PERFORMANCE AUDIT

REVIEW OF STATE TAX CREDITS ADMINISTERED BY THE DEPARTMENT OF ECONOMIC DEVELOPMENT

From The Office Of State Auditor
Claire McCaskill

Redemption of community and economic development tax credits continue to rise while benefits remain difficult to quantify. In addition, the total outstanding liability amount of these tax credits is unknown.

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Office of
Missouri State Auditor
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YELLOW SHEET

State does not track tax credits outstanding causing inaccurate revenue projections; economic impact studies on credits still difficult to perform due to poor data

State officials do not track the total dollar amount of tax credits issued but not yet redeemed. Not knowing this amount can lead to inaccurate state revenue projections. In addition, the data collected on many of the 35 tax credits administered by the Department of Economic Development is not complete enough to analyze a tax credit program's economic impact.

State law mandates the State Auditor's office analyze the economic impact of each tax credit program. This report is the second such analysis and focuses on six programs. Auditors again found an impact study difficult, if not impossible in some cases, due to inadequate data. In addition, auditors question continuing the Qualified Research Expense tax credit and call for closer monitoring of residential projects using the Historic Preservation tax credit.

State budget more accurate if departments cooperated

Economic development officials track the number of tax credits issued, while the departments of Insurance and Revenue track the total tax credits redeemed. But no one matches the issued credits to the redeemed credits to calculate what is outstanding and could still be redeemed. This figure is vital to accurately project state revenues and quantify the state's potential future liability. The revenue shortfall caused by the unexpected $60 million cost increase of the 2001 Pharmaceutical Tax Credit clearly showed the importance of tracking this figure. (See page 3)

Overestimating credit redemption skews state budget

Economic development officials have overestimated the amount of credits redeemed by $14 million in 2001 and $50 million in 2000. Inaccurate redemption estimates results in faulty revenue projections. Tight budgetary times magnify the need for the most accurate estimates. Tracking tax credits outstanding could improve these estimates. (See page 5)

Cost-benefit studies question continuing one program

Measuring true economic and fiscal impact of these programs will continue to be difficult until project-level data is captured. Auditors used the Regional Economic Models, Inc., Policy Insight Model to analyze total economic impact for four of the six selected programs. The following briefly summarizes our impact study results (years referred to below are fiscal):

Historic Preservation ($48.2 million redeemed through 2001): Analysis showed the residential-only projects do not produce as much state economic benefit as the commercial projects. It could not be determined if the economic benefits of residential projects justified the costs. As a result, residential-only projects should be more closely monitored, particularly the 39 percent of the residential projects located in middle- to upper-income areas.

Results of the commercial project analysis showed significant economic impact on jobs and demands. But the incomplete jobs and housing unit data made it impossible to tell the types of jobs created or the businesses that benefited. (See page 7)

Qualified Research Expense ($30.4 million redeemed through 2001): Analysis showed there may be insufficient economic benefit to warrant continuing the program. If businesses primarily used this credit to reduce production costs, the state would see no positive impact for several years, if at all. Projections show only a negligible improvement to state revenues. In addition, the jobs and demand created do not justify the credit. (See page 15)

Brownfield Remediation ($6.1 million redeemed through 2001): Results show the program had a positive economic impact. (See page 20)

Brownfield Jobs/Investment ($17,000 redeemed through 2001): The total economic benefit could not be measured due to insufficient data. In addition, economic development staff estimated $85,000 in credits could be redeemed in 2002. This estimate triples the total redeemed so far and users only redeemed $5,000 in credits in 2001. (See page 25)

Seed Capital ($3.6 million redeemed through 2001): These credits are no longer available since the program reached its $9 million statutory cap. Nevertheless, the analysis showed the credit having an immediate positive impact, with the exception of wage rates. (See page 29)

Youth Opportunities and Violence Prevention ($8.3 million redeemed through 2001): An economic impact analysis could not be completed because program data did not include quantifiable items such as jobs or economic investment. Our review focused on the administration of the program. Auditors found more than half the credits authorized went unused and credits issued for some projects exceeded those authorized. (See page 35)

Department needs more authority to gather adequate project data

Economic development officials have created a new system to improve data collection at the project level. But department staff also said state law does not require companies receiving credits to provide most information needed for a cost-benefit analysis. Although department officials ask for voluntary reporting on projects, they cannot force compliance. (See page 40)

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State law (Section 620.1300, RSMo 2000) mandates the State Auditor's Office perform cost-benefit analyses on the 35 tax credit programs administered by the Department of Economic Development. This report is the second such analysis with a general review of all these tax credits and a detailed economic impact study of six of them. The review included obtaining necessary data to sufficiently evaluate each program's state economic impact. When some of the needed data was not available, auditors had to obtain some data through independent research. While we may comment on internal control issues incidental to obtaining the data necessary for a cost-benefit analysis, this report is not an internal control audit and contains no opinions on such controls for any state agency mentioned.

We concluded department officials need to track the dollar amount of tax credits outstanding to improve the state budget process and allow for an effective cost-benefit analysis for each tax credit program. The level of tax credits approved, issued and redeemed has risen sharply in the past 3 years. With an increasing number of tax credits outstanding, actual future redemption could come in above estimates and negatively impact state revenue projections. Additionally, auditors found the Qualified Research Expense Tax Credit program needs to be considered for restructuring or

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elimination because an economic impact analysis suggests this credit may not provide sufficient benefit to the state.

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State Auditor

February 22, 2002 (fieldwork completion date)

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RESULTS AND RECOMMENDATIONS

1. Tax Credits Outstanding are Not Tracked and the Economic Benefits of One Tax Credit are Questionable

Department of Economic Development staff currently do not track the dollar amount of tax credits outstanding each fiscal year. Without taking outstanding tax credits into consideration, it is more difficult to estimate the future cost of economic development tax credit programs, which could lead to faulty state revenue projections. Through the Department of Revenue and the Department of Insurance tax credit tracking systems, it is possible to derive the dollar amount of tax credits redeemed each fiscal year. Department of Economic Development officials also provide the Department of Revenue with the issued amount of tax credits. Department of Economic Development staff stated they do not match redeemed credits with issued credits to calculate outstanding credits because there is not a system in place to make such matches. As a result, staff are not able to determine the amount of tax credits outstanding. Additionally, the economic benefits of the Qualified Research Expense Tax Credit are questionable.

Focus of audit

Audit staff performed a general review of all 35 tax credit programs administered by the Department of Economic Development. (*See Appendix I, page 44, for a list of programs.*) Data was obtained from the Department of Economic Development and through independent research by our office on 6 of the 35 tax credit programs. The purpose of this data collection was to obtain sufficient information necessary to perform a cost-benefit analysis of the effectiveness of these six tax credit programs.

Estimated costs of tax credits

In early 2001, the state experienced firsthand the negative impact of a tax credit program on the budgetary process if the program is not properly managed and monitored. The Pharmaceutical Tax Credit Program was estimated to cost $20 million; however, actual costs came in at over $80 million. The higher cost was a major contributing factor to the revenue shortfall in the fiscal year 2001 state budget. In state fiscal year 2001, approximately $150 million of community and economic development tax credits administered by the Department of Economic Development were redeemed, which was below the $164 million estimated by the Department of Economic Development. However, the Historic Preservation Tax Credit was estimated at $27 million in redemptions and actual redemptions were $34 million and the Brownfield Remediation Tax Credit was estimated at $3.6 million in redemptions and actual redemptions were $4.5 million.

Future liability unknown

Overestimating the amount of redeemed tax credits in the past coupled with annual and cumulative caps on many of Missouri's community and economic development tax credit programs have to-date prevented the occurrence of a situation similar to the Pharmaceutical Tax Credit issue. However, future budget problems may occur because outstanding economic development tax credits are not tracked, and as a result the potential future liability from tax credits is unknown. The Historic Preservation Tax Credit and the Brownfield Remediation Tax Credit are growing rapidly and have no caps on the amount of tax credits that can be issued.

These two credits had poor redemption estimates in the prior fiscal year and are examples of tax credit programs that could present future problems.

Impact on state revenues

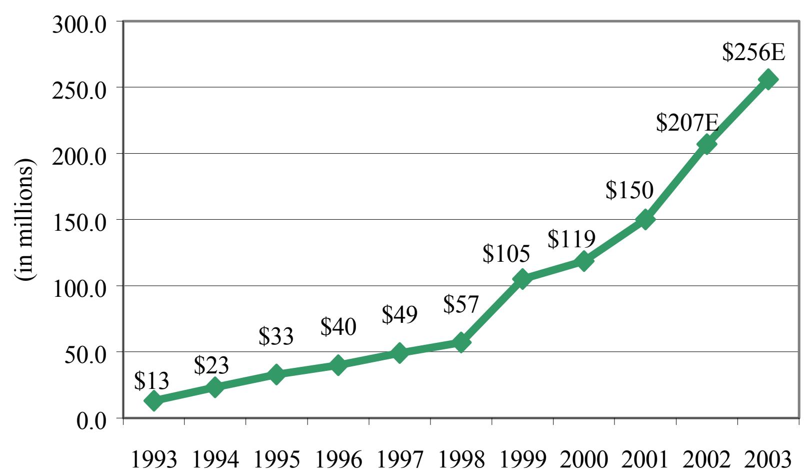
The usage of state tax credits administered by the Department of Economic Development continues to rise. The aggregate dollar amount of administered programs for the state fiscal year 2001 and estimates for state fiscal year 2002 are as follows:

- Issued credits $213 million (FY 2002 estimate $302 million)
- Redeemed credits $150 million (FY 2002 estimate $207 million)

The increases in the dollar amount of issued and redeemed tax credits occurred despite the repeal of one tax credit program in 1998[1] and two other tax credit programs reaching their caps.[2]

The dollar amount of redeemed tax credits has steadily increased since 1993, as shown in Figure 1.1.

Figure 1.1: Amount of State Tax Credits Redeemed by State Fiscal Year



E – Estimate made by Department of Economic Development staff in 2001

Sources: Tax Expenditure Reports prepared by the State & Fiscal Studies Unit, University of Missouri-Columbia; Department of Revenue tax credit tracking system; and Department of Economic Development's Statements of Benefits and Costs (Form 14s)

[1] Guarantee Fee Tax Credit, Section 135.766, RSMo Supp. 1999, was repealed in 2000.
[2] Both the Certified Capital Companies (CapCo) Tax Credit, Section 135.500, RSMo 2000, and the Seed Capital Tax Credit, Section 348.300, RSMo 2000, expired in 2000 when caps on the amount of tax credits authorized were reached.

Department of Economic Development has estimates of tax credit redemptions

Estimating when a taxpayer will redeem a tax credit is difficult due to various provisions in the authorizing statutes allowing taxpayers to carry the tax credit forward or backward to other tax years. Additionally, the tax credit may not be redeemed at all if the taxpayer does not have any state tax liability to offset and the tax credit cannot be sold or transferred to another taxpayer. During tight budgetary times the importance of the accuracy of estimates is magnified compared to times when there is a budget surplus.

In early 2001, Department of Economic Development officials estimated $163.8 million in tax credits would be redeemed for state fiscal year 2001. This estimate came in $14 million above the $150 million actually redeemed, as tracked by the Department of Revenue. In state fiscal year 2000, officials estimated redemption at $169 million, $50 million above the $119 million actually redeemed.

Redemptions were overestimated

A Department of Economic Development official said tax credit estimates are based on the historical trends of the tax credit program and the pipeline of future projects. While estimates that result in an understatement of revenue do not create the same budget problems as estimates that result in an overstatement of revenue, such as a budget shortfall, Department of Economic Development officials should strive to ensure the best possible estimates are submitted to state budget officials.

More accurate estimates of future tax credit redemptions should occur if the Department of Economic Development tracked tax credits outstanding.

Recommendation

We recommend the Director, Department of Economic Development:

1.1 Implement a system that tracks tax credits outstanding so that state officials and citizens have an accurate and full accounting of the current liability and the potential future liability the state has from these economic development tax credit programs. This outstanding tax credits balance should be used to increase the accuracy in estimates of anticipated tax credit redemptions.

Department of Economic Development Responses

1.1 The Department has developed and deployed a Customer Management System (CMS) that includes the tracking of tax credits issued by the department. The Department of Revenue is now entering current information on redeemed credits into CMS and historical data from FY01. This will provide the state with an electronic system that allows us to determine the amount of tax credits outstanding. Precisely when this system can be relied on for a complete accounting of outstanding tax credit liability depends on what historical data the Department of Revenue is able to enter and bring the Department of Insurance on board as well. Since there are tax credits in many other *departments in addition to this department, the true total outstanding amounts could not be ascertained until those departments take similar responsibility for tax credit accounting.*

The system was not intended as a tool for improving the accuracy of estimated tax credit redemption. We still will not know, with certainty, when a taxpayer will redeem its tax credits. And many of the department's tax credits have carry-forward provisions -- typically for five years but some are as long as twenty years or simply have no "expiration" at all. The system can help us better estimate whether redemption in a particular program typically comes within the same year as issuance, or within three years or the like, and this may help us better determine trends, but it is not a failsafe method of pinpointing when a credit will be redeemed. The law creating the program with a carryforward option provides freedom to a taxpayer to choose when to redeem a credit, which runs counter to our ability to accurately predict the same.

