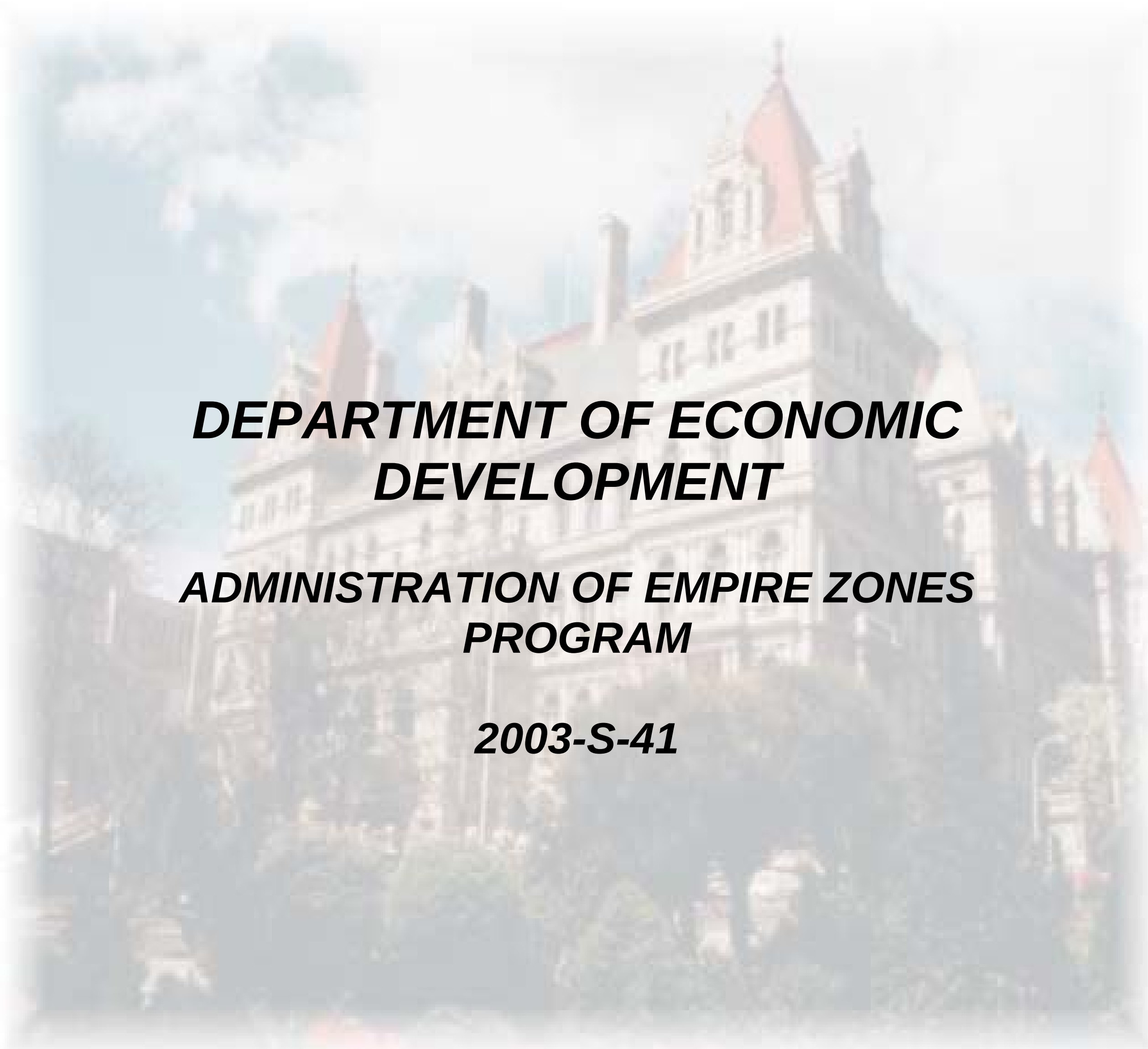
# *A REPORT BY THE NEW YORK STATE OFFICE OF THE STATE COMPTROLLER*

**Alan G. Hevesi**
**COMPTROLLER**



## *DEPARTMENT OF ECONOMIC DEVELOPMENT*

### *ADMINISTRATION OF EMPIRE ZONES PROGRAM*

***2003-S-41***

**DIVISION OF STATE SERVICES**

OSC Management Audit reports can be accessed via the OSC Web Page:

http://www.osc.state.ny.us

If you wish your name to be deleted from our mailing list or if your address has changed,

contact the State Audit Bureau at (518) 474-3271

or at the

Office of the State Comptroller

110 State Street

11th Floor

Albany, NY 12236

**Alan G. Hevesi**
**COMPTROLLER**

**Report 2003-S-41**

Mr. Charles A. Gargano
Commissioner
New York State
Department of Economic Development
30 South Pearl Street
Albany, NY  12245

Dear Mr. Gargano:

The following is our report on the Department of Economic Development's administration of the Empire Zones Program.

We performed this audit pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law. We list major contributors to this report in Appendix A.

*Office of the State Comptroller*
*Division of State Services*

April 26, 2004

# EXECUTIVE SUMMARY

# DEPARTMENT OF ECONOMIC DEVELOPMENT ADMINISTRATION OF EMPIRE ZONES PROGRAM

## SCOPE OF AUDIT

The New York State Empire Zones Program (Program), formerly known as the New York State Economic Development Zones Program, was created by the Legislature in 1986. The Program assists economically-distressed parts of the State by giving tax and other incentives to businesses to stimulate private investment and create new jobs in designated Empire Zones (zones). The zones, which consist of a maximum of two square miles, are administered at the local level by a zone administrative board, whose members are appointed by a sponsoring locality (city, county, town, or village). The Program is administered at the State level by the Department of Economic Development (DED). There are currently 72 zones located in 51 of the 62 counties across New York State with a total of about 8,600 businesses.

For the period April 1, 1999 through January 31, 2004, we addressed the following questions about DED's administration of the Program:

- Does DED review the cost effectiveness of the Program?
- Does DED oversee and monitor the performance of the individual zones and the certified businesses within those zones, and take necessary action when the zones or businesses do not perform as required?
- Does DED independently verify information reported by the zones and businesses?
- Does DED fulfill its required role in reviewing zone designation and business certification applications submitted under the Program?

## AUDIT OBSERVATIONS AND CONCLUSIONS

We found that DED's administration of the Program needs improvement to ensure that taxpayer moneys devoted to the Program produce the results intended by the Legislature. DED does not perform cost/benefit analyses of the Program, the individual zones, or the zone businesses to determine if their achievements in creating new jobs and making investments are commensurate with the State and local tax credits and utility cost discounts provided by the Program. It is estimated that State tax credits alone to zone businesses will total about $291 million in 2004. It is therefore imperative that DED establish a system to continually evaluate the effectiveness of the Program. (See pp. 15-20)

We also identified weaknesses in the various Program reporting systems that prevent them from being useful tools for DED to oversee and monitor the performance of zone businesses and the individual zones and for assessing overall Program results. Businesses participating in the Program are required to submit a Business Annual Report (BAR) to the zone and DED. The BAR includes, among other information, job, payroll, investment, and selected tax data. Businesses that do not submit a BAR are supposed to be decertified. Each zone is required to compile this information along with other zone activity information and annually file a Zone Annual Report (ZAR) with DED.

DED has created a data collection system for BAR information; however, the BARs do not capture information on all benefits that a business receives, and the data, which is self-reported by the business, is not independently verified by DED or the zones. In addition, the BARs lack information needed to properly assess the Program. The BARs require the businesses to report estimated tax benefits, not actual credits claimed. They also do not require information on utility cost discounts nor any local benefits received. Another shortcoming is that BARs do not capture any information on the pay rates of new employment created, so an analysis cannot be done as to the type and quality of jobs being created.

In November 2003, we reviewed the 2002-year BARs on file at DED for a random sample of 116 businesses and found that 27 of the 103 businesses (26 percent) that were required to have a 2002-year BAR had not submitted one to DED. Yet, only 2 of the 27 businesses had been decertified by DED. We also compared the BARs to the business certification applications for 54 businesses to measure progress toward their job creation goals and found that only 18 (33 percent) had met such goals. No action was taken by DED regarding these underperforming businesses. Our review of the ZARs indicated the zones are not completing these reports in a consistent manner including how they count new jobs created and what should be counted and reported as a new business. We also found that DED does not use the ZAR for any meaningful analyses or monitoring of the individual zones. DED merely files them. (See pp. 21-29)

In addition, we determined that DED needs to improve its zone application review process. We found that DED officials are not required to document their decisions regarding which applications to recommend for zone designation. We noted instances where senior DED officials recommended applicants for zone designation contrary to what would have been expected based on the written summaries of their applications prepared by DED staff. Regarding DED's review of applications submitted by businesses to become zone certified, we found that DED has not developed or promulgated specific job creation and investment criteria. As a result, businesses that plan to create few to no jobs and make little or no investment are approved. (See pp. 31-35)

During our audit, DED released a nine-point improvement plan designed to address a number of Program areas needing improvement. We are not able to assess whether the plan will address the deficiencies we identified because details supporting the plan were still in development when our audit ended.

## *COMMENTS OF DED OFFICIALS*

A draft copy of this report was provided to DED officials for their review and comment. Their comments have been considered in preparing this report, and are included as Appendix B. DED officials were in general agreement with most of our recommendations and identified actions that they are taking to improve the Empire Zone Program. Appendix C contains State Comptroller's Notes, which address some matters of disagreement contained in DED's response.

# CONTENTS

# INTRODUCTION

## Background

In 1986 the New York State Legislature amended the General Municipal Law (GML) to establish the Economic Development Zones Program. Effective May 15, 2000, all references in State law to the Economic Development Zones Program were revised to call the program the Empire Zones Program (Program). The purpose of this Program is to stimulate economic growth in areas of New York State that are characterized by persistent and pervasive poverty, high unemployment, limited job creation, a dependence on public assistance, abandoned industrial and commercial facilities, and shrinking tax bases. The Program attempts to stimulate economic growth by promoting the development of new businesses and the expansion of existing businesses through tax credits and other incentives. The Program is administered at the State level by the Department of Economic Development (DED).

The GML initially authorized the designation of up to 10 economic development zones within 18 months of the July 30, 1986 effective date. Subsequent legislation expanded the Program, and at the time of our audit there were 72 empire zones (zones) throughout New York State with a total of about 8,600 businesses. There are zones in 51 of the State's 62 counties. Some counties have multiple zones. Each zone consists of a maximum of two square miles. To be designated as a zone, an area generally must be characterized by poverty, unemployment, and general economic distress according to the most recent Federal census data. However, the Legislature has created some zones to address the potential loss of large employers, or the loss of a local military facility or defense contractor.

Once a zone is designated, it is required to establish an administrative structure that will implement the zone's economic revitalization plan. There are multiple components to this structure including: the Zone Administrative Board (ZAB) and the Zone Coordinator. The ZAB is responsible for monitoring, evaluating, and coordinating the activities of the zone. The ZAB may contract with a zone administrative entity, such as a community-based local development corporation, to run the zone on a day-to-day basis. ZABs are made up of at least six members and are required to have representatives of certain organizations in and around the zone, such as local business, organized labor, and a resident of the zone.

The zone coordinators are responsible for working with the zone administrative entity to run the day-to-day activities of the zone that will implement the zone plan. The zone coordinators can be employees of the sponsoring localities or the zone administrative entity. Typically, zone administrative expenditures are funded by DED and the sponsoring localities. For the 2002-2003 fiscal year, DED provided $3.1 million in administrative grant funds to the zones. These grants are matched by the sponsoring localities.

Businesses in the zones may receive reductions in their State taxes through an expanded investment tax credit, tax credits on wages paid to new employees (these credits are doubled when new employees are hired who live within the zone), and a refund on the State sales tax paid for materials used in building, expanding, or reconstructing business property within the zone. Starting in 2001, if a business becomes a Qualified Empire Zone Enterprise (QEZE), it is eligible for additional incentives. These incentives include sales tax exemptions, real property tax credits, and QEZE tax reduction credits that are available to businesses that add jobs and meet annual employment tests. The municipalities that have zones are also encouraged to provide local incentives and utility providers are encouraged to provide utility rate discounts.

To qualify for certain benefits, such as a sales tax refund on construction materials and real property tax credits, a business only needs to reside within the boundaries of a zone. However, other benefits depend on a business receiving "zone-certification." This generally entails increasing, or at least maintaining, jobs or investment in a business. The creation of jobs cannot be the result of shifting jobs between localities. Once certified through the application process, a business can also receive additional benefits by applying for QEZE status.

DED is responsible for reviewing zone applications, approving changes to the zone boundaries, developing the procedures for certifying businesses as eligible for tax credits and other incentives, monitoring the activities of the zones and certified businesses, and evaluating the Program’s success in accomplishing its objectives.

DED has dedicated 8.5 full-time equivalent staff to the Program. In addition, the Department of Labor (DOL) plays a role in certifying businesses as eligible for tax credits and other zone incentives by determining whether the applying business is in compliance with the applicable labor laws, and the Department of Taxation and Finance (Tax Department) is responsible for administering the relevant tax credits and refunds. Local officials also administer each zone.

In 1991, the Legislature established the Economic Development Zone Review Commission (Commission) to determine whether the Program should continue. The Commission recommended that the Program should continue, but stressed the need for certain improvements to enable the Program to accomplish its objectives. In 1993, the Legislature incorporated many of the Commission's recommendations in an amendment to the GML, including requirements to establish a system for evaluating Program effectiveness, to compare Program benefits to Program costs, and for an independent entity to evaluate the Program before the end of 1995.

In our prior audit of the Program, issued in May 1996, we found that DED had neither established a system nor collected the data needed to determine whether the Program was accomplishing its objectives. DED also did not collect data relating to the financial benefits given to businesses participating in the Program. As a result, DED could not determine whether Program benefits exceeded Program costs. We also identified weaknesses in DED’s monitoring of the zones’ progress in creating and retaining jobs. The weaknesses we identified in DED oversight were caused, to some extent, by legal provisions denying DED access to certain information maintained by the Tax Department.

In our current audit, we found that many of the weaknesses cited in our prior audit continue to exist. We found that DED officials engaged a consultant, as recommended by the Commission, to independently evaluate the Program. Although the consultant’s report was issued in 1999, DED has not implemented a system to routinely evaluate the Program. DED has made some improvements in its business reporting system, but still does not gather sufficient and accurate data from businesses to identify the amount of tax credits and other benefits that businesses obtain from the Program or the full extent of the businesses' job creation and investment performance. DED also has not obtained access to data from the Tax Department.

In recent years, the news media has reported occurrences where existing businesses form new businesses in order to qualify for zone benefits that the original business would not have received. Businesses that used this technique became eligible for certain tax benefits that could continue for up to 15 years. This situation was possible because of a loophole in the State Tax Law. While this practice was legal, critics considered it abusive because it was contrary to the intent of the Program. On May 29, 2002, the State Legislature passed amendments to Section 14 of the State Tax Law to close the loophole. These changes became effective on August 1, 2002 and prevent other businesses from using this technique in the future. However, the amendments do not prevent the businesses that used the loophole from continuing to legally receive certain tax reductions.

The total current cost of the Program is not known because some benefits are provided by local governments and utility companies and are not reported to DED. Additionally, the actual State tax credits administered by the Tax Department are not promptly known due to routine lags in filing and processing tax returns. However, the Tax Department and the Division of the Budget estimate the cost of the Program State tax benefits for the 2004 year will total about $291 million. We consider this a conservative figure because it does not include the local tax incentives, utility cost discounts, or any local infrastructure improvements to accommodate the zone.

The Program is scheduled to sunset July 31, 2004. In November 2003, DED released a proposal to extend the Program for an additional five years, and to make certain Program improvements. We are not able to assess whether the plan will address the deficiencies we identified, because specific details supporting the plan were still in development when our audit ended.

## *Audit Scope, Objectives and Methodology*

We audited DED's administration of the Empire Zone Program (Program) for the period April 1, 1999 through January 31, 2004. The objectives of our performance audit were to determine whether DED reviews the cost-effectiveness of the Program; whether DED oversees and monitors the performance of certified businesses and the individual zones, and takes necessary action when businesses or zones do not perform as required; whether DED independently verifies information reported by businesses and zones; and whether DED fulfills its required role in reviewing applications for zone designation and for certification of zone businesses.

To accomplish our objectives, we interviewed officials from DED's central office, and reviewed the GML and State Tax Law. We reviewed 39 zone briefing memos, which are documents prepared by DED staff that summarize a zone application**,** and two actual zone applications (one that received zone designation and one that did not) to evaluate the zone designation process. We also reviewed zone annual reports (ZARs) submitted by each zone in 2001 and 2002 for timeliness and completeness. In addition, we selected a random sample of 116 certified businesses for review. For each of these businesses, we reviewed their certification application, and any 2001 and 2002 business annual reports (BARs) they submitted for timeliness and completeness. We also evaluated the information on the DED Program database. In addition, we used a sample of 75 tax returns for 43 certified businesses to compare employment figures and tax credits reported by the businesses on their BAR reports to the information reported by the businesses on their tax returns.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations of DED that are within our audit scope. Further, these standards require that we understand DED's internal control structure and its compliance with those laws, rules, and regulations that are relevant to the operations included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions, and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under Generally Accepted Government Auditing Standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

## *Response of DED Officials to Audit*

We provided a draft copy of this report to DED officials for their review and comment. Their comments were considered in preparing this report, and are included as Appendix B. Appendix C contains State Comptroller's Notes, which address matters of disagreement contained in DED's response.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the Department of Economic Development shall report to the Governor, the State Comptroller and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

# PROGRAM COST EFFECTIVENESS

We found that DED does not perform cost/benefit analyses of the Program, zones, or businesses to determine if their achievements in creating new jobs and making investments are commensurate with the State and local tax credits and utility discounts provided under the Program.

The primary intent of the Program is to stimulate the creation of new jobs and new businesses, as well as investment in businesses located in designated areas of the State that have experienced depressed economic conditions. The Program provides incentives to businesses in the form of State and local tax reductions, and utility cost discounts to encourage these intended results. As previously mentioned, the total cost of the Program is not known, but it is estimated that it will cost at least $291 million for 2004 in State credits alone. To determine if the Program is achieving results that are commensurate with these costs, DED officials need to routinely assess the Program's cost effectiveness. A fundamental measure of Program cost effectiveness is an analysis of Program costs versus the benefits produced to the State by the businesses in the Program. To implement such a system, DED needs to:

- accurately track Program costs, the number of jobs and businesses created, investments in businesses in the Program, and any other significant benefits produced such as wages paid to new employees in newly created jobs and retention of businesses that planned to relocate out of State;

- analyze costs and benefits at the Program, zone, and business level; and

- take corrective measures to improve performance that is below expected levels.

A prior audit report issued by the State Comptroller's Office (Report 95-S-78, issued May 23, 1996) found that DED officials had neither taken actions to determine whether the Program was effective nor had they developed a system for doing so. Subsequent to that audit, DED officials contracted with Program

Evaluation and Management Research, Inc. (PEMRI), an independent consultant, to conduct a legislatively-mandated independent evaluation of the Program. PEMRI issued a report on its evaluation in September 1999 based on an analysis of Program data available for 1993 through 1995. PEMRI found that the average annualized cost to create a job ranged from about $14,648 to $16,807, which they concluded was more costly than most other states' comparable economic development zones programs at the time. However, the current usefulness of the PEMRI results are diminished because it is based on 1993-95 data, when there were 40 zones and 1,975 certified businesses. Since then, the Program has expanded to 72 zones and about 8,600 businesses, and tax credits have been enhanced significantly with the QEZE component.

The PEMRI report made several recommendations to improve the ability of Program staff to monitor and evaluate the Program. These recommendations included revising applications and reports to establish a consistent and standardized database on public and private capital investments and other expenditures, and seeking better coordination with the Departments of Labor and Tax to improve the exchange of certain key data about the Program. We noted that these recommendations have generally not been implemented. Furthermore, DED officials have not implemented a system to routinely conduct comprehensive, ongoing assessments of the costs and benefits at the Program, zone, or business level, nor have they required each zone to perform cost/benefit analyses of their own zone or the businesses within their respective zones that claim State tax credits and other incentives.

A cost/benefit analysis is particularly important for the businesses that claim relatively high levels of tax credits, report job losses or creation of relatively few jobs, and still claim tax credits, or do not meet projected investment levels. For example, the Tax Department's report titled *Analysis of Article 9-A General Business Corporation Franchise Tax Credits* for 1999 shows that a large portion of the State tax reductions are received by a small percentage of the businesses. The report shows that 137 of the approximately 2,300 zone certified businesses in 1999 accounted for the entire $43 million of Empire Zone Investment Credits used, or an average of about $314,000 per business. This $43 million is a substantial portion of the total tax credits of $64 million in 1999. As the higher-level QEZE benefits are claimed by businesses in the subsequent years, the need for DED to have a system to identify such businesses and scrutinize the cost/benefits at the business level increases.

In response to our prior audit, DED officials told us that they had focused on establishing the zones and providing technical assistance and that the objectives of measuring and determining cost effectiveness were secondary. They also replied that the data to perform such an analysis could not legally be obtained from the Tax Department due to secrecy provisions in the Tax Law. In recognition of this, we recommended that DED seek legislative authorization to obtain relevant information from the Tax Department.

We found that DED still does not have access to detailed data from the Tax Department that could be used to assess the cost effectiveness of the Program and verify zone and business performance. Additionally, DED has not sought legislation to obtain it. DED can obtain Tax Department public reports that provide Program-wide costs of tax credits for the most recent year available. The 2004 Tax Expenditure Report includes actual costs for 2000 tax credits and estimates of QEZE benefits for 2004. The significant time lag in the availability of actual tax credit cost data is due to the time it takes for returns to be filed, including extensions, and for Tax Department processing of the returns. The Tax Expenditure Report is useful for analyzing Program-wide actual cost/benefits for 2000 and estimated cost/benefits for 2004. However, DED has not implemented a system to routinely use the report for such analysis. Also, the report does not contain zone and business level data and, therefore, cannot be used for cost/benefit analyses at those levels.

In an effort to obtain more detailed and current tax credit data, DED revised the Business Annual Report (BAR) prepared by zone businesses to include gross payroll amounts and estimated tax credits to be received, including QEZE tax credits. (The BAR, which is DED’s primary tool for monitoring business performance, contains various performance-related data provided by the businesses.) However, the BAR still does not capture information on all benefits that the businesses receive, and the data is self-reported by businesses and not verified. Additionally, the BAR does not capture the wages paid for the new jobs added. Another significant weakness is that key performance measures such as jobs created, new businesses, and investment levels obtained from the BARs are overstated due to a Program loophole. This loophole allowed previously existing businesses to reform or restructure and then receive Program benefits. Such businesses will appear to be new businesses and their employees will appear to be new jobs on the BARs.

However, DED officials told us that they cannot determine the extent to which Program statistics are overstated by these businesses due to the loophole. Furthermore, as detailed later in our report, we found inaccuracies with DED's other monitoring tool, the Zone Annual Report (ZAR). Due to the inaccuracies contained in the BARs and ZARs, neither of these two reporting systems can be relied on to accurately assess the costs and benefits produced by specific businesses, zones, or the entire Program.

We found other DED reporting inconsistencies. DED officials provided us with a copy of a December 31, 2003 response to a State Assembly request related to the Program. Part of the information provided was a spreadsheet of 1,403 QEZE businesses showing their base-year average jobs for 1995-1999 and their jobs in 2001. In the response to the Assembly DED states "these 1,403 businesses reported a base level employment of 28,430 and a 2001 tax year employment of 77,861." This statement appears to imply an increase of 49,431 jobs from 1999 to 2001. However, our analysis of this data showed otherwise. We examined all of the 89 businesses that showed an increase in employment of over 100 jobs during that time period. Our analysis found that the increase in jobs as presented by DED was overstated by 15,168 jobs. For example, one business on the document provided by DED shows zero jobs between 1995 and 1999 and 3,760 jobs in 2001. As a result, it appears that the business created 3,760 jobs between 1999 and 2001. However, in fact, the business was not certified until August 2001 and it had 3,677 employees at the time it was certified. While this business did create jobs, it created 83 jobs instead of 3,760. In addition, according to DED officials, the data provided to the State Assembly did not include any businesses that have been decertified from the Program. However, we identified 7 businesses in our sample of 89 that have been decertified. DED reported that these businesses created a total of 1,089 jobs.

We also conducted an audit of the Empire Zone Program at the Tax Department. As part of that audit, we selected a random sample of 116 certified businesses from DED's Program database and requested their 2001 and 2002 tax returns from the Tax Department (a total of 232 returns). We received 75 of the 232 requested tax returns for 43 businesses from the Tax Department (we reduced our sample size to 75 returns, because of the time necessary to retrieve the returns). Twenty of the 75 tax returns claimed Program tax credits. The 20 returns were for 13 businesses, including returns for both years for 7 businesses and returns for one of the two years for 6 businesses.

We attempted to prepare cost/benefit analyses using the claimed levels of Program tax credits and jobs created per the tax returns and the investments reported per the businesses' BARs for the 13 businesses. We used the investment level reported on the BAR because that information is not the basis for tax credit eligibility, so the tax return does not capture it. Our analysis shows that the businesses provided varying levels of benefits to the State for the tax credits they received. For example, one business's 2002 tax return shows it received a $201,000 tax credit and created only 1 job. The business, which was certified in 2002, did not submit a BAR for 2002, so we cannot determine the amount of investment it reportedly made. However, its application indicated it would invest $250,000. In contrast, a business certified in 1999 claimed 2002 tax credits of about $18,000, and created 27 jobs. The business's BAR also indicates that it planned to invest over $435,000 in 2002.

The results illustrate the need for DED to implement a system to routinely analyze the cost/benefit of the Program. Because the Program's overall cost/benefit is the cumulative results of the cost/benefit of the individual businesses, DED needs to be able to assess the results at the business level. Furthermore, the concentration of relatively high proportions of the tax credits among a comparatively small portion of the businesses suggests that DED should focus its attention on those businesses. Due to the lack of access to Tax Department records, DED should improve the BAR to include data on the businesses' actual tax returns, rather than estimates.

## Recommendations

1. Implement a system to assess the cost effectiveness of the Program, zones, and businesses based on:

    - complete and accurate data on all tax credits at the State and local level and utility discounts; and
    - expected and actual business performance in adding jobs, including the level of wages paid and investments made.

    (In response to our draft report, DED officials did not directly address our recommendation to implement a system to assess the cost effectiveness of the Program, zone and businesses based on complete and actual costs and benefits. However, DED did indicate that provisions of its 9-point plan require the establishment of performance measures for determining the economic and revitalization impacts of the Program.)

2. Implement a system to take corrective action when performance falls below acceptable levels and to take enforcement actions such as decertification when performance does not improve. Focus attention on the businesses receiving a relatively high proportion of the tax credits.

    (In response to our draft report, DED officials indicate that the law states that they cannot decertify a business if its performance is impacted by economic conditions which a business could not anticipate or which were beyond its control.)

    <u>Auditor's Comments</u>: We agree. However, the law does allow for decertification when failure to perform is not due to such mitigating factors.

# OVERSIGHT AND MONITORING OF BUSINESSES AND ZONES

In 1993 the Legislature amended the GML to mandate that DED be responsible for coordinating the implementation of a system to evaluate the effectiveness of the Program. Because the performance of the businesses and zones drive the effectiveness of the Program, DED needs a system to monitor and evaluate the performance of the zones and businesses to be able to evaluate the Program. To achieve this objective, it would be appropriate for DED to collect sufficient, competent, relevant, and useful data to support any analysis and as a basis for decision-making. DED must have a system in place to use the data for meaningful comparisons and analysis. Further, DED must have procedures in place outlining the responsibilities of each stakeholder (DED, zones, and businesses) in the process and a training program to ensure each stakeholder is instructed in their responsibilities and to ensure that they will follow the required procedures.

DED receives BARs and ZARs annually. Each is potentially valuable as a monitoring tool. We identified areas where DED has taken steps to meet its monitoring expectations. For example, DED created a data collection system, capturing most data from applications and BARs on their database for access and analysis, created a Policy and Procedures Guidebook (Manual) that addresses all the administrative responsibilities for the zone coordinators, makes site visits, and provides training for zone coordinators and local staff working on the Program. However, as detailed in the following sections of this report, we also identified areas where DED needs to improve its oversight and monitoring of businesses and zones participating in the Program. Among other things, DED needs to verify the accuracy of performance-related data reported by zones and businesses, and take necessary action when zones and businesses substantially fail to meet their intended goals.

## *Business Annual Reports*

The GML requires DED to collect information from businesses for monitoring purposes. In this regard, DED requires businesses to report information on the BARs. The BARs capture information including the business's average employment for the year, their total planned investment for the year, and whether or not they qualify for various tax credits and how much they estimate they will claim for those tax credits. Despite DED's efforts to compile information on their business performance, we determined that DED needs to further improve the contents of the BARs to enhance their utility as a monitoring tool.

BARs contain information that is mostly self-reported estimates made by the businesses, and DED does not verify the accuracy of the reported data. The only review done is a reasonableness check of the figures reported, primarily to identify data entry-type errors when BAR information is entered onto DED's database. However, due to the lack of verification, DED has no assurance the data is accurate. We reviewed the 2001 and 2002 BARs for a random sample of 116 certified businesses and found that 72 (37 in 2001 and 35 in 2002) of the 136 BARs submitted (53 percent) were incomplete or improperly completed. Another shortcoming is that BARs capture only gross employment numbers and are not designed to capture an increase in a business's employment that could be compared with the new jobs-created data reported on the ZARs. Further, the BARs capture gross payroll for a business. They do not capture any information on the pay rates of any new employment created, so an analysis cannot be done as to the types and quality of jobs being created.

While DED has modified the BARs in recent years to capture estimated tax credits that businesses expect to claim, the BARs still do not require businesses to report any actual credits claimed or information on utility cost discounts that businesses receive nor any local benefits that add to the cost of the Program. Lacking complete and accurate information relating to employment pay rates and data on all benefits received by the businesses impairs DED's ability to assess the Program's and businesses' effectiveness.

We also found that the BARs are not compiled by DED in a timely manner. Each certified business is required to submit a

BAR annually by May 31st for the prior calendar year. DED hires temporary staff to input the BAR information to the Program database. We compared DED's database information to the information recorded on the 2002-year BAR reports as of November 26, 2003. The database showed no entries for 2,115 (28 percent) of the 7,431 businesses listed. As a result, we concluded that this database is not complete and cannot be used for analysis by DED until DED completes data entry and reasonableness checks. To alleviate such significant data entry delays, we believe DED should investigate the use of scannable documents and online BAR reporting.

In addition, BAR information covers a calendar year. For a business with a non-calendar year tax year, the tax year may not have been completed by the time BAR submission is required and therefore the business may not be able to reliably estimate its expected tax benefits. Under this scenario, a business may not have completed figures for investments either. DED should consider modifying BARs to include credits claimed in the business's last completed tax year. While the data is still unverified, this will provide DED with actual business data instead of estimates.

Any business that does not submit a BAR as required is to be decertified. We reviewed the 2001 and 2002 BARs for a random sample of 116 businesses. We found 27 of the 103 businesses that were required to have a 2002-year BAR did not submit one and should have been decertified. As previously indicated, BAR reports are due on May 31st for the preceding calendar year. However, at the time of our review in November 2003, only 2 of 27 had been decertified. Since these businesses were not decertified in a timely manner, there is the potential that these businesses may be able to take advantage of an extra year of tax credits if they are not decertified by the time they file their tax returns.

In addition, once we completed our review of the BARs submitted by the 116 businesses in our sample, we requested the 2001 and 2002 tax returns from the Tax Department for each of these businesses. However, we reduced our sample size to 75 returns (38 for 2001 and 37 for 2002) because of the time necessary to retrieve the returns. As previously indicated, the 75 returns were for 43 businesses. Twenty of the 75 tax returns (for 13 businesses) claimed Program tax credits. For each of these returns, we compared the employment, payroll, and tax credit figures reported on the BARs to those figures reported on the tax returns. We found discrepancies between the credits claimed on the BARs and the tax returns for all 13 businesses in our sample. We also found discrepancies in the employment and payroll figures for the majority of the 13 businesses. For example, one business reported on the BAR that it would claim credits totaling $22,860. When we reviewed the tax return, we found that the business actually did not claim any credits. Also, we found that two businesses did not submit 2002 BARs. However, both of these businesses claimed tax credits totaling $208,176. As a result of such discrepancies, DED does not have an accurate understanding of what businesses are claiming or the actual costs of the Program.

In addition, while the current BAR information can be used for some analysis to evaluate business progress and performance in the Program, we did not find that DED was performing these analyses to identify potentially underperforming businesses. We also compared BARs to applications for 54 businesses to measure business progress toward the goals they reported on their applications and found that only 18 (33 percent) had met such goals. We were able to review the first two years of certification for 32 of the 54 businesses. Of these, 19 did not meet their goals in either year, only 8 met their job creation goals in both years and 5 met their goals in one of the two years. For the remaining 22 businesses we were only able to review one year. Twelve of these 22 businesses did not meet their job creation goals in the year we reviewed.

During our separate reviews of 11 zones, we compared the businesses' projected job creation identified on their applications to "actual" job creation reported on the BARs for a judgmental sample of 473 businesses that were certified and that submitted a BAR. We generally focused our selection on businesses that were not recently certified to increase the likelihood that they would submit a BAR. We found that only 140 of the businesses sampled (30 percent) reported that they met or exceeded their projected job growth. The remaining businesses reported that they reduced staffing, did not add enough jobs to meet their projections, or kept staffing unchanged.

When an analysis is done that identifies underperforming businesses, appropriate action must be taken for those businesses. In addition to DED not taking action against the businesses that did not submit the BARs, we noted that none of the businesses we identified as not meeting their goals have been decertified by DED. Although the GML provides for decertification of underperforming businesses, according to DED officials, no business has ever been decertified for underperformance. Further, our review of DED decertification reason codes indicates there is no code to decertify businesses for underperformance (there are decertification codes for out-of business, moved out of the zone, no BAR, and others). In addition, our separate reviews of 11 zones found that zones do not decertify businesses that do not meet their performance goals. As a result, once businesses are certified into the Program, there is the possibility that they can continue to participate in the Program without necessarily creating new jobs.

## Recommendations

3. Modify the BAR to increase its effectiveness as a monitoring tool by including complete and actual information, such as the increase in jobs, the types and quality of jobs created, pay rates of new employment, and the actual tax and other benefits received.

4. Provide more complete instructions and training to businesses on the completion of the BARs to help ensure they are properly completed.

5. Address BAR data entry delays by investigating the use of time saving approaches, such as scannable documents and online BAR reporting.

6. Act timely to decertify a business that does not submit its BAR as required.

7. Perform analysis of BAR data collected to evaluate the performance of certified businesses in the Program, such as whether they have met employment goals.

8. Verify the information reported on BARs to Tax Department information on a sample basis.

(In response to our draft report, DED officials indicate that steps are being taken to implement Recommendations 3 through 8.)

**Recommendations (Cont'd)**

9. Act timely to decertify businesses identified through analysis as having recurrent performance shortfalls (e.g., not meeting employment projections).

   (In response to our draft report, DED officials state that it is not necessary to decertify businesses that do not meet their job creation goals because the tax law restricts benefits to job creation.)

   Auditor's Comments: State tax benefits are not the only benefits a business receives. In addition, as we note in the report, some existing businesses were able to reorganize and enter the Program as "new" businesses, prior to legislation that closed this "loophole." Such businesses could create one job and receive tax benefits that are not limited by the employment increase factor.

   (DED acknowledges this situation in its response and in its plans for reform of the Program.)

## *Zone Annual Reports*

Each zone is required to submit a ZAR that summarizes significant zone activities, accomplishments, and the zone's progress toward achieving its short- and long-term goals. The ZAR also captures zone summary information including the number of jobs created by certified businesses during the year, the number of new businesses created during the year, the number of jobs retained during the year, the number of businesses retained during the year, and the total amount of private capital leveraged with public funds during the year.

The ZAR is a key component of DED's system for monitoring the zones. However, we found that DED does not use the ZARs for any meaningful analysis or monitoring. Instead, DED officials receