why certain information that might appear on a checklist would not provide the information required to make a determination. Instead, some of that information may be presented by the decision-maker of the company during testimony to the Council.

The test applications actually illustrate how each case is different. Each requires different information. Each requires different levels of due diligence. Each can be best determined based on the evidence and documentation relevant to the applicant’s situation and through the face-to-face that occurs at the Council meeting, which is documented in each applicant file.

Appendix V: VEPC Response

The Council and staff take the due diligence requirements very seriously. We agree with the Finding comments regarding a lack of response to the supplemental questions that applicants must answer, such as the status of any permit applications. However, the Finding states that these questions are sent to the applicant after they file their application. That is no longer the case. Again, reference should instead be made to the But For information document attached here and published on the VEGI website. The applicants are now asked to respond to these questions as part of the application. This allows VEPC staff to follow up if any of the responses indicates some activity that might mean the project is starting prior to application. The four test applications indicate that not all applicants are responding to all of these questions. In some cases, these issues were addressed during applicant testimony. However, the Council will work with staff to ensure that these important questions are always addressed by applicants in their application and investigated by staff, as needed.

It should be noted, however, that application for a permit, or even issuance of a permit, does not mean a project will occur. Certainly, receipt of a permit is a reasonable and acceptable occurrence after an Initial Application is approved. That is not to say that obtaining information about permits is not important due diligence for the Council to undertake. Expecting staff to visit each local planning office is excessive, especially given the budget constraints facing all state agencies. But those offices can be contacted.

The Finding comments on the requirement that a Letter of Good Standing be filed for an application to be considered complete. This is now a requirement which was added through mutual agreement and arrangement between VEPC and the Tax Department. However, the idea was conceived in early 2007 and the process set up at the Tax Department to ensure expedited issuance of such a document to VEGI applicants was not in place until mid 2007. Therefore, the only test applications that include the document are those that occurred after the process was fully implemented.

Recommendation:
The Council takes the But For very seriously and has developed a process, in cooperation with the Auditor's Office, which is more effective for making a determination and documenting that determination. However, the audit Finding chose to ignore several steps added to that process and instead recommends adding a checklist of required evidence and due diligence. There is no one-size-fits-all checklist for the But For determination. The circumstances of each applicant are different and the applicant should decide what evidence is relevant to their case. They should not be given a list of what

could be provided, nor required to provide information or documentation solely to fulfill the requirements of a checklist.

The Council has implemented But For requirements for the VEGI program that are detailed in the information published for the program. The Council is not relying on the content of a document written in 2006 for a previous program. Instead of checking off that the applicant provided certain information, the Council considers all the data, information, and evidence provided by the applicant and conducts a thoughtful, deliberative But For analysis. Additionally, the Council has implemented But For procedures, developed in cooperation with the Auditor's office, that this Finding did not consider: requiring certain signatures to certify that the application is true and correct; requiring a company decision-maker who signed the application to testify at a Council meeting; and documentation of the Council's But For determination in a "Finding of Fact and Opinion."

Further work is required to ensure that all mandatory information, including answers to a set of But For questions, is provided by applicants to the Council. Further work is required by VEPC staff to ensure that all due diligence required by each application, as allowed by current resources, is carried out. All tools currently available must be utilized, as recommended by the Finding.

The Council appreciates the recommendation that additional resources may be required to perform all due diligence. However, there are no additional resources available, so the Council will consider the recommendation regarding a "bill back" scheme to help cover costs. This cannot be accomplished by administrative process. It will require statutory authorization. The Council may consider requesting such authority as part of the report that is required to be filed with the Legislature later this year.

The recommendation to involve an "independent public advocate" is interesting. Council members are all members of the public appointed for that very purpose. As appointees of the Governor, we may not be considered "independent," by some. But frankly we are offended by the implication that we take our responsibilities to the taxpayers of Vermont any less seriously than would an assessor hired by the State Treasurer or other "additional analyst."

Any set of individuals will bring unique perspectives and experience to this decision. It is this diversity of thought that is essential to the integrity of the decisions made by the Council to authorize an incentive. It is time for this statutory provision to be accepted for what it is: a subjective decision based on reasoned consideration of multiple sources of data and information by people of integrity and with positive intent for all citizens of Vermont.

B. UTILIZATION OF NAICS: The Finding is correct in that it states that during a major update to the cost-benefit model to prepare to process applications under the new VEGI program, the industry classification system was upgraded from the old Standard Industrial Code (SIC) system to the newer North American Industrial Classification System (NAICS). The Finding is also correct to state that on April 1, 2007, ***in the middle of the year***, the Vermont Department of Labor separated two NAICS codes that had previously been combined. The separated NAICS produced data that result in two background growth rates that are very different from the rate previously resulting from the combined codes.

However, in accordance with statute, and to help keep the program fair, uniform, efficient and cost-effective, the data utilized in the cost-benefit model, including the calculation of background growth rates, is and always has been updated on an annual basis. Therefore, we must respectfully decline to implement this recommendation.

Background:
All the updates to the cost-benefit model required to implement the VEGI program were documented and presented to the Joint Fiscal Committee of the Vermont General Assembly by the VEGI Technical Working Group in November 2006. The Legislature's Joint Fiscal Committee approved the model changes and updates, including the utilization of an "***annual*** 15-year average rate of change by NAICS sector" for the calculation of background growth rates. Under this approved methodology, background growth rates are determined annually for each sector utilizing the most recent 15 years of data. The background growth rates are set for the upcoming calendar year and applied uniformly throughout the year for all applications. The actual list of background growth rates for the first year of the VEGI program were presented to the Joint Fiscal Committee as part of the presentation of the transition to NAICS and the new background growth rate calculation methodology. Upon approval, the 2007 background growth rates were published on the VEGI website and utilized for all 2007 applications.

In preparation for considering 2008 applications, annual model updates were made to incorporate the latest available data, including the calculation and preparation of new background growth rates for use with 2008 applications. This update incorporated the separated data by Vermont Department of Labor, which occurred during the year for which the updates were being performed. These annual model updates were transmitted to the Joint Fiscal Committee on February 7, 2008.

The model changes and updates were performed, and the background growth rates utilized, in accordance with 32 V.S.A. §5930a(d), which requires that annual cost-benefit model modifications be approved by the Joint Fiscal Committee and that the cost-benefit model be applied in a uniform manner.

Further, the model has been developed to reduce and minimize errors by building in automated functions within the spreadsheet with appropriate 'flags' to alert a model operator of any potential issues. To be consistent with the Finding recommendation, these automated processes would have to be removed. Instead they would be replaced with significantly more manual interaction with the model, particularly for the data function. An increase in manual interaction for each application may result in the potential for an increased number of errors that may only lead to issues of concern in future audits.

The cost-benefit model operator acted correctly by using the background growth rate that had been calculated as part of the annual model update, approved, and published for utilization for ***all*** 2007 applications. These rates were calculated for utilization using the methodology derived by the VEGI Technical Working Group, approved by the Joint Fiscal Committee, and published as annual background growth rates for the program.

VEPC staff acted properly by utilizing the same approved and published background growth rate in the separate check of the incentive calculation. The parallel spreadsheet to check the incentive calculation did not and will not include a formula to check the background growth rate. The rate used was and will be the annual rate for the appropriate sector, as calculated on an annual basis using the approved methodology, and published.

Therefore, VEPC respectfully declines to implement the recommendation for this finding, because to do so would:

- Violate statute which requires that all cost-benefit model changes, which are performed on an annual basis, be approved by the Joint Fiscal Committee.
- Violate the statutory requirement that the cost-benefit model be applied in a uniform manner.
- Alter the methodology for calculating annual background growth rate each year as approved by the Joint Fiscal Committee in November 2006.
- Impose the risk that two companies in the same sector have two different background growth rates applied during the same year based solely on the date of application.

- Add unnecessary complications and inefficiencies to the program if data changes during the year are to be incorporated into the model as they occur instead of on an annual basis as part of the annual model update.
- Add prohibitive model update costs if all data changes during the year are to be incorporated into the model as they occur instead of on an annual basis as part of the annual model update.
- Add risk of model operator error due to manual data entry versus automated functions.

We agree that it is unfortunate that federal confidentiality rules sometimes can result in suppression of key data (i.e. by combining two NAICS subcategories), which at times results in changes to what is possible with fiscal cost-benefit analysis procedures within the required NAICS codes configurations. However, constantly checking and re-checking for data updates and revisions throughout the year is: (1) not efficient, (2) would be costly to the program, and (3) would still not guarantee the most timely and accurate data since many data series can be revised several times over time as more complete data is incorporated and revisions are made to initial and even sometimes revised estimates.

We believe that an annual update, with built in automated functions, presents the greatest efficiency, provides accuracy and consistency, and results in the most equitable fiscal cost-benefit analysis processes over time for all potential applicants, while at the same time minimizing the potential for errors.

An appropriate additional step might be for VEPC staff to utilize the audit Finding's formula to check the background growth rates that are calculated annually before they are approved, published, and utilized for the year.

C. **REGIONAL DIFFERENTIAL ADJUSTMENT:** This finding appears to be the result of an error in the language utilized in the VEGI program materials. The program materials ("Administrative Rules," "Regional Differential Adjustment" information documents) state, ***"Placement of each county in the model regions will be updated and determined each year based on current data***…"

The classification of counties for the purpose of categorization for the regional differential adjustment is ***reviewed*** annually. However, updating the conclusions of the previous annual review is not always merited. Relative changes in the data sets used to make this determination are typically "glacial" in nature. Barring structural shifts in the economic conditions of a county, there is no need to make changes to the county's regional differential classification each year. But this is not to say information is not reviewed annually and actions taken when they are determined to be needed and prudent.

The program material incorrectly states that placement in the model regions will be updated "each year." As recommended by the Finding, the program material will be corrected to state that the regional classifications will be reviewed annually and changes will be made to the classifications as required by economic conditions.

FINDING 3: FISCAL MANAGEMENT

A. **Annual Cap and 80% Incentive ratio:** The Council concurs that no person can claim that a But For determination can be 100% infallible. The Council has never claimed that and never will. The past and current Council members, or any other group of Vermont citizens, whether checked by a "public advocate" or not, can only carry out the But For determination "to the best of their ability," as required by statute. The decision is subjective and the decision-makers are human.

However, the Finding is incorrect to state that the But For is the "sole premise that is supposed to ensure net fiscal neutrality…" The Finding is also incorrect to state that the 80% Incentive Ratio and the Program Cap are the additional tools that help protect the State's resources. The But For actually ensures the activity is incremental to the state and therefore ensures a positive fiscal impact (not neutral). The tools that ensure additional protection are the 80% Incentive Ratio and the cost-benefit modeling, with the calculation of background growth, not the Program Cap.

The Program Cap only serves to limit the potential for new economic growth that can add new, well-paying jobs for Vermonters through the utilization of future revenues generated by the incented projects which the state would not have realized without the approval of the incentives.

The mechanisms that have been built into this program ensure that it generates net new revenues for the state that can be used to sustain other programs or reduce the tax burden of individual Vermont workers.

B. **Use of Historical Growth of Applicant Company vs Industry Average to Calculate Background Growth rates:** The use of an applicant's actual historical growth data instead of an industry average was discussed and debated at length back in 1998 by economists, legislators, stakeholders, and many others involved in the process that created the Economic Advancement Tax Incentive program, the precursor to the VEGI program. That process involved the Act 60 Oversight Committee (legislators), with input from the legislature's economist, a Cost-Benefit Model Advisory Committee consisting of a wide variety of stakeholders, the VEPC Board, and VEPC's consulting economists. The recommendation at that time was to utilize the industry average method.

The alternatives were again debated by the VEGI Technical Working Group (which included four economists) when changes and updates to the cost-benefit model to implement the VEGI program were recommended to the Joint Fiscal Committee in November 2007.

In both instances, the industry average approach was the recommended alternative that was recommended and approved. Therefore, we respectfully decline to implement this recommendation for the following reasons:

- Such a change would violate the statutory requirement that the cost-benefit model be applied in a uniform manner (32 V.S.A. §5930a(d)). Applying a company's historical data, "when available," as recommended by the Finding, but industry average data for start-ups, companies being recruited to Vermont, or relatively new companies, would result in application of the model in a manner that is not uniform.
- The industry average approach was presented to and approved by the Joint Fiscal Committee when the cost-benefit model was established for the EATI program in October 1998 and again when the changes to the model were approved for implementation of the VEGI program in November 2006. Changing the methodology would violate those approvals.
- The Finding recommendation would set up a disadvantage and additional burden to Vermont-based companies in the application process. Companies considering moving to Vermont, start-ups, and companies with only a few years of operations in Vermont would be considered using the industry average and would only have to provide the three years of previous year's data as now required. Since the industry average methodology is based on 15 years of data, a Vermont company would have to provide 15 years of previous data.
- The Finding recommendation would impose unnecessary inefficiency and additional cost to the program. The 15 years of data would have to be provided and checked and the growth rate based on the company's data would have to be

calculated and compared to the industry average, with an additional determination of the higher rate and then application of the appropriate rate.

- If 15 years of data is not required to be consistent with the industry average methodology, then an entirely new level of subjective analysis would be added to the review of an applicant's data that could not by its very nature be consistently applied across all applicant situations. Specifically, determinations would have to be made on a case-by-case basis as to what the correct amount of historical data would be to calculate a sufficient company growth rate. Using this approach, each application would involve a subjective determination as to the appropriate length of time for the historical data series.
- From a modeling perspective, this approach could favor those companies with larger number of employees or those with a longer history of operation over smaller or new, start-up companies. This is an unavoidable outcome of this suggested approach since "relative percent increases" would be much higher for smaller or start-up companies due to their relatively small number of employees (i.e. 1 new employee for a 2 person firm represents a +50% increase versus a gain of 1 employee for a 100 employee firm which would come in at just +1.0% and appears miniscule to a large company).
- Also from a modeling perspective, the recommended approach would likewise put younger companies at a disadvantage in the program since these firms typically have faster growth in the early years of operation when their base is small. This would be counter to the original legislative intent of the program.

Based on more than a decade of program operation, the use of a long-term (i.e. 15 years, which approximates the last 2 full business cycles) fulfills the legislative intent of not providing incentives for the first dollar of desired activity without introducing biases into the fiscal cost-benefit analysis procedures. Such biases would ultimately and unintentionally discourage job creation for small and start-up businesses—a part of the Vermont economy that the VEGI program is better equipped to encourage than the previous program. The current practice of industry-based long–term hurdle rates for background growth is an economically sound process that has worked well, even under the old EATI program. It represents a standardized approach for all potential applicant companies so there is a "level playing field" for all applicant companies—whether large or small, existing old, existing new, or start-up. Measuring companies against a benchmark established by the industry total of the applicant and its peers is the most equitable and efficient solution for a successful program.

FINDING 4: COMPARATIVE ASSESSMENT OF VEGI WITH EATI:

The Council generally concurs with this Finding in regards to the VEGI program meeting the objectives that prompted the creation of the new program.

However, the Finding is incorrect to contend that "There is serious risk that the current program could be considerably more expensive (than the previous EATI program)." Simply put, there is no unknown risk and no "expense." If applications are approved, the level of incentives that might be paid out are as well known as the estimated positive return to the state. The design of the program, especially when compared to the EATI program, ensures that if incentives are earned, it is because the projected economic activity has occurred, generating tax revenue for the state. The incentives are paid out in installments ensuring that, from the start, the state is revenue positive.

Further, the incentive payments are not an "expense," they are an investment. As accountants understand, a balance sheet consists of expenses ***and*** income. One cannot be ignored to favor the other. The program consists of income and expenses. The new revenue generated to the state coffers is the income. The incentive payments and incidental costs to the state cause by the project are the expenses. The balance is shown to be positive in each case by the program's cost-benefit modeling. Because of the program design, if the activity occurs that earns the incentive, the state makes money. If companies receive incentive installments they are creating new jobs and making capital investments that generate new revenues to the state from many sources because of the economic activity. A fraction of the new revenues are paid back to the companies as the incentive and there are some costs, such as new students in school. However, in the end, the projects generate a much greater level of new revenues than are paid out in incentive installments. ***For the companies that were approved in 2007, the State of Vermont will realize over $8 million in net new revenues after the cost of the incentives***, and get 1000 new, well-paying jobs, $37 million in new payroll, and investments totaling over $68 million.

A further issue with this Finding is that it does not speak to one of the major objectives that drove the creation of the VEGI program: simplification (reduce complexity), efficiency, and clarity. Many of the recommendations made by the audit add ambiguity and complexity, create inefficiencies, add costs, and impose process without adding value.

Appendix VI: Information Regarding the "But For" Approval Criterion

VERMONT

VERMONT ECONOMIC PROGRESS COUNCIL

VERMONT EMPLOYMENT GROWTH INCENTIVE

INFORMATION REGARDING THE "BUT FOR" APPROVAL CRITERION

As part of the approval process for the Vermont Employment Growth Incentive program, the Vermont Economic Progress Council must determine if all applications meet three basic criteria:

- Whether the economic activity would not occur or would occur in a significantly different and significantly less desirable manner without the incentive (But For);
- Whether the economic activity will generate more new revenue for the state than is foregone through the incentive (cost-benefit modeling); and
- Whether the company and economic activity meet a set of "quality control" guidelines.

Statutory Citation: 32 VSA §5930a(c). "The council shall first review each application (for VEGI incentives) and ascertain, to the best of its judgment, that but for the economic incentive to be offered, the proposed economic development would not occur or would occur in a significantly different and significantly less desirable manner. Applications that do not meet the "but for" test are not eligible for economic incentives, and shall not be considered further by the council."

Why is this part of the program? The cost-benefit modeling that is required by statute is conducted with the assumption that the activity for which an incentive is sought will all be incremental to the state's economy. With an affirmative But For determination, the state is giving up a portion of the new revenues that it would never have received, and therefore there is theoretically no cost to the taxpayers. Without the But For, the state is giving up that which it would have gained anyway, which represents a cost to the taxpayers. Vermont has limited economic development resources. Including a But For "gatekeeper" ensures that the program is acting as a true incentive for economic activity that would not have occurred and does not reward economic activity that would take place normally or without an incentive.

How is compliance ascertained? The Council will consider all evidence, including the But For statement and all supporting documentation, provided by the applicant and information obtained by staff. An officer of the company (one of the application signatories) that is responsible for the decision outlined in the But For statement must attend the Council meeting during which the application will be considered, present the project to the Council and respond to questions posed by Council members. Only the Council members, not staff, can make the But For determination. It is the responsibility

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of the applicant to present a clear But For case and support it with documentation and evidence.

How this criterion is addressed differs for each applicant and depends on the company, the project and the situation. A company could be making a "Grow, No Grow" decision that is dependent on receiving an economic incentive. The company could be making a location decision where several states are vying for the location or expansion. The incentive could be a key factor, making an impact of significance, on the scope or timing of a project. Or, the incentive could make a difference regarding whether or not a project occurs because of a financial significance to the company.

What are the application requirements?
VEGI applicants must provide a But For statement (Form E) and the same two company officers are required to sign the But For statement and the application.

The But For statement must include narrative detail supporting the specific But For argument being made by the applicant sufficient for the Council to make a But For determination. For example:

- If the But For is a "yes" or "no" go decision, who is making that decision and what factors are being considered?
- If the But For is based on a location decision, who is making that decision and what factors are being considered? The applicant must provide information, including contact information, on other locations and incentives offered by those locations, if any.
- If the But For is about a significantly different and less desirable outcome (scope, scale, timing), provide details about how the project would be significantly different and less desirable and include data projections showing the different and less desirable results. This includes But For statements that are based on financial need, where the applicant is stating that the project financials would not work without the incentives. Any But For statement that argues that the outcome would be significantly different and less desirable must address the following:
    - How is it significantly different ***and*** less desirable?
    - What is the ***significance*** of the difference and desirability? What is the level of significance?

As appropriate to the But For statement being made, the applicant must address issues that apply to their particular situation and provide any supporting documentation, data or information that supports and substantiates the But For statement.

To supplement the But For statement, applicants must submit supporting documents and information, as appropriate, to substantiate their But For, such as:

- Information regarding incentives offered by other locales and copies of any specific incentive offers. Include names and contact information for any out-of-state officials contacted.
- Data (spreadsheets) documenting significantly different/significantly less desirable outcome without incentives or financial need.

Appendix VI: Information Regarding the "But For" Approval Criterion

- Documents that substantiate "But For" or applicant's answers to the questions above.
- Any press releases, media statements, news reports, regarding the project contained in the application.
- Copies of any signed or proposed lease or Purchase and Sale agreements.
- Financial statements.
- Business plan.
- Equity/Financing plan.
- Market information.

Also, the following questions must be addressed by all applicants:

- Have you placed ads for the new jobs? Where?
- Will you need any permits? Have you applied for permits for this project? Have any been approved?
- Will you purchase, build or lease? Have you negotiated or signed any purchase and sales or lease agreements?
- Have you made any payments or obligations to architects, engineers, or designers for sites in Vermont or elsewhere?
- Are you negotiating with any economic development officials in (fill in alternate location)? Who are they and what are they offering for incentives?
- Are any permits in place or applied for in Vermont or in (alternate location)? What type, date?
- How will the project be financed? Are any elements of the financing plan in place? Equity investors? Bank financing?
- Will the project receive or has it received any public funds or financing (VEDA, USDA/RD, CDBG, USEDA)?
- Is there a business plan for this project?

Any supplemental information must be submitted directly to VEPC either electronically or by mail and indicated on the "Other" line on VEGI Application Form A.

A company officer (one of the application signatories) is required to attend the VEPC meeting at which the application will be considered. The applicant will have the opportunity to briefly outline the company, project and application and VEPC Board members will ask the applicant questions about the application, including questions pertinent to the But For.

Due to the presentation of proprietary business information by the applicant, as required by statute, the Council will meet with the applicant and deliberate in executive (closed) session. However, a vote on the application will take place in public (open) session during the meeting at which the application is considered. A majority (5) of votes acting in the same manner are required to take action. If the Council finds that they do not have all the information required to make a determination, the application can be tabled. The Council will consider all application information and all of the application criteria (But For, guidelines, cost-benefit) together to make an approval or

Appendix VI: Information Regarding the "But For" Approval Criterion

denial decision. However, in accordance with statute, if the applicant does not meet the But For criterion, the application cannot be approved.

For further information on the VEGI program, go to
www.thinkvermont.com/vepc/vegi
or contact VEPC at:
Phone: (802) 828-5256 or (802) 828-5765
Email: Fred@thinkvermont.com

Appendix VII: VEGI Application Form G. Authorizations and Certifications

FORM G **AUTHORIZATION AND CERTIFICATIONS** **Read the VEGI Program Information, Administrative Rules and all instructions before filling in this form**

Authorization to Share Information: ***The Commissioner of Taxes and the Vermont Economic Progress Council are hereby authorized to share information for purposes of determining the eligibility of the applicant to receive incentives listed in this application, and any future incentives claimed by the applicant or received by the applicant.***

Certification of Intent: ***I declare under penalties of perjury that this application and all documents attached in support of this application are true, correct, and complete to the best of my knowledge.***

Certification of Understanding: ***I have read the Administrative Rules of this program and understand that the incentive authorized can only be earned if targets are met, that future installments of earned incentives can be forfeited if employment or payroll levels drop below targets, that the total amount of incentive authorized is in part based on the capital investment targets included in this application and that if the capital investment projections are not met the incentive amount may be decreased proportionate to the percent of the capital investment that was not completed, including possible recapture, if required, and that if the applicant company drops employment or payroll below 10% of the employment or payroll levels at the time of application, 100% of the incentives paid will be recaptured.***

Certification Regarding Employment: ***I certify that in accordance with Title 32, Section 5930a(c)(1), the new jobs to be created by the project included in this application do not include any jobs or employees transferred from another existing operation in Vermont that is a division or subsidiary of any kind of the applicant company and that the new jobs are not replacements for positions within the applicant's business that were vacated or terminated within the past two years.***

Certification of Good Standing: I certify that the applicant company is in good standing with the State of Vermont as defined by 32 VSA Section 3113(g).

Signature 1: Signature of top Vermont Officer of company:

Signature:

Typed Name:

Title: Date:

Signature 2: Signature of Corporate Officer (If applicant is a subsidiary/division) or of second Vermont company officer:

Signature:

Typed Name:

Title: Date:

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