Economic Benefits are Questionable for One of Six Tax Credit Programs Reviewed

Auditors asked Department of Economic Development officials to provide all the information and data available for 6 of the 35 tax credit programs administered by the department. Auditors used the information and data provided in conjunction with independent research to perform an extensive review of the following six tax credit programs:

A. Historic Preservation Tax Credit
B. Qualified Research Expense Tax Credit
C. Brownfield Remediation Tax Credit
D. Brownfield Jobs/Investment Tax Credit
E. Seed Capital Tax Credit
F. Youth Opportunities and Violence Prevention Tax Credit

As stated in a prior audit,[3] the state lacks an adequate performance measurement system that would allow for a comprehensive review of the state's economic development tax credit programs. Unless project level data is captured, such as types of new businesses and jobs created, it is difficult to measure the economic and fiscal impact the tax credit project may have on state and local economies. Despite the limitations, audit staff used available data to perform the following analyses.

[3] *Review of State Tax Credits Administered by the Department of Economic Development*, SAO Report No. 2001-13

A. Historic Preservation Tax Credit

Results from an economic impact analysis of the Historic Preservation Tax Credit indicate the residential component of the program does not produce as much economic benefit to the state as do projects with a commercial component. While there is insufficient data to determine if the economic benefits of residential-only projects justify the costs, the residential component of the program should be monitored closely, particularly when projects are not located in low- to moderate- income areas. Historic Preservation Tax Credit redemptions were estimated at $27 million in fiscal year 2001 and actual redemptions were $34 million.

The Historic Preservation Tax Credit is authorized by Sections 253.545 to 253.559, RSMo 2000, and became effective January 1, 1998. The statute authorizes a tax credit in an amount equal to 25 percent of the total costs and expenses to rehabilitate eligible projects provided such costs exceed 50 percent of the total basis in the property. The amount of tax credits allowed per project is unlimited. No annual or cumulative caps exist for the tax credit program. The credit is sellable and transferable and can be carried back 3 years and forward for 10 years.

Eligibility for the tax credit is automatic if a structure is certified as historical

Eligible property must be a certified historic structure located in Missouri and listed individually on the National Register of Historic Places or be part of a certified historic district. In addition, the rehabilitation must meet standards consistent with the standards of the Secretary of the United States Department of the Interior for rehabilitation as determined by the state historic preservation officer of the Missouri Department of Natural Resources. *(See Appendix V, page 53, for the procedures required to list a Missouri property on the National Registry.)*

State program is often used to leverage federal program (except for residential)

The Historic Preservation Tax Credit is used as a supplement to the federal rehabilitation tax credit,[4] to provide additional financing for the rehabilitation of a historic structure. However, unlike the federal program, which is restricted to income-producing commercial projects only, owner-occupied residential rehabilitation projects may be eligible to receive the Missouri tax credit. Therefore, the Missouri credit may be used on projects that would be ineligible for the federal credit. Another significant difference is the federal program has provisions for recapture of the tax credit in certain circumstances, whereas the Missouri program does not have any recapture provisions. Table 1.1 compares key aspects of the state and federal programs.

[4] The federal rehabilitation tax credit is authorized in Internal Revenue Code (IRC) Section 47 (2001).

Table 1.1: State and Federal Historic Preservation Tax Credit Provisions

Provision	State Historic Preservation Tax Credit	Federal Rehabilitation Tax Credit
Credit for certified historic structures	25% of qualified expenditures	20% of qualified expenditures
Credit for non-certified structures[1]	None	10% of qualified expenditures
Commercial or income producing	Yes	Yes
Residential	Yes	No
Minimum qualified expense	>50% of total basis	Adjusted basis or $5,000
Restoration time period	None	Either a 24 or 60 month period
Holding requirement	None	5 years
Recapture	None	Yes
Carry forward provision	10 years	20 years
Carry back provision	3 years	1 year
Transfer/Sell	Yes	No

[1]Structures built prior to 1936
Source: Section 253.545-253.559, RSMo 2000; IRC Section 47 (2001)

Purpose

The authorizing statute does not explicitly state the purpose for the Historic Preservation Tax Credit. Department of Economic Development officials have interpreted the purpose of the program to be an incentive for the redevelopment of commercial and residential historic structures in the state.

State taxes impacted

Pursuant to Section 253.550, RSMo 2000, the Historic Preservation Tax Credit may be used to offset taxes imposed by Chapters 148 and 143, RSMo 2000, excluding withholding tax imposed by Sections 143.191 to 143.261, RSMo 2000. Chapter 148 imposes the financial institution tax. Chapter 143 imposes the state individual and corporate income tax.

Data issues

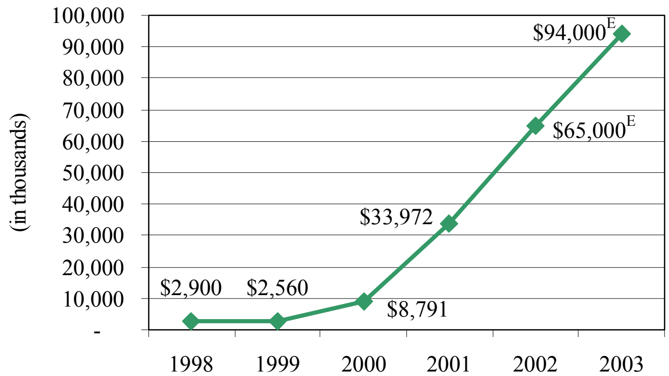
Better data would facilitate analysis

Department officials provided a database which included the name, location city, total tax credits issued, total costs, rehabilitation costs, and the estimated and actual jobs and housing units created for each project. The jobs and housing unit data was incomplete. The inadequate data made it impossible to tell the types of jobs created and the businesses benefiting from the project. Some information was provided on the tax base of the property before and after the rehabilitation for some projects, but not others. The database also did not include the dollar amount of redeemed credits. It is difficult to measure the full economic impact of a tax credit program when project level data is not maintained in a reportable format. Department of Economic Development officials are implementing a new management information system they propose will allow for more detailed data capture and reporting in the future. *(See Issue 2, page 40, for more information on the management information system.)*

Direct economic impact

If measured strictly by the amount of redeemed credits, the cost of the Historic Preservation Tax Credit program has been approximately $48.2 million through fiscal year 2001. Figure 1.2 illustrates the redeemed credits by year since program inception with estimated redemptions for fiscal years 2002 and 2003.

Figure 1.2: Historic Preservation Tax Credit Program



E – Estimate made by Department of Economic Development staff in 2001

Sources: Tax Expenditure Reports prepared by the State & Fiscal Studies Unit, University of Missouri-Columbia; Department of Revenue tax credit tracking system; and Department of Economic Development's Statements of Benefits and Costs (Form 14s)

More than 100 projects have been completed

As of April 2001, there have been 109 projects completed since the inception of the Historic Preservation Tax Credit program. Approximately, $58 million in tax credits have been issued for these projects. The Department of Economic Development database cited increases in construction spending (investment), jobs, housing units, and the redeveloped tax base properties as the benefits of these projects.[5] Table 1.2 provides a summary of these direct benefits as recorded on the Department of Economic Development database.

[5]Data is based on information provided by the developers of these projects, either as estimates when the project was approved or upon certification the project was completed.

Table 1.2: Benefits of Historic Preservation Tax Credit

Issue	Economic Impact
Investment in Eligible Projects	$278 Million
Investment in Rehabilitation Projects	$233 Million
Increase in Property Tax Base	$ 10 Million[6]
Jobs Created	1,984
Housing Units Created	866[7]

Source: Department of Economic Development database and summary log

Commercial versus residential projects

Unlike the Federal Rehabilitation Tax Credit, where only income-producing properties are eligible, the Historic Preservation Tax Credit may be used for either commercial or residential properties. Of the 109 projects completed, 44 were residential. Of the remaining 65 projects, 32 were commercial and 33 were commercial/residential. Commercial/residential projects were primarily residential rental properties, i.e., apartment complexes.

The tax credits redeemed for commercial/residential properties accounted for 57 percent of the total amount issued for the Historic Preservation Tax Credit program. Commercial projects accounted for 38 percent of the tax credits issued and residential projects accounted for only 5 percent of the tax credits issued. Commercial/residential and commercial projects were much larger in scope than the residential projects and therefore had higher rehabilitation costs to qualify for the tax credit.

The commercial/residential and commercial projects have produced tangible direct benefits in the form of jobs and housing units. Residential projects do not produce jobs and usually only create a single housing unit for the owner. Based on this analysis the economic benefits from the commercial/residential and commercial projects would be greater to the state than those derived from the residential projects. However, benefits such as the rehabilitation of a historic home which may be a key factor in the revitalizing a neighborhood, can be a positive result from residential projects.

[6] The Department of Economic Development's database reported an "Estimated Increase in Property Tax Base" of over $83 million. Either the projects did not raise the tax base as anticipated or more likely, from our review of the database, Department of Economic Development staff did not follow-up with the developer to get the actual increase.

[7] Estimated housing units totaled 2,055; however, the databases only reported 866 actual housing units. Either the projects did not create as many housing units as anticipated or more likely, from our review of the database, Department of Economic Development staff did not follow-up with the developer to get the actual increase.

Verification of jobs

In an attempt to verify jobs created, auditors asked the developer/owner to provide a tenants list for each property. Only 32 of the 65 developers/owners listed in the Department of Economic Development database could be contacted because of inaccurate data or no response to our inquires. Of these 32 properties, audit staff attempted to verify the number of employees at the businesses leasing space in the historic structures. Only some of the jobs reported on the database could be verified because some of the businesses had multiple locations and the data available was for all jobs not just the jobs created by the tax credit.

Tax credits allow historic structures to become competitive

Developers told us the Historic Preservation Tax Credit allowed the renovated building to become cash-flow positive, while offering tenants competitive rates compared to surrounding high quality properties. Several developers said they were able to keep the price per square foot low enough to be attractive to small businesses.

For those completed projects where the tenants could be verified, the majority of them were small businesses with less than 100 employees with many having less than 10 employees. The business types included restaurants; other retail; and law, engineering, graphic design and wireless communications firms. The few large tenants in several of the structures included a large hotel chain, a data-processing firm and a state agency.

Total economic impact

Auditors used the Regional Economic Models, Inc., Policy Insight Model for the state to analyze the total economic impact of the Historic Preservation Tax Credit program on the economy. The model compares the baseline forecast of the state economy with an alternative forecast that takes into account the effect of the tax credit. The outputs from the model are as follows:

- Growth in total employment
- Growth in gross state product
- Growth in personal income
- Growth in real disposable income
- Growth in industry output
- Growth in wage rate
- Fiscal impact

Two variables in the model were changed to create the alternative forecast: 1) capital cost, all industries (share), and 2) government spending.

Our methodology was to run the model based on how the tax credit impacts the state economy. Although the tax credit stimulates construction activity, it is not certain this rehabilitation spending would have taken place outside the normal economic activity already forecast by the model. For example, the tax credit may only have shifted construction activity from one location in the state to another. One way to avoid having to make an assumption on construction activity is to assume the tax credit is used to lower the capital costs of all industries in the state. The lowering of capital costs will demonstrate how the tax credit creates demand and jobs in the state economy.

To derive how much the tax credit lowered capital costs, the $58 million in tax credits issued was divided by the sum of non-residential fixed investment and producers' durable equipment fixed investment expressed in constant dollars. To keep the state budget in balance, government spending was reduced by the $58 million in state tax credits. The tax credit was introduced to the model at a constant rate over a 10-year period (2000-2009). The results from the model were reviewed over a 16-year period (2000-2015).

Using these inputs and assumptions, the model produced the following economic impact results:

- Total employment in the state will have increased by approximately 550 jobs in 2000 due to the tax credits reducing the capital costs of industry in the state. Employment will continue to grow during the next 9 years peaking at about 1,700 jobs in 2009. Once the tax credit ends in 2010, job growth decreases substantially and turns negative in the final 3 years of the 16-year analysis period.

- Gross state product steadily increases in the course of the 10 years the tax credit program is in effect, peaking at an increase of approximately $134 million in 2009. In 2010, the first year the credit is removed from the analysis, the increase in gross state product is smaller at $47 million and then trends back towards the baseline forecast.

- Growth in personal income follows the same trend as gross state product, peaking in 2009 at an increase of nearly $78 million. Similar to gross state product, personal income growth declines substantially in 2010 and begins to return to the baseline forecast in the later years.

- The same trends found in gross state product and personal income are found in the measurement of real disposable income. Growth in real disposable income peaks in 2009 at $114 million and then beginning in 2010, once the tax credit stimulus is removed, real disposable income growth trends back towards the baseline forecast.

- Growth in industry output peaks at just under $272 million in 2009. Once the tax credit is removed in 2010, growth in industry output begins to decline and move back towards the baseline forecast.

- In the first year the tax credit is introduced to the model, there is a positive effect on wage rates. However, in the following years, the impact on wage rates is negative. Once the tax credit is removed the negative effect on wage rates grows substantially.

- The model predicts the fiscal impact on the state will be positive during the 10-year time period the tax credit is in effect. However, once the tax credit ends in 2010, there is a sharp decline in state revenues.

Summary of results

Based on the way the Historic Preservation Tax Credit was introduced to the model, the results show the tax credit having a significant positive economic impact on jobs and demand. The model also shows that by lowering capital costs the tax credit will stimulate economic activity, which is then taxed, resulting in enough additional state revenue to offset the cost of the tax credit. However, in the years following the removal of the tax credit as a stimulus, tax revenues would fall below the baseline forecast, possibly reflecting an over-stimulus effect of the tax credit program.

The analysis did not consider the impact of the federal rehabilitation tax credit. If the federal rehabilitation tax credit had been included in our analysis, the positive economic impact may have been even more substantial because the 20 percent federal tax credit would be treated as free money from a state budget standpoint. Including the federal tax credit in our analysis would have been difficult and subject to error on the aggressive side because none of the residential projects could use the federal tax credit. Despite receiving a list of federal tax credit projects in Missouri from the National Park Service, auditors were unable to accurately match the list with the Department of Economic Development database. Many of the commercial and commercial/residential projects used the state tax credit to leverage the federal tax credit.

Our methodology also ignores the potential economic impact of any additional housing units or tourism, this tax credit program created. Historic buildings can add to an areas' culture and promote tourism. One developer stated citizens from Kansas come to his small Missouri town to dine and shop because of the town's revitalized main street, a result of the rehabilitated historic buildings on the street.

Noneconomic influences

One aspect of the Historic Preservation Tax Credit not addressed in the economic impact analysis is the extent historic preservation may increase the quality of life. Additionally, the rehabilitation of a historic home or a home in a historic neighborhood may be a key factor in revitalizing the neighborhood.

An argument could also be made that state tax credit programs should benefit as many citizens as possible and state-sponsored economic development incentives should be geared towards improving areas in need of revitalizing. While these two issues have economic aspects to them, the economic impact to the state may not necessarily depend on the location of the tax credit project. Therefore, the geographic distribution and the census tract income level distribution of the tax credit projects were treated as noneconomic influences in the award of the tax credit. Department of Economic Development officials do not have any discretion on project location. The only criteria for eligibility is for the project to be a certified historic structure. (*See Appendix III, page 48, for a list of how tax credits are approved.)*

Although a substantial majority of the projects have been in the St. Louis and Kansas City metropolitan areas, there have been some projects in other parts of the state. As mentioned earlier, smaller towns have found the tax credit beneficial in revitalizing main streets.

For residential projects completed, 57 percent (25 of 44) were located in low- or moderate-income census tracts, 39 percent (17 of 44) were located in middle- or upper- income census tracts and 4 percent (2 of 44) had unknown census tracts. For commercial/residential projects completed, 40 percent (26 of 65) were located in low- or moderate-income census tracts, 57 percent (37 of 65) were located in middle- or upper- income census tracts and 3 percent (2 of 65) had unknown census tracts. Although residential projects may not provide tangible economic benefits such as jobs, the projects may be revitalizing low- and moderate-income neighborhoods. (*See Appendix IV, page 49, for a distribution of projects by geography and census tract income level.*)

Recommendations

We recommend the Director, Department of Economic Development:

1.2 Improve data collection and reporting on Historic Preservation Tax Credit projects. Specifically, the data should include the actual number of jobs and housing units created once the project is completed. Additional information, such as types of jobs created and the types of tenants occupying the completed building, should also be obtained.

1.3 Improve data collection for the residential component of the tax credit program to allow this component to be closely monitored. This is particularly important when projects are not located in low- and moderate-income neighborhoods.

Department of Economic Development Responses

1.2 The Historic Preservation Tax Credit Program is an entitlement program. Accordingly, there is limited information that we can require from an applicant – only that information that goes to the entitlement. This does not include the data specified in the recommendation (jobs, number of housing units, types of tenants). We do ask for more information than the law requires, and have a fair rate of voluntary compliance with our request. The recommendation seems to focus on post-completion collection of data. In addition to having no authority to force recipients or their tenants to provide us with information before or after completion, we do not have adequate staff to conduct such detailed audits of projects.

1.3 This is an entitlement program and current law does not require recipients or tenants to provide such information. In addition, there is no indication that the law was intended to primarily aid projects in low to moderate-income areas. To the contrary, when the legislature intends for a program to benefit such areas, or otherwise focus on geographic areas based on factors such as poverty and unemployment, it has specifically required as such or indicated a preference for such. (Note the many programs that are for distressed communities or have enhanced benefits for distressed communities.) The lack of any such requirement or enhanced benefit in this program is indicative that where the projects are located was not intended to be a measure of the success of the program.

B. Qualified Research Expense Tax Credit

An economic impact analysis of the Qualified Research Expense Tax Credit indicates this program may not provide sufficient economic benefit to warrant its continuation. Section 620.1039, RSMo 2000, authorizes a tax credit equal to 6 1/2 percent of the taxpayer's qualified research expenses in the current year that are in excess of the average qualified research expense for the preceding 3 years. The net increase is not to exceed 200 percent of the average qualified research expense. The Qualified Research Expense Tax Credit is on a first come basis and is approved through a formula. (*See Appendix III, page 48, for a list of how tax credits are approved.)* The program has an annual cap of $9.7 million and may be carried forward for up to 5 years. Under certain circumstances, up to 40 percent of the credit may be transferred or sold. The program has been in effect since 1994.

Purpose

Pursuant to Section 620.1039, RSMo 2000, qualified research expense has the same meaning as that prescribed in IRC Section 41(d). Qualified research as defined by IRC Section 41(d) is discovering technological information which develops a new or improved taxpayer business component.[8] The research may qualify for the tax credit if it relates to a new or improved function, performance, reliability or quality, not including if the research relates to style, taste, cosmetic, or seasonal design factors. Qualified research does not include:

- Research after commercial production
- Duplication of existing business component
- Foreign research
- Computer software (unless used internally)
- Surveys, studies, etc.
- Adaptation of existing business components
- Social sciences, etc.
- Funded research

The state tax credit can also be used to leverage an existing federal tax credit. Table 1.3 compares the federal and state tax credit programs.

Table 1.3: Federal and State Research Tax Credit Provisions

Provision	State Qualified Research Expense Tax Credit	Federal Tax Credit for Increasing Research Activities
Credit description	6.5% of the excess qualified research expense above the average Missouri expenses over the last 3 years; the expense is not to exceed 200% of that average excess.	20% of the excess of the qualified research expense over the base amount and 20% of the basic research payments.
Carry forward provision	5 years	15 years
Carry back provision	None	3 years
Annual cap	$9.7 Million	N/A

Source: Section 620.1039, RSMo 2000; IRC Section 41(c)(3)

[8] A business component is any product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, license or used by taxpayers in their trade or business. IRC Section 41(d).

State taxes impacted

Pursuant to Section 620.1039, RSMo 2000, the Qualified Research Expense Tax Credit may be used to offset taxes imposed by Chapters 148 and 143, RSMo 2000, excluding withholding tax imposed by Sections 143.191 to 143.261, RSMo 2000. Chapter 148 imposes the financial institution tax. Chapter 143 imposes the state individual and corporate income tax.

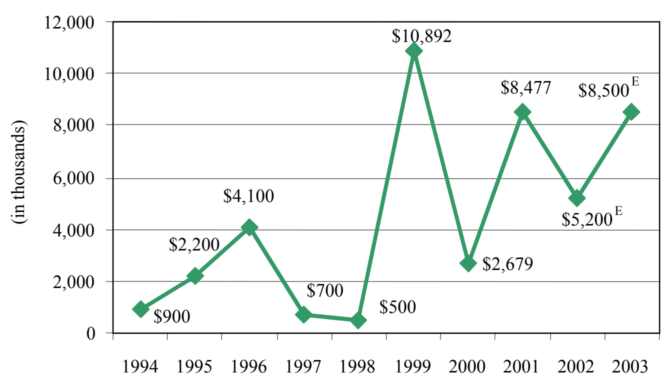
Information and data issues

Department of Economic Development staff provided our office with a log of the projects that have used the Qualified Research Expense Tax Credit. This information did not include the types of business using the tax credit. Through independent research, auditors obtained the business addresses and Standard Industrial Classification codes for most of the businesses. Many of the businesses were headquartered out of the state which made it difficult in determining what business activities took place in the state.

Direct economic impact

If measured strictly on the amount of redeemed credits, the cost of the Qualified Research Expense Tax Credit has been approximately $30.4 million through fiscal year 2001. Figure 1.3 illustrates the redeemed credits by year since program inception with estimated redemptions for fiscal years 2002 and 2003.

Figure 1.3: Qualified Research Expense Tax Credit Program



E – Estimate made by Department of Economic Development staff in 2001

Sources: Tax Expenditure Reports prepared by the State & Fiscal Studies Unit, University of Missouri-Columbia; Department of Revenue tax credit tracking system; and Department of Economic Development's Statements of Benefits and Costs (Form 14s)

While audit staff researched these businesses to ensure they had some type of operation in the state, it was not possible to obtain detailed descriptions of their Missouri operations. Therefore, it could not be determined if the actual research and development being performed would directly benefit the state.

Total economic impact

Auditors used the Regional Economic Models, Inc., Policy Insight Model for the state to analyze the total economic impact of the Qualified Research Expense Tax Credit program on the economy. The model compares the baseline forecast of the state economy with an alternative forecast that takes into account the effect of the tax credit. The outputs from the model are as follows:

- Growth in total employment
- Growth in gross state product
- Growth in personal income
- Growth in real disposable income
- Growth in industry output
- Growth in wage rate
- Fiscal impact

Two variables in the model were changed to create the alternative forecast: 1) production cost and 2) government spending.

Because the data captured and reported by Department of Economic Development staff for this tax credit program did not include elements that were conducive to an economic impact analysis, audit staff had to perform extensive independent research to verify the type of businesses qualifying for the tax credit. Because of time and resource limitations, only tax credits approved in fiscal year 2000 were included in our analysis, despite the fact the tax credit program dates back to 1994. However, the chosen sample is indicative of the impact of the overall program.

To measure the total economic impact of the Qualified Research Expense Tax Credit program, the approved dollar amount of tax credits received by each project (business) was taken and projected out at the specific industry growth rate over a 10-year time period (2000-2009). The results from the model were reviewed over a 16-year period. (2000-2015). The assumptions are the usage of the tax credit will increase at the growth rate of the specific industries over a 10-year time period, and the tax credit program will end after this 10-year period. Because of the statutory cap the growth of the tax credit was not allowed to exceed $9.7 million.

Using these inputs and assumptions, the model produced the following economic impact results:

- The Qualified Research Expense Tax Credit results in a loss of jobs during the first 5 years of the analysis period. The largest loss of jobs comes in the first year with a loss of 161 jobs. The job losses diminish during the 5 subsequent years until job growth begins in 2005. There is a peak positive effect from the tax credit in 2010, the first year without the tax credit, when there is an increase of 160 jobs.

- Gross state product declines in the first 3 years of the analysis period and then begins to increase in 2003. Growth in gross state product peaks at $11 million in 2010, the last year of the tax credit, and then begins to return to the baseline forecast once the tax credit is removed as a stimulus.

- The negative effect of the tax credit on personal income lasts 2 years longer than on gross state product. Personal income declines during the first 6 years of the policy analysis before turning positive in 2006. Like gross state product, growth in personal income peaks in 2010, at a total of $7.3 million, before gradually returning towards the baseline forecast.

- The impact of the tax credit on real disposable income is positive during the entire 16-year analysis period. The increase in real disposable income peaks in 2009, at $4.3 million, before gradually moving back towards the baseline forecast.

- Industry output also experiences positive growth during the 16-year analysis period. In 2009, industry output growth peaks at almost $22 million, before trending back towards the baseline forecast.

- The tax credit has a negative impact on wage rates during all the years the tax credit is in effect. Wage rates spike higher in 2010 and 2011, the first and second years after the tax credit is removed from the economy. In the subsequent years, the wage rate trends back towards the baseline forecast.

The tax credit has a negative effect on state revenues during all 10 years the tax credit is in effect. The largest projected decline would be a $770,000 decrease in state revenue in 2000. The effect on state revenues turns positive in 2010, with a projected increase of $20,000 in state revenue; however, the impact on state revenues turns negative again in 2011 and stays negative for the remaining 4 years of the analysis period.

Summary of results

If businesses primarily used the Qualified Research Expense Tax Credit to reduce production costs there would be no positive impact to the state economy until at least several years out, if at all. The credit is projected to have only a negligible impact on state revenues. In addition, per the model analysis the jobs and demand created are not substantial enough to justify the credit, possibly because many businesses using the credit are in more mature industries with slow or negative growth rates.

Recommendation

We recommend the Director, Department of Economic Development:

1.4 Review the Qualified Research Expense Tax Credit to determine if there are ways to improve its impact on the state economy. If the positive impact on the economy cannot be improved, this tax credit should be considered for elimination.

Department of Economic Development Responses

1.4 *For the period of this audit, the Qualified Research Expense Tax Credit was essentially an entitlement program. In 1998 Senate Bill 827 was enacted, which made the tax credit authorization discretionary and placed a $10 million cap each taxable year on the program. In 2000, Senate Bill 894 made additional changes to the program, the most significant allowing the credits to be sold. Additionally, applicants who had unredeemed tax credits from January 1, 1996 to December 31, 1999, could transfer or sell up to 40% of the unredeemed, with the requirement that the proceeds from the sale of the credit had to then be expended within three years on research activities conducted by a state university.*

Since these statutory changes were made, the department has been working to revise the program to target certain industries and to better promote the use of the credit by emerging companies. We will be asking for more information than ever before, which will aid in measuring the success of the program. The department will consider including any relevant "key data elements" suggested in the audit report.

C. Brownfield Remediation Tax Credit

The Brownfield Remediation Tax Credit is a discretionary program with no annual or cumulative caps. (*See Appendix III, page 48, for a list of how tax credits are approved).* The limit per project is at the discretion of Department of Economic Development officials and depends on the amount of remediation costs, and the state economic impact. Eligible projects must be accepted into the Missouri Department of Natural Resources "Voluntary Cleanup Program" and cannot be an Environmental Protection Agency "Superfund" site. The credit is sellable and transferable and may be carried forward for up to 20 years. Brownfield Remediation Tax Credit redemptions were estimated at $3.6 million in fiscal year 2001 and actual redemptions were $4.5 million.

Purpose

State statutes do not explicitly state the purpose of the Brownfield Remediation Tax Credit. An eligible project may receive up to 100 percent of the remediation costs if the business that is to operate on the premises is projected to create at least 10 new jobs, or retain at least 25 jobs, or a combination thereof. A project is eligible if it will create new jobs or preserve existing jobs, attract new business to the state, prevent existing businesses from leaving the state, or improve the economic welfare of the state.

The property must be abandoned or underutilized for at least 3 years because of real or suspected environmental contamination. The ownership of the property must have reverted to the state or local government; or if the property is privately owned, the city or county must endorse the project for inclusion in the program, and the property must be transferred to a person other than the party potentially responsible for the contamination. Additionally, the local government must have provided at least a 50 percent real property tax abatement for 10 years or tax increment financing.

State taxes impacted

Pursuant to Section 447.708, RSMo Supp. 2001, the Brownfield Remediation Tax Credit may be used to offset taxes imposed by Chapters 148, 147 and 143, RSMo 2000, excluding withholding tax imposed by Sections 143.191 to 143.261, RSMo 2000. Chapter 148 imposes the financial institution tax. Chapter 147 imposes the corporate franchise tax. Chapter 143 imposes the state individual and corporate income tax.

Information and data issues

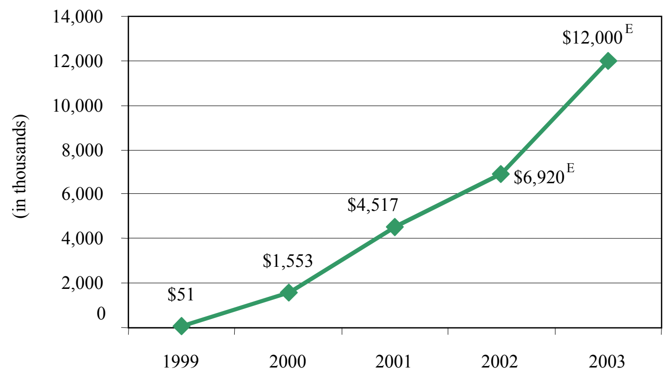
As stated in a prior audit,[9] department officials need to improve data capture and reporting at the project level. Unless project level data is captured, such as types of new businesses and jobs created, it is impossible to measure the economic and fiscal impact a tax credit project may have on state and local economies. Department officials did not provide this data when requested which limited the analysis of the program.

[9] *Review of State Tax Credits Administered by the Department of Economic Development*, SAO Report No. 2001-13.

Direct economic impact

If measured strictly by the amount of redeemed tax credits, the cost of the Brownfield Remediation Tax Credit has been approximately $6.1 million through fiscal year 2001. Figure 1.4 illustrates the redeemed credits by year since program inception with estimated redemptions for fiscal years 2002 and 2003.

Figure 1.4: Brownfield Remediation Tax Credit Program



E – Estimate made by Department of Economic Development staff in 2001

Sources: Tax Expenditure Reports prepared by the State & Fiscal Studies Unit, University of Missouri-Columbia; Department of Revenue tax credit tracking system; and Department of Economic Development's Statements of Benefits and Costs (Form 14s)

The lack of key information and data made it impossible to determine some direct economic benefits of the Brownfield Remediation Tax Credit program. Eligibility for the tax credit requires the project to produce or retain jobs, or attract or retain businesses. Based on the information provided by Department of Economic Development officials, it could not be determined if any of these requirements were achieved.

Total economic impact

Auditors used the Regional Economic Models, Inc., Policy Insight Model for the state to analyze the total economic impact of the Brownfield Remediation Tax Credit program on the economy. The model compares the baseline forecast of the state economy with an alternative forecast that takes into account the effect of the tax credit. The outputs from the model are as follows:

- Growth in total employment
- Growth in gross state product
- Growth in personal income
- Growth in real disposable income
- Growth in industry output
- Growth in wage rate
- Fiscal impact

Two variables in the model were changed to create the alternative forecast: 1) capital cost, all industries (share), and 2) government spending.

Our methodology was to run the model based on how the tax credit impacts the state economy. Although the tax credit induces remediation activity of some type, it is not certain this remediation spending would not have taken place outside the normal economic activity already forecast by the model. For example, the tax credit may only have induced the shifting of remediation activity from one location in the state to another. One way to avoid making an assumption on remediation activity is to assume the tax credit is used to lower the capital costs of all industries in the state. The lowering of capital costs will demonstrate how the tax credit creates demand and jobs in the economy.

To derive how much the tax credit lowered capital costs, the $18.6 million in tax credits issued was divided by the sum of non-residential fixed investment and producers' durable equipment fixed investment expressed in constant dollars. To keep the state budget in balance, government spending was reduced by the $18.6 million in tax credits issued. The tax credit was introduced to the model at a constant rate over a 10-year period (2000-2009). The results from the model were reviewed over a 16-year period (2000-2015).

Using these inputs and assumptions, the model produced the following economic impact results:

- Total employment in the state will have increased by 177 jobs in 2000 due to the reduction in capital costs resulting from the tax credit. Employment would continue to grow during the next 9 years peaking at about 544 in 2009. Once the tax credit ends in 2010, job growth decreases substantially.

- Gross state product steadily increases in the course of the 10-year analysis period, peaking at an increase of approximately $43 million in 2009. In 2010, the first year the credit is removed from the analysis, the increase in gross state product declines to $15 million and then trends back towards the baseline forecast.

- Growth in personal income follows the same trend as gross state product, peaking in 2009 at an increase of nearly $25 million. Also similar to gross state product, personal income growth declines substantially in 2010 and begins to return to the baseline forecast in the later years.

- The same trends found in gross state product and personal income are found in the measurement of real disposable income. Growth in real disposable income peaks in 2009 at $36 million and then beginning in 2010, once the tax credit stimulus is removed, real disposable income growth trends back towards the baseline forecast.

- Growth in industry output peaks at just under $87 million in 2009. Once the tax credit is removed in 2010, growth in industry output begins to decline and move back towards the baseline forecast.

- In the first year the tax credit is introduced to the model there is a slight positive effect on wage rates. However, in the following years the impact on wage rates is negative. In 2010 when the credit is removed there is a sharp decrease, then there is a rebound in 2011, although the impact on the wage rate is still negative. The wage rate amount then continues to decline.

The model predicts the fiscal impact on the state will be positive during the 10-year time period the tax credit is in effect. However, once the tax credit ends in 2010 there is a sharp decline in state revenues.

Summary of results

Based on the way the Brownfield Remediation Tax Credit was introduced to the model, the results show the tax credit having a positive economic impact on the state. Our methodology does not include any benefits from new businesses or housing units from the cleaned-up site because Department of Economic Development officials did not provide such data for consideration. Our methodology also ignores any quality of life benefits such as less pollution or revitalization of a neighborhood because sufficient data was not available.

Noneconomic influences

The clean-up of toxic waste sites may not have any measurable economic impact; however, the clean-up of an abandoned polluted site may revitalize an area and allow for some economic activity to emerge in an area where none existed before. Additionally, the quality of life for the surrounding area may improve after the clean-up.

An argument could also be made that state tax credit programs should benefit as many citizens as possible and state-sponsored economic development incentives should be geared towards improving areas in need of revitalization. While these two issues have economic aspects to them, the economic impact to the state may not necessarily depend on the location of the tax credit project. Therefore, the geographic distribution and the census tract income level distribution of the tax credit projects are treated as noneconomic influences in the award of the tax credit. Department of Economic Development officials have discretion on project locations.

All but 2 of the 16 projects utilizing the tax credit are in the St. Louis metropolitan area. The other two are located in Cole and Wayne counties. Two of the projects were in low-income census tracts and five of the projects were in moderate-income census tracts. The Cole County project was in a low-income census tract and the Wayne County project was in a moderate-income census tract. (*See Appendix IV, page 49, for a distribution of projects by geography and census tract income level.*)

Recommendation

We recommend the Director, Department of Economic Development:

1.5 Ensure all key information from tax credit applications and other information provided by a developer/owner who is cleaning up a site is documented in an electronic format that allows for an independent review.

Department of Economic Development Responses

1.5 Most of the information requested by the Auditor's office is tracked either by CMS or in a Microsoft Access/Excel database or spreadsheet. This information includes project name, address, Senator and Representative districts, approved amounts of tax credits, issued amounts of tax credits (as well as recipients and addresses), total estimated project costs, estimated (projected) job numbers and whether the project is in a distressed or targeted area.

Information that was requested that is not tracked is the average wages of projected employees and the actual amount of employees that locate at the project site at the completion of the project. We do not have adequate staff to conduct post-completion audits of projects and ascertain this information. Moreover, while we can attach reporting requirements to the recipients of the tax credits, it would be untenable to attempt to require reporting from the eventual owners of the properties, or the lessees.

D. Brownfield Jobs/Investment Tax Credit

The Brownfield Jobs/Investment Tax Credit is at the discretion of Department of Economic Development officials and is approved through a formula. *(See Appendix III, page 48, for a list of how tax credits are approved.)* There is no cumulative cap; however, the annual cap is at the discretion of department officials, as well as the limit per project, which also depends on the amount of remediation costs and the state economic impact. The credit is not sellable or transferable and may not be carried forward. A refund of unused credits is allowed by Section 135.245, RSMo 2000. Eligible projects must be accepted into the Missouri Department of Natural Resources "Voluntary Cleanup Program" and cannot be an Environmental Protection Agency "Superfund" site.

Purpose

Pursuant to Section 447.708, RSMo Supp. 2001, eligible businesses may receive a $400 tax credit for each employee per year for up to 10 consecutive years. Eligible businesses may receive additional $400 credits for each employee exceeding the 10 new jobs created or 25 jobs retained and for each employee meeting the definition of "a person difficult to employ," as defined by Section 135.240, RSMo 2000. Eligible businesses may also receive investment credits based on the formula provided by Section 135.225(4), RSMo 2000. The credits may not exceed the greater of that portion of the taxpayer's income attributed to the project or 100 percent of the total business' income tax if the project is a new facility and the taxpayer does not operate other facilities in the state. The project may be eligible for tax credits if the taxpayer expands an existing facility or operates other facilities in the state; however, the credits would be capped at either 50 percent or 25 percent of the total business' income tax depending on the situation.

The property must be abandoned or underutilized for at least 3 years because of real or suspected environmental contamination. The ownership of the property must have reverted to the state or local government; or if the property is privately owned, the city or county must endorse the project for inclusion in the program, and the property must be transferred to a person other than the party potentially responsible for the contamination. Additionally, the local government must have provided at least a 50 percent real property tax abatement for 10 years or tax increment financing.

Department of Economic Development officials base the credit upon eligibility requirements and interpretation of the program. Public policy to be implemented by the tax credit would be to provide an incentive to businesses or developers to redevelop contaminated property and to create new jobs or to retain jobs.

State taxes impacted

Pursuant to Section 447.708, RSMo Supp. 2001, the Brownfield Jobs/Investment Tax Credit may be used to offset taxes imposed by Chapters 148, 147 and 143, RSMo 2000, excluding withholding tax imposed by Sections 143.191 to 143.261, RSMo 2000. Chapter 148 imposes the financial institution tax. Chapter 147 imposes the corporate franchise tax. Chapter 143 imposes the state individual and corporate income taxes.

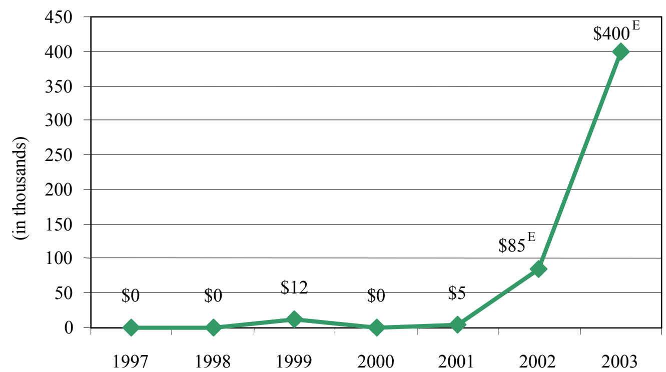
Information and data issues

Although there were only four projects listed under this tax credit program, audit staff received little information on the projects besides the name of the business that used the credit. Key data missing included a full street address of the property, the Standard Industrial Classification code of the employer, the number of jobs created or retained, whether or not the employee met the definition of difficult to employ and the amount of credits approved, issued and redeemed under the program.

Direct economic impact

The Brownfield Jobs/Investment Tax Credit program has not been used much by businesses. According to Department of Revenue records, credits redeemed totaled approximately $5,000 in fiscal year 2001, and Department of Economic Development staff estimate the credits redeemed will total $85,000 in fiscal year 2002. Figure 1.5 illustrates the redeemed credits by year since program inception with estimated redemptions for fiscal years 2002 and 2003.

Figure 1.5: Brownfield Jobs/Investment Tax Credit Program



E – Estimate made by Department of Economic Development staff in 2001

Sources: Tax Expenditure Reports prepared by the State & Fiscal Studies Unit, University of Missouri-Columbia; Department of Revenue tax credit tracking system; and Department of Economic Development's Statements of Benefits and Costs (Form 14s)

Job verification

One business did not meet criteria for tax credit

There were four businesses listed on the Department of Economic Development project log for this tax credit program. Three of the businesses were located in the same project. Department of Labor - Division of Employment Security records were used to verify the number of full-time employees for each business receiving the tax credits. Division officials are responsible for collecting unemployment taxes from businesses and maintain records that indicate the number of employees a business has when taxes are paid. According to division officials, 2 of the 4 businesses had less than 10 employees. One of the businesses reported only four employees when the tax credit was issued and this business reported only one employee in the fourth quarter of 2000, the last time the business filed a report with the division. However, this business met the Department of Economic Development's guideline that an eligible business within a project must have created at least 2 new jobs or retained 25 jobs as long as the project in total created at least 10 new jobs and retained 25 jobs. The other business reported no employees in the first quarter of 1999, but was issued tax credits in March 1999. The business is no longer active in the state.

Total economic benefit

There was not sufficient data to measure the total economic benefit of this tax credit program on the state. A more in-depth review of this program would have been possible, if the type of business and jobs data, as well as amount of approved, issued and redeemed credits had been provided**.**

Noneconomic influences

This tax credit program provides an incentive for businesses to hire employees who meet the definition of difficult to employ. No data was provided that would indicate if this incentive is working.

All four projects using the tax credit were in the St. Louis metropolitan area. One of the projects was located in a moderate-income census tract. The other three were located in a middle-income census tract. (*See Appendix IV, page 49, for a distribution of projects by geography and census tract income level.*)

Recommendations

We recommend the Director, Department of Economic Development:

1.6 Review these projects to ensure employment requirements are met.

1.7 Recapture the tax credits from the business receiving tax credits during the same quarter it reported having no employees.

Department of Economic Development Responses

1.6 When a business submits the necessary forms to claim the Brownfield tax benefits at approved sites, the number of employees and the amount of investment is provided by the applicant. Tax credits are issued for a one-year period (or portion thereof) and monthly averages of both jobs and investment are requested. These monthly averages are then used to verify that the businesses met the employment and investment criteria (the same method is used in the Enterprise Zone program). There is also a separate form to submit if any employees are considered "difficult to employ".

1.7 No business received tax credits for a quarter in which it reported having no employees. Credits were issued to the business stated in the audit in March 1999. These credits were issued for new jobs and investment in calendar year 1998. The forms requesting these *credits were submitted in 1999. The business was only in existence in 1998 and accordingly only received tax credits for that year.*

Auditor's Comment

Since the Brownfield Jobs/Investment tax credit program is a discretionary program, the Department of Economic Development should have verified that the firm still had employees in 1999 before issuing the tax credits. The purpose of this tax credit program is to encourage the creation of additional jobs and investment in the business which is impossible if the firm no longer has any employees.

E. Seed Capital Tax Credit

Section 348.302, RSMo 2000, authorizes the Seed Capital Tax Credit. Originally enacted in 1986, this tax credit program was a 30 percent tax credit designed to encourage the creation of seed capital,[10] start-up capital[11] and follow-up capital[12] for commercial activities located in the state.

Legislation in 1993 provided a $5 million cumulative cap on the amount of tax credits authorized. In 1999, the legislature authorized $4 million more in seed capital tax credits (and increased the credit from 30 percent to 50 percent), but limited the qualifying commercial activity to that located in a distressed community, as defined in Section 135.530, RSMo 2000. This tax credit was intended to be approved at the discretion of the four Missouri innovation centers located in Columbia, Kansas City, Rolla and St. Louis. (*See Appendix III, page 48, for a list of how tax credits are approved.)* The centers were to receive distributions of equity and dividends or other earnings of the fund. The credit is sellable and transferable, with a carry forward period of 10 years.

Currently, the statutory cap has been reached and there are no available tax credits remaining under this program.

Purpose

Section 348.302, RSMo 2000 authorizes the Seed Capital Tax Credit program. Pursuant to the authorizing statute, any taxpayer who makes a contribution to a qualified fund would be eligible to receive the tax credit. A qualified fund is any corporation, partnership, joint venture, unincorporated association, trust or other organization established with the sole purpose of making investments, of which 90 percent must be qualified investments. A qualified investment is any investment of seed capital, start-up capital and follow-up capital in a commercial activity located in the state. The qualified fund must enter into a contractual relationship with one of the approved Missouri innovation centers. The contract must contain a provision allowing the innovation center to receive not less than 10 percent of any distributions of equity and dividends or other earnings of the fund.

State taxes impacted

Pursuant to Section 348.300, RSMo 2000, the Seed Capital Tax Credit may be used to offset taxes imposed by Chapters 148, 147 and 143, RSMo 2000, excluding withholding tax imposed by Sections 143.191 to 143.261, RSMo 2000. Chapter 148 imposes the financial institution tax. Chapter 147 imposes the corporate franchise tax. Chapter 143 imposes the state individual and corporate income tax.

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[10] Capital provided for research, development and precommercialization activities to prove a concept for a new product or process or service, and for activities related thereto.

[11] Capital provided for use in preproduction product development or service development or initial marketing thereof, and for activities related thereto.

[12] Capital provided which a qualified fund has previously invested seed capital or start-up capital and which does not exceed ten times the amount of such seed and start-up capital.

Information and data issues

Department of Economic Development officials did not actively track the businesses that received Seed Capital Tax Credit funding; however, audit staff was provided with the names of the businesses that received funding under the 1993 phase of the program and the distressed community (1999) phase of the program.

In light of the shortage of information, audit staff contacted representatives of the state innovation centers to see if they maintained a database of the businesses benefiting from the Seed Capital Tax Credit. Innovation center staff said such a database does not exist. According to an innovation center official, the Seed Capital Tax Credit program was a difficult program to administer, and no one was interested in showing how well the program worked. The official also stated that because the tax credit program had expired there was no interest in following-up on the businesses receiving the benefits of the credit. This lack of interest in tracking the success or failure of businesses receiving funds generated by this tax credit illustrates the need for the Department of Economic Development officials to capture data required to assess the effectiveness of all tax credit programs administered.

The lack of a streamlined structure made it difficult to administer the Seed Capital Tax Credit program. According to the innovation center official, for each seed capital transaction, a trust had to be set-up at a local bank to handle the funds and the associated paperwork. This process was cumbersome and inefficient because of the time and cost involved. Originally, this tax credit program was envisioned to have only one or two fund managers involved; however, this outcome did not occur because a fund manager who would handle a large number of small transactions could not be found.

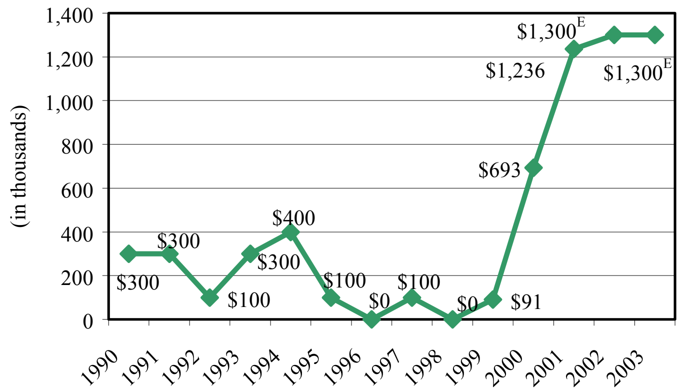
The innovation center official said the problems with the Seed Capital Tax Credit program were taken into consideration during the drafting of the New Enterprise Creation Act Tax Credit program. This program, which came into effect in July 1999, has had no activity as of February 2002. The program has been designed to avoid the inefficiencies of the Seed Capital Tax Credit program by allowing for only one fund manager and a placement agent to handle the transactions.

Department of Economic Development officials provided projects logs for both the distressed community phase and the 1993 phase of the Seed Capital Tax Credit program. Under the distressed community phase, 14 businesses received funding and under the 1993 phase, 10 businesses received funding; however, 2 of the 10 businesses also received follow-up funding under the distressed community phase. Under the 1993 phase of the program, several investment funds set-up by venture capital firms also received funding; however, no information was provided on the actual businesses the venture capital firms may have funded.

Direct economic impact

If based strictly on the redeemed amount of tax credits, the cost of the Seed Capital Tax Credit program has been approximately $3.6 million through fiscal year 2001. Figure 1.6 illustrates the redeemed credits by year since program inception with estimated redemptions for fiscal years 2002 and 2003.

Figure 1.6: Seed Capital Tax Credit Program



E – Estimate made by Department of Economic Development staff in 2001

Sources: Tax Expenditure Reports prepared by the State & Fiscal Studies Unit, University of Missouri-Columbia; Department of Revenue tax credit tracking system; and Department of Economic Development's Statements of Benefits and Costs (Form 14s)

Under the distressed communities phase, the tax credit represented 50 percent of the total contribution. The $4 million in tax credits issued leveraged $8 million in total investment for the 14 projects. Under the 1993 phase, the tax credit was 30 percent of the total contribution. The approximately $5 million in tax credits issued leveraged about $16 million in total investment for 10 businesses and several venture capital investment funds.

Total economic impact

Auditors used the Regional Economic Models, Inc., Policy Insight Model for the state to analyze the total economic impact of the Seed Capital Tax Credit program (1999 legislation only) on the economy. The model compares the baseline forecast of the state economy with an alternative forecast that takes into account the effect of the tax credit. The outputs from the model are as follows:

- Growth in total employment
- Growth in gross state product
- Growth in personal income
- Growth in real disposable income
- Growth in industry output
- Growth in wage rate
- Fiscal impact

Two variables in the model were changed to create the alternative forecast: 1) production cost and 2) government spending.

Because the data capture and reporting by Department of Economic Development officials for this tax credit program did not include elements that were conducive to an economic impact analysis, audit staff had to perform extensive independent research to verify the type of businesses qualifying for the tax credit. Because of the lack of timely key data for projects prior to 1999, only tax credits issued subsequent to January 1, 1999 were included in our analysis, despite the fact the tax credit program dates back to 1990.

To measure the total economic impact of the Seed Capital Tax Credit, the $4 million in issued tax credits was projected at the specific industry growth rate over a 10-year time period (2000-2009). The results from the model were reviewed over a 16-year period (2000-2015). The assumptions made are the usage of the tax credit will increase at the growth rate of the specific industries over a 10-year time period and the tax credit program will end after this 10-year period. This analysis is hypothetical since the tax credit program has expired and no more tax credits will be issued. We evaluated this tax credit because it should have a similar effect on the economy as the New Enterprise Creation Act Tax Credit which basically replaces the Seed Capital Tax Credit.

Using these inputs and assumptions, the model produced the following economic impact results:

- The Seed Capital Tax Credit would have been a positive impact on job growth for the entire hypothetical 16-year analysis period. Growth peaked in 2009 with an increase of 164 jobs.

- Growth in gross state product also would have been positive for the entire 16-year period. Growth in gross state product would have peaked at $8.4 million in 2009, the last year the tax credit was effective. In 2010, the first year the credit is removed from the analysis, the increase in gross state product begins to gradually trend back towards the baseline forecast.

- Growth in personal income follows the same trend as gross state product; however, it peaks in 2010 at $8.3 million. Also, similar to gross state product, personal income growth declines gradually towards the baseline forecast after the peak year.

- The same trends found in gross state product are found in the measurement of real disposable income. Growth in real disposable income peaks in 2009 at $8.3 million and then beginning in 2010, once the tax credit stimulus is removed, real disposable income growth trends back towards the baseline forecast.

- Growth in industry output peaks at just over $18.4 million in 2009. Once the tax credit is removed in 2010, growth in industry output begins to decline and move back towards the baseline forecast.

- The tax credit has a negative impact on wage rates for the entire 10-year period the tax credit is in effect. Wage rate growth occurs in the three years following the end of the tax credit, but wage rates then turn negative again for the remaining years.

- The model predicts the fiscal impact on the state will be negative the first year of the tax credit but then predicts growth in state revenues until 2011. State revenues are predicted to decline again from 2012 to 2015.

Summary of results

The Seed Capital Tax Credit has an immediate positive impact on the economy, with the exception of wage rates. Unlike the Qualified Research Expense Tax Credit, the Seed Capital Tax Credit was used by businesses in high growth industries. This may account for the differing impacts of these two tax credit programs on the state economy.

Noneconomic influences

While a business clearly has an economic impact on the community it chooses to locate in, there may also be noneconomic benefits and costs. For example, a new successful business locating in a community may spur further revitalization of the community and improve the quality of life for the residents. In 1999, the legislature limited the Seed Capital Tax Credit program to commercial activity located in a distressed community. A successful business in a distressed community may lead to further revitalization of the distressed area. However, there may also be noneconomic costs to the community. For example, if the business produces pollution or causes higher traffic congestion, such noneconomic costs may reduce the quality of life in the community.

An argument could also be made that state tax credit programs should benefit as many citizens as possible and state-sponsored economic development incentives should be geared towards improving areas in need of revitalization. While these two issues have economic aspects to them, the economic impact to the state may not necessarily depend on the location of the tax credit project. Therefore, the geographic distribution and the census tract income level distribution of the tax credit projects are treated as noneconomic influences in the award of the tax credit.

Because the distressed community phase of the Seed Capital Tax Credit program was only promoted by the innovation centers in Columbia and St. Louis, the businesses benefiting from this tax credit are only located in the Columbia (four businesses) and St. Louis (ten businesses) metropolitan areas. Under the 1999 legislation requiring all of the businesses to be located in a distressed community, 36 percent (5 of 14) of the projects were in low-income census tracts, 7 percent (1 of 14) were in moderate-income census tracts, 36 percent (5 of 14) were in middle-income census tracts, 7 percent (1 of 14) were in upper-income census tracts and 14 percent (2 of 14) had unknown census tracts. (*See Appendix IV, page 49, for a distribution of projects by geography and census tract income level.*)

Recommendations

We recommend the Director, Department of Economic Development:

1.8 Track and maintain a database of all businesses that receive state economic development incentives. Since the Seed Capital Tax Credit program has expired, the department should ensure new programs, like the New Enterprise Creation Act Tax Credit program, follow this recommendation.

1.9 Consider promoting economic development incentive programs that aid start-up businesses in high-growth industries.

Department of Economic Development Responses

1.8 The Business Development Group has a tracking system in place to track the status of companies receiving investments through the New Enterprise Creation Act and other incentive programs.

1.9 The Department currently promotes programs that aid businesses in high-growth industries, such as the New Enterprise Creation Act and the Certified Capital Companies program. We work in cooperation with groups such as the Missouri Technology Corporation, Seed Capital Investment Board and Venture Capital Roundtable to review and develop programs to assist companies in the high-growth industries of life science, advanced manufacturing and information technology.

F. Youth Opportunities and Violence Prevention Tax Credit

The Youth Opportunities and Violence Prevention Act, Sections 135.460, 620.1100 and 620.1102, RSMo 2000, authorizes this tax credit. The tax credit program is designed to encourage contributions to non-profit organizations that perform youth-related social services and violence prevention projects. Department of Economic Development officials approve the tax credit through competitive selection.

Representatives from eligible organizations must complete a detailed application describing the activity or program they want approved. Eligible applicants are:

- Non-Profit Organizations
- Schools
- Religious Organizations
- Missouri Businesses
- Public or Private Entities

Department of Economic Development officials use a rating system to assign points to each area of the application based upon the degree of serving At-Risk Kids. These children have been identified as those living in high crime areas, poverty, or single-parent homes, as well as lacking adequate education skills and/or being susceptible to teen pregnancy. Once approved, the organization will be allocated tax credits based on the dollar amount of contributions estimated for an agreed upon fund-raising period.

There is a $6 million annual cap on the tax credits. There is a $250,000 cap per applicant and a $200,000 cap per contributor on the amount of tax credits allowed. The tax credit is 30 percent of property contributions and 50 percent of monetary contributions made to the non-profit organization. The taxpayer (contributor) can carry the tax credit forward up to 5 years.

Section 135.460.5(5), RSMo 2000, allows for a tax credit to be issued for any employment/internship/apprenticeship program in business or trades for persons less than 20 years old. Pursuant to this section, the credit claimed is limited to 50 percent of the amount paid to the intern or apprentice in that tax year, but the credit cannot exceed $10,000.

Purpose

The authorizing statute states the purpose of the Youth Opportunities and Violence Prevention Tax Credit program is to broaden and strengthen opportunities for positive development and participation in community life for youth, and to discourage such persons from engaging in criminal and violent behavior. Towards this goal the legislature identifies the following eligible activities or programs:

- Degree Completion
- Internship/Apprenticeship
- Youth Clubs/Association
- Adopt-A-School
- Mentor Role Model
- Substance Abuse Prevention
- Youth Activity Centers
- Conflict Resolution
- Employment/Internship
- Counseling
- Violence Prevention

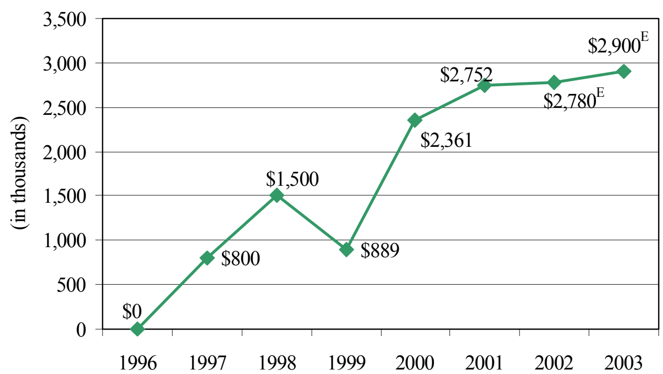
State taxes impacted

Pursuant to Section 135.460, RSMo, 2000, the Youth Opportunities and Violence Prevention Tax Credit may be used to offset taxes imposed by Chapters 153, 148, 147 and 143, RSMo 2000, excluding withholding tax imposed by Sections 143.191 to 143.261, RSMo 2000. Chapter 153 imposes the express companies tax. Chapter 148 imposes the financial institution tax. Chapter 147 imposes the corporate franchise tax. Chapter 143 imposes the state individual and corporate income tax.

Direct economic impact

If measured strictly on the amount of redeemed tax credits the cost of the Youth Opportunities and Violence Prevention Tax Credit program has been approximately $8.3 million through fiscal year 2001. Figure 1.7 illustrates the redeemed credits by year since program inception with estimated redemptions for fiscal years 2002 and 2003.

Figure 1.7: Youth Opportunity and Violence Prevention Tax Credit Program



E – Estimate made by Department of Economic Development staff in 2001

Sources: Tax Expenditure Reports prepared by the State & Fiscal Studies Unit, University of Missouri-Columbia; Department of Revenue tax credit tracking system; and Department of Economic Development's Statements of Benefits and Costs (Form 14s)

The Youth Opportunities and Violence Prevention Tax Credit program does not lend itself to an economic impact analysis because information on this tax credit program does not contain quantifiable economic data such as jobs or economic investment. Therefore, our review focused on the administration of the tax credit program and compliance with the intended purpose of the tax credit.

Application process to become an eligible youth opportunity program

A Department of Economic Development official stated that the first step in the approval process requires an application to be filed with the department along with an interview with the project manager and the community development representative. A rating system is used to assign points to each area of the application based upon the degree of serving targeted children.

After the initial review, applicants are then referred to the Director of Community Development for further review and approval. A final review and approval is made by the Executive Director.

Once the project has been approved, the organization is required to sign a program agreement, which spells out the rules and guidelines. Project officials are required to submit quarterly reports to the Department of Economic Development measuring the projects' target outcomes, performance targets and milestones. The community development representative from the Department of Economic Development conducts a site inspection annually. At the end of the project, a final report is submitted which compares projected results to actual results.

Department of Economic Development officials prepare an annual report for the General Assembly summarizing outcomes from completed and current projects. Successful results are verified at the project level and reported on the project's final report, which is used to prepare the report for the General Assembly. This report provides only successful outcomes and does not provide any benchmark data that would allow for an analysis of the overall success rate of the program.

Approval process

Tax credits are approved and issued by the project manager. When qualifying contributions are received, a letter is given to the contributor stating a tax credit is available. The contributor is required to send the letter and copy of the check to the Department of Economic Development in order to receive the tax credit certificate. The project officials are required to sign a signature authorization form at the beginning of the project which is used by the project manager to verify authorizations. Tax credit certificates are good for 6 years, including the year in which the contribution was made.

Department staff maintain a contributor list in the new management information system for tax credits issued. During the site visit, the list is used to make a spot check against the project's list of contributors. The project manager said she has not experienced any problems with this system.

Additional tax credits

Additional tax credits are available to employment projects if persons under 20 years old are employed. The credit allows a 50 percent credit to the employer on wages paid. Additional credits issued are not tracked separately and will appear with all other program credits.

Review of projects closed in 2000

The 17 projects that closed in 2000 were reviewed. The following issues were noted:

- Officials for 5 of 17 projects did not submit a final report within 6 months as required in the agreement.

- Over 50 percent of the tax credits authorized were not used. If tax credits considered towards the annual cap are not fully-utilized, there is a risk other qualified organizations may not receive tax credits resulting in some youths not being served.

- The tax credits issued exceeded authorized tax credits for three projects. Department of Economic Development staff stated these three projects included tax credits issued under Section 135.460.5(5), RSMo 2000, which allows for a tax credit to be issued for employing a person under 20 years of age.

- In one case the inspection addressed the fundraising status and other strengths and weaknesses of the program. However, more information could have been provided such as (1) explanations for the types of changes in project activities, (2) reasons for over-estimating budgeted funds, (3) reasons for not marketing the programs, and (4) plans for corrective measures. For this program, authorized tax credits were not monitored as agreed in the program agreement. Tax credits totaling $111,000 were originally authorized; however, only $30,000 was used. Department of Economic Development officials allowed the remaining $81,000 in tax credits to remain outstanding until the project closed.

Noneconomic influences

Economic benefits from the Youth Opportunities and Violence Prevention Tax Credit program are difficult to quantify. While programs that help reduce the negative economic impact of crime and violence would positively impact the economy, quantifying this benefit is difficult.

An argument could also be made that state tax credit programs should benefit as many citizens as possible and state-sponsored community development incentives should be geared towards improving areas in need. Therefore, the geographic distribution and the census tract income level distribution of the tax credit projects are treated as noneconomic influences in the award of the tax credit.

Projects receiving benefits from this tax credit are located throughout the state. The St. Louis and Kansas City metropolitan areas account for approximately 60% of the projects. The projects are not concentrated in any particular census tract income level. Approximately 36% of the projects were in low- or moderate- income census tracts and 45% were in middle- or upper-income census tracts. The census tract income level could not be determined for 19% of the projects. (*See Appendix IV, page 49, for a distribution of projects by geography and census tract income level.*)

Recommendations

We recommend the Director, Department of Economic Development:

1.10 Monitor the authorized and outstanding tax credits to ensure authorized tax credits are not under-utilized.

1.11 Enforce quarterly and final reporting deadlines.

Department of Economic Development Responses

1.10 In the past we have only recaptured enough credits to cover requests for additional credits. However, since the budget crisis began, we believe that it is contrary to being a responsible steward of these programs to recapture all unused authorized credits for redistribution. In fact, a portion of the tax credit cuts that were implemented in response to Governor Holden's directive to reduce the cost of tax credit programs by $7,500,000 were from this program via not redistributing unused credit authority. While we value this program as we do many others, we must also be responsive to the budget needs of the state.

1.11 Beginning with FY02, we have a process in place to ensure that project reports are submitted in a timely manner. Quarterly reports are due within two weeks of the end of the quarter. We allow some flexibility with that date, realizing that some projects have multiple sites with data that must be compiled. If a project has not submitted a quarterly report in two quarters we send a letter requesting documentation to be submitted by a certain date. If no response is received, we send a letter suspending the agreement until the documentation has been received in our office.

Final report reminders are sent shortly after the project's fund-raising period ends. If the final report is not received, we send one additional reminder letter, then refer it to department legal counsel for a demand letter. If satisfactory response is not received, we refer the matter to the Attorney General's Office for repayment of tax credit amounts.

2. <u>Follow-Up of Issues from Prior Audit</u>

An overriding issue from the prior audit of state tax credits was the lack of data necessary to evaluate the programs. In response to this issue, department staff are revising the department's management information system to allow for better data capture and reporting.

The new system is called the Customer Management System (CMS). According to the department's information systems manager, this system is going to provide a Data Mart concept where a client (department management, project managers, development officers, etc.) can look at customers (projects, taxpayers, etc.) and see all the department products the customer has used.

For example, this Data Mart concept would allow authorized staff within the department to retrieve a Historic Preservation Tax Credit project and view all the tax credits, loans and grants this project received from the department. Additionally, department officials plan to give limited access to Department of Revenue staff to directly enter redeemed credits into the system. This would eliminate the shuffling of paper back and forth by the agencies and would reduce the risk of entry errors, since a Department of Revenue operator would key in the amount that would be used by both agencies.

Issues remaining open

Department of Economic Development officials have not:

- Determined how to provide CMS data to the State Auditor's Office for future cost-benefit analysis.
- Been able to provide key data elements by project for the tax credit programs administered.

Department of Economic Development proposal

Department of Economic Development officials state that most of the information required to determine the effectiveness of the various tax credit programs is not mandatory by law. These officials maintain that while they ask for voluntary reporting from many of the projects utilizing the tax credit programs, they cannot compel a business or other entity to provide information, unless the law so provides.

These officials further state that if the department was given clear authority to compel businesses and other entities to provide information and data necessary to determine the effectiveness of the various tax credit programs, a compliance and auditing unit to perform the new duties would be needed. Department officials propose that additional personnel would be necessary to staff such a unit with at least seven staff being needed depending on the reporting requirements. These officials stated the new unit would require a budget of approximately, $500,000, or .33 percent of the $150 million in tax credits redeemed last year.

Recommendations

We recommend the Director, Department of Economic Development:

2.1 Ensure that at a minimum the CMS captures and has reporting capabilities for the following key data elements for each tax credit project:

- Description of project
- Street address of project
- Standard Industry Classification code for project
- Approved amount
- Issued amount
- Claimed amount
- Outstanding amount
- Number of jobs created, both direct and indirect
- Payroll amount
- Average wage
- Dollar amount of investment
- Percentage discount on sale of tax credit
- Name of party that redeems credit
- Street address of party that redeems credit
- Housing units created

2.2 Create a compliance and auditing unit for capturing and reporting data necessary to measure the effectiveness of all state tax credit programs administered by department officials. If the unit cannot be established by shifting existing resources, funding should be requested in future budgets.

Department of Economic Development Responses

2.1 CMS currently has the capability to capture the majority of the key data elements listed above. The Department will consider including additional elements. Some of the information would have to be entered by the Department of Revenue and it may have to consider the implications of section 32.057, RSMo, in determining what information can lawfully be entered and/or accessed.

2.2 The Department agrees that a compliance and auditing unit for capturing and reporting data necessary for the State Auditor to measure the effectiveness of all tax credit programs would need to be established. Given the budget reductions that have occurred since FY 2001, the department cannot shift existing resources, as we would not be able to also administer programs, many of which are entitlement programs.

In addition, even if we had adequate staff to form such a unit, for many programs we would still be working with voluntarily supplied information for the same reasons we have previously discussed herein.

Depending on the fiscal outlook for the state and the funding priorities of the department, consideration will be given to requesting a compliance and auditing unit during a future budget cycle.

APPENDIX I

OBJECTIVE, SCOPE AND METHODOLOGY

Objective

To gather and review information and data needed to perform a cost-benefit analysis that would provide policymakers with sufficient information to evaluate the effectiveness of all state tax credit programs administered by the Department of Economic Development.

Scope and Methodology

Information and data was reviewed for all 35 tax credit programs administered by the Department of Economic Development. A more in-depth analysis was performed on six tax credit programs:

1. Historic Preservation Tax Credit
2. Qualified Research Expense Tax Credit
3. Brownfield Remediation Tax Credit
4. Brownfield Jobs/Investment Tax Credit
5. Seed Capital Tax Credit
6. Youth Opportunities and Violence Prevention Tax Credit

Table I.1 lists the 35 tax credit programs administered by the Department of Economic Development and the authorizing state statute.

APPENDIX I

Table I.1 Tax Credit Programs

Program	Authorizing Statute
Affordable Housing Assistance	§ 32.111
Brownfield Jobs/Investment	§ 447.700
Brownfield Remediation	§ 447.700
Brownfield Demolition	§ 447.700
BUILD Missouri Bonds	§ 100.700
Business Facility	§ 135.100
(Capital) Small Business Investment	§ 135.400
Certified Capital Companies (CapCo) (cap expired)	§ 135.500
Community Development Bank	§ 135.400
Community College New Jobs Training Bonds	§ 178.894
Development	§ 32.105
Dry Fire Hydrant	§ 320.093
Enterprise Zone	§ 135.200
Family Development Account	§ 208.755
Film Production	§ 135.750
Guarantee Fee (repealed)	§ 135.766
Historic Preservation	§ 253.545
Skills Development Account (Individual Training Account)	§ 620.1400
Mature Worker Child Care	§ 620.1560
MDFB[13] Development and Reserve	§ 100.286
MDFB Export Finance	§ 100.286
MDFB Bond Guarantee Credit	§ 100.297
MDFB Infrastructure	§ 100.286
Missouri Low Income Housing	§ 135.350
Neighborhood Assistance	§ 32.100
Neighborhood Preservation	§ 135.535
New Enterprise Creation	§ 620.635
New Generation Cooperative Incentive	§ 32.100
Rebuilding Communities	§ 135.535
Qualified Research Expense	§ 620.1039
Seed Capital (cap expired)	§ 348.300
Small Business Incubator	§ 620.495
Transportation Development	§ 135.545
Winery and Grape Growers	§ 135.700
Youth Opportunities and Violence Prevention	§ 135.460

Source: Auditor prepared using Department of Economic Development Form 14s and the Tax Expenditure Reports

[13] MDFB - Missouri Development Finance Board

APPENDIX I

Our review involved two interrelated parts. First, audit staff examined the economic literature to determine how a cost-benefit analysis might be performed on state tax credit programs. The auditors also reviewed information and data that was available on each state tax credit program administered by the Department of Economic Development. As the review progressed audit staff realized the analysis was dependent on the information and data available, thus attempts were made to obtain information that would allow us to perform the cost-benefit analysis determined appropriate. Our results indicated key data needed for an effective cost-benefit analysis was not available or when it was available it could not always be verified, which decreased its usefulness.

While there is some literature on economic development tax incentives in general, and on big tax incentive packages for large companies in particular, there is very little written on the effectiveness of state tax credit programs. There is also some literature on the cost-benefit of state tax incentives from a national perspective. The scope of our work was limited to the economic impact of the tax credits on the state and did not consider the effects from a national perspective.

In the economic literature three ways to perform a cost-benefit analysis on tax credits were described:

- A cost benefit analysis may require a determination of the efficiency of the tax credit. A tax credit is efficient if it encourages activity that would not have occurred but for the tax credit. A tax credit is inefficient if the activity would have occurred without the tax credit.

- A cost benefit analysis may require determining if the state's economic benefit resulting from the private sector's contribution or investment is greater than the tax revenue decrease that results from the private sector's utilization of the tax credit.

- Finally, a cost benefit analysis may be performed to determine if a tax credit is more efficient than an equivalent direct spending program because such a subsidy uses the pre-existing tax system to communicate state policy at a relatively low marginal cost. In some cases direct government outlays will be preferable to comparable tax expenditures; in other cases, a tax subsidy through the state revenue code will be the preferred means of implementing state policy.

The cost benefit analysis mandated by Section 620.1300, RSMo 2000, is based on the first two types of cost benefit analysis, therefore no attempt was made to review whether or not the tax credit was more or less efficient than a direct subsidy.

To measure the economic impact of the tax credit on the state economy the State Auditor's Office purchased a secondary user license to allow us to use a dynamic econometric modeling program called Policy Insight, developed by Regional Economic Models, Inc. (REMI) of Amherst, Massachusetts. Founded in 1980, REMI constructs models that reveal the economic and demographic effects policy initiatives or external events may cause on a regional economy. One of the major features of the REMI model is it functions as a dynamic model which forecasts how changes in the economy and adjustments to those changes will occur on a year-by-year basis. The Missouri Development Finance Board holds the primary user license of the model.

Additionally, pursuant to Section 620.1300, RSMo 2000, the noneconomic influences of the tax credit programs were reviewed if possible.

BACKGROUND

The review of state tax credit programs was performed under the mandate of Section 620.1300, RSMo 2000.

This statute states:

> "a cost-benefit analysis shall be prepared to evaluate the effectiveness of all programs operated by the department of economic development for which the department approves tax credits, loans, loan guarantees, or grants. Each analysis shall be conducted by the state auditor, and shall include, but not be limited to, the costs for each program, the direct state and indirect state benefits and the direct local and indirect local benefits associated with each program, the safeguards to protect noneconomic influences in the award of programs administered by the department, and the likelihood of the economic activity taking place without the program. The results of each analysis shall be published and distributed, by January 1, 2001, and every two years thereafter, to the governor, the speaker of the house of representatives, the president pro tem of the senate, the chairman of the house budget committee, the chairman of the senate appropriations committee and the joint committee on economic development policy and planning."

APPENDIX III

REQUIREMENTS FOR APPROVING TAX CREDITS

Table III.1 lists how Department of Economic Development (DED) officials interpret state law requirements for approval of each tax credit.

Table III.1: Tax Credit Project Approval Methods

Tax Credit Program	Method
Youth Opportunities and Violence Prevention	Competitive
Neighborhood Assistance	Competitive selection by DED
Affordable Housing Assistance	Competitive selection by MHDC[14]
BUILD Missouri Bonds	Discretion based on other state competition
Brownfield Remediation	DED discretion
Brownfield Demolition	DED discretion
Community Development Bank	DED discretion
Community College New Jobs Training Bonds	DED discretion
Development	DED discretion
Film Production	DED discretion
New Generation Cooperative Incentive	DED discretion
Small Business Incubator	DED discretion
MDFB[15] Bond Guarantee Credit	MDFB discretion
MDFB Development and Reserve	MDFB discretion
MDFB Export Finance	MDFB discretion
MDFB Infrastructure	MDFB discretion
Certified Capital Companies (CapCo)	CapCo's discretion
New Enterprise Creation	Fund Manager discretion
Seed Capital	Innovation Centers discretion
Brownfield Jobs/Investment	Formula; DED discretion
Missouri Low Income Housing	Formula; MHDC discretion
Business Facility	Formula
Enterprise Zone	Formula
Guarantee Fee	Formula
Historic Preservation	Formula
Winery and Grape Growers	Formula
(Capital) Small Business Investment	Formula; first come
Dry Fire Hydrant	Formula; first come
Individual Training Account	Formula; first come
Mature Worker Child Care	Formula; first come
Rebuilding Communities	Formula; first come
Qualified Research Expense	Formula; first come
Transportation Development	Formula; first come
Family Development Account	First come
Neighborhood Preservation	First come

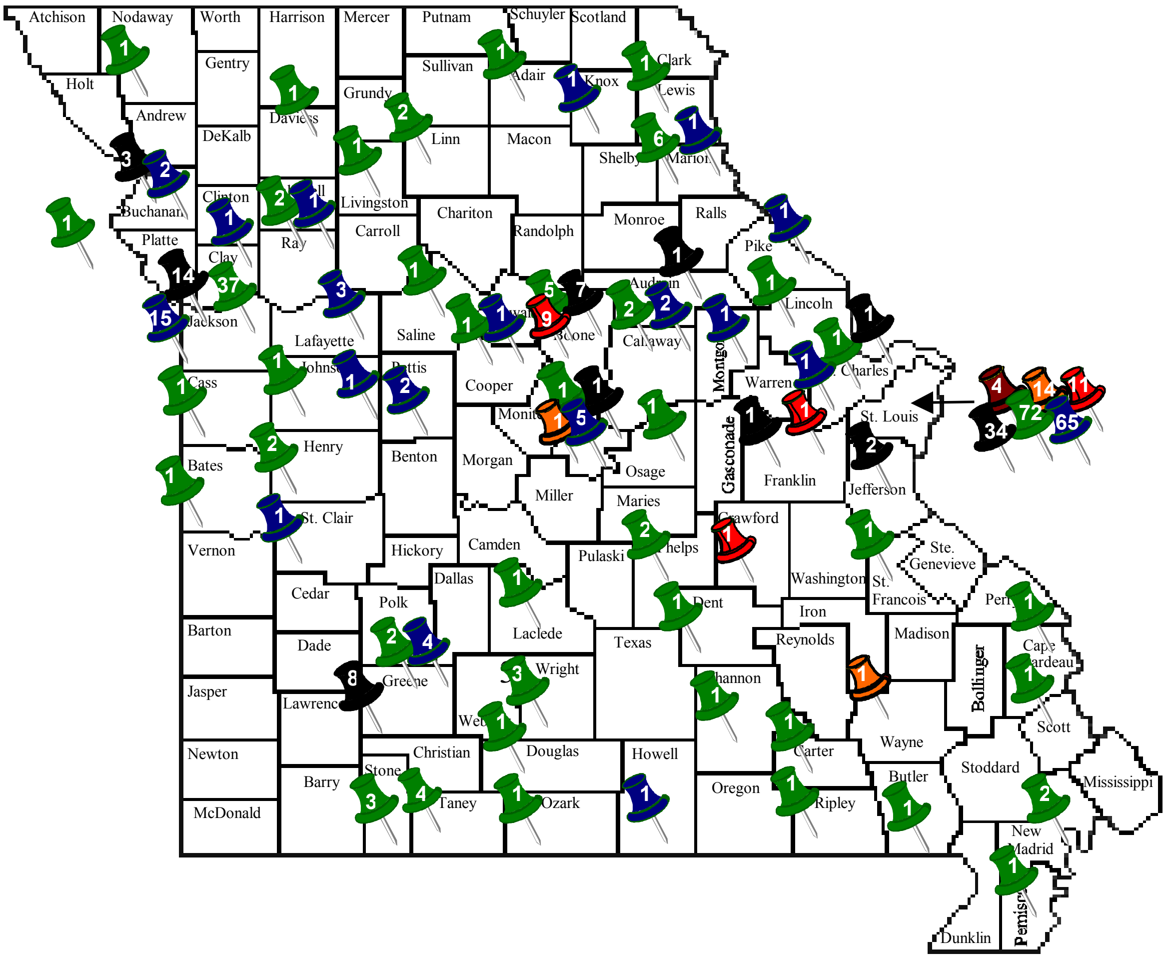
Source: Department of Economic Development tax credit summaries

[14] MHDC - Missouri Housing Development Commission
[15] MDFB - Missouri Development Finance Board

APPENDIX IV

GEOGRAPHIC DISTRIBUTION OF TAX CREDITS

This map shows the geographic location and number of tax credit projects for the six programs reviewed.



- Represents Historic Preservation Tax Credit Program
- Represents Seed Capital Tax Credit Program
- Represents Qualified Research Tax Credit Program
- Represents Brownfield Jobs/Investment Tax Credit Program
- Represents Brownfield Remediation Tax Credit Program
- Represents Youth Opportunities and Violence Prevention Tax Credit Program

Historic Preservation Tax Credit

Although this tax credit program has benefited projects statewide, there is a large concentration of projects located in the St. Louis metropolitan area. Of the 109 total projects completed since 1998, 60.6 percent (66/109) of the projects were located in the St. Louis metropolitan area. The Kansas City metropolitan area accounted for 13.8 percent (15/109) of the total projects. The remainder of the projects were located throughout the state with 15.6 percent (17/109) of the projects in the central part of the state, 4.5 percent (5/109) in the northern part and 5.5 percent (6/109) in the southern part of the state.

Brownfield Remediation Tax Credit

Most of the projects are concentrated in the St. Louis metropolitan area. Only 2 of the 16 projects are located in other parts of the state; one in Cole County and one in Wayne County.

Brownfield Jobs/Investment Tax Credit

Four projects have utilized this tax credit. All four businesses that used this tax credit were located in the St. Louis metropolitan area.

Qualified Research Expense Tax Credit

The map only includes the 72 businesses that were awarded the credit in 2000. These businesses were located across the state. Since 1994, approximately 450 businesses have been awarded the qualified research tax credit.

Seed Capital Tax Credit

Under the distressed community phase of the seed capital program (i.e., projects subsequent to the 1999 legislative change), there were a total of 14 businesses that received funds from the program. Businesses benefiting from the Seed Capital tax credit were located in the St. Louis metropolitan area (10 projects) and the Columbia area (4 projects). Under the 1993 legislation there were 10 businesses that received funds. These projects were located in Columbia (5 projects), St. Louis (3 projects), Cuba (1 project) and Washington (1 project).

Youth Opportunities and Violence Prevention Tax Credit

This tax credit has benefited projects statewide. The largest concentration of projects is located in the St. Louis metropolitan area with 75 projects (38.9 percent). There are 38 projects (20.8 percent) located in the Kansas City metropolitan area including one that is headquartered in Kansas, but has operations in the Kansas City, Missouri area. There are 17 projects (9.3 percent) in the central part of the state, while 16 (8.7 percent) are in the northern part and 40 (21.9 percent) are in the southern part of the state.

APPENDIX IV

Distribution of tax credit projects by census tract income level

Several of the state tax credit programs in the state are designed to promote economic development in distressed communities throughout the state. A distressed community is defined in Section 135.530, RSMo 2000, as follows:

> "distressed community" means either a Missouri municipality within a metropolitan statistical area which has a median household income of under seventy percent of the median household income for the metropolitan statistical area, according to the last decennial census, or a United States census block group or contiguous group of block groups within a metropolitan statistical area which has a population of at least two thousand five hundred, and each block group having a median household income of under seventy percent of the median household income for the metropolitan area in Missouri, according to the last decennial census. In addition the definition shall include municipalities not in a metropolitan statistical area, with a median household income of under seventy percent of the median household income for the nonmetropolitan areas in Missouri according to the last decennial census or a census block group or contiguous group of block groups which has a population of at least two thousand five hundred each block group having a median household income of under seventy percent of the median household income for the nonmetropolitan areas of Missouri, according to the last decennial census."

Under this definition, the entire city of St. Louis qualifies as a distressed community; however, neighborhoods in the city of St. Louis vary in income levels. Therefore, to more narrowly analyze the community impact from the geographic location of each tax credit project, the census tract income levels for each of the projects were reviewed. Table IV.1 lists census tract income levels.

Table IV.1: Census Tract Income Levels

Census Tract Category	Median Family Income Percentage Level
Low	< 50%
Moderate	> = 50% and < 80%
Middle	> = 80% and < 120%
Upper	>= 120%

Source: Federal Financial Institutions Examination Council

Table IV.2 lists the number of projects for the census tract income levels noted in the previous table for each of the five tax credits reviewed for which such an analysis is relevant. The Qualified Research Expense Tax Credit program did not lend itself to census tract income distribution analysis. Large corporations with multiple offices usually claim this tax credit and it would not be meaningful to show the income level of the census tract of each office.

Table IV.2: Number of Tax Credit Program Projects by Census Tract Type

Census Tract Income Level	Historic Preservation	Brownfield Remediation	Brownfield Jobs/ Investment	Seed Capital	Youth Opportunities and Violence Prevention
Upper	10	0	0	1	30
Middle	44	4	3	9	53
Moderate	26	5	1	2	37
Lower	25	2	0	8	29
Undetermined	4	5	0	4	34
Total	109	16	4	24	183

Source: Auditor prepared

Table IV.3 illustrates the census tract income level for Historic Preservation Tax Credit residential projects versus commercial and commercial/residential projects.

Table IV.3: Historic Preservations Tax Credit Projects by Property Type and Census Tract

	# of Projects By Census Tract Income					
Property Type	Low	Moderate	Middle	Upper	N/A	Total
Residential	12	13	13	4	2	44
Commercial, Commercial/Residential	13	13	31	6	2	65
Total	25	26	44	10	4	109

Source: Auditor prepared

APPENDIX V

PROCESS TO LIST A MISSOURI PROPERTY ON THE NATIONAL REGISTRY

Eligible property for the Historic Preservation Tax Credit must be a certified historic structure, located in Missouri and listed individually on the National Register of Historic Places (National Registry), or be part of a certified historic district. In addition, the rehabilitation must meet standards consistent with the standards of the Secretary of the United States Department of the Interior for rehabilitation as determined by the state historic preservation officer (preservation officer) of the Missouri Department of Natural Resources.

An applicant must contact the preservation officer and obtain a packet which contains a survey form and other information. The applicant must return the survey along with photographs of the property. A panel of five or six people in the office of the preservation officer will review the survey to determine if the property meets historic significance, historic context and integrity. There are four criteria that the National Park Service uses for significance:

- Association with historic events or activities,
- Association with important persons,
- Distinctive design or physical characteristics, or
- Potential to provide important information about prehistory or history.

The property must meet at least one of the criteria. Historic integrity must also be evident through historic qualities including location, design, setting, materials, workmanship, feeling, and association. Historic context is information about the historic trends of the property. The panel sends applicants a letter to notify them that the property is eligible according to the criteria set forth by the National Park Service. The office also sends information on how to write a National Register nomination, which is basically a fill in the blank form.

The applicants must submit the nomination form along with a descriptive narrative of the property, statement of significance narrative (basically the historic significance of the property), a United States Geological Survey Map, a sketch of the floor plans, and black and white photographs of the property. The staff will again review the information to determine if it meets the standards, and request any revisions if needed.

After revisions are made, the information is sent to the Missouri Advisory Council for Historic Preservation (Council) which meets four times a year usually in February, May, August, and November. The property owner and local government officials must be notified of the nomination and are given the opportunity to decline the listing of the property on the National Registry. If the Council approves the nomination, it is forwarded to the National Park Service Keeper of the National Register, who has 45 days to make a final decision.

Representatives from the National Park Service state this process takes about 3 months to complete; however, the Missouri National Register Officer indicated it usually takes 6 months to a year to complete.

APPENDIX VI

TAX CREDIT REVIEW STATUS

Table VI.1: Program Review Status

Tax Credit Program	Review Status
Brownfield Jobs/Investment § 447.700	Reviewed in 2001
Brownfield Remediation § 447.700	Reviewed in 2001
Historic Preservation § 253.545	Reviewed in 2001
Qualified Research Expense § 620.1039	Reviewed in 2001
Seed Capital (cap expired) § 348.300	Reviewed in 2001
Youth Opportunities and Violence Prevention § 620.1100	Reviewed in 2001
Film Production § 135.750	Reviewed in 2000
Rebuilding Communities § 135.535	Reviewed in 2000
Small Business Incubator § 620.495	Reviewed in 2000
Winery and Grape Growers § 135.700	Reviewed in 2000
Affordable Housing Assistance § 32.111	To be reviewed
Brownfield Demolition § 447.700	To be reviewed
BUILD Missouri Bonds § 100.700	To be reviewed
Business Facility § 135.100	To be reviewed
(Capital) Small Business Investment § 135.400	To be reviewed
Certified Capital Companies (CapCo) (expired) § 135.500	To be reviewed
Community Development Bank § 135.400	To be reviewed
Community College New Jobs Training Bonds § 178.894	To be reviewed
Development § 32.105	To be reviewed
Dry Fire Hydrant § 320.093	To be reviewed
Enterprise Zone § 135.200	To be reviewed
Family Development Account § 208.755	To be reviewed
Guarantee Fee (repealed) § 135.766	To be reviewed
Individual Training Account § 620.1400	To be reviewed
Mature Worker Child Care § 620.156	To be reviewed
MDFB[16] Development and Reserve § 100.250	To be reviewed
MDFB Export Finance § 100.250	To be reviewed
MDFB Bond Guarantee Credit § 100.286	To be reviewed
MDFB Infrastructure § 100.250	To be reviewed
Missouri Low Income Housing § 135.350	To be reviewed
Neighborhood Assistance § 32.100	To be reviewed
Neighborhood Preservation § 135.535	To be reviewed
New Enterprise Creation § 620.635	To be reviewed
New Generation Cooperative Incentive § 32.100	To be reviewed
Transportation Development § 135.545	To be reviewed

Source: Auditor prepared

[16] MDFB – Missouri Development Finance Board

APPENDIX VII

GLOSSARY OF ECONOMIC TERMS

Table VII.1: Glossary of Economic Terms

Term	Definition
Capital Cost (share) policy variable	This variable changes the capital costs within the specified industry by the proportion or percentage of the dollar value of the capital share of output entered. This policy variable should be used when a policy scenario is expected to change the implicit rental cost of capital, thus resulting in substitution between capital and labor usage.
Production Cost (amount) policy variable	This variable changes the relative production costs of the specified industry by the dollar amount entered. This variable should be used when a specific policy will affect the cost of doing business in a region without directly changing the relative costs of factor inputs (labor, capital, and/or fuel).
Government Spending (amount) policy variable	This variable converts the change in state and local government spending entered into industry demands using the technical coefficients matrix. This variable should be used to increase or decrease general public expenditures associated with a particular simulation.
Employment	Components of employment are private non-farm employment, government employment, and farm employment.
Gross State Product	Gross state product as a value added concept is analogous to the national concept of gross domestic product. It is equal to output excluding the intermediate inputs. It represents compensation and profits.
Personal Income	A Bureau of Economic Advisors concept based on place of residence; the sum of wage and salary disbursements, other labor income, proprietors' income, rental income, personal dividend income, personal interest income, and transfer payments, less personal contributions for social insurance.
Real Disposable Income	Disposable income divided by the personal consumption expenditure price index, based in 1992 dollars; amount of real dollars available for consumption and savings. The determinants of real disposable personal income are personal income, income taxes, and the consumer price deflator.
Wage Rate	Average annual wage rate, calculated by dividing wage and salary disbursements by employment.

Source: REMI Policy Insight Glossary

APPENDIX VIII

ISSUED AND REDEEMED TAX CREDITS

Table VIII.1 lists the aggregate amounts of tax credits issued and redeemed for the six tax credit programs reviewed in-depth in this report.[17]

Table VIII.1: Issued and Redeemed Tax Credits (in thousands)

Tax Credit		Issued Amount	Redeemed Amount
Historic Preservation	$	58,506	48,222
Qualified Research	$	65,151	30,448
Brownfield Remediation	$	18,581	6,121
Brownfield Jobs/Investment	$	160	17
Seed Capital	$	8,828	3,620
Youth Opportunities	$	9,162	8,301

Source: Auditor prepared using Department of Economic Development project logs, Department of Revenue tax credit tracking system, and State Tax Expenditure Reports

[17] Tax credit amounts outstanding cannot be ascertained until a system is developed that tracks redeemed and expired credits at the project level. See recommendation 1.1 on page 5 of this report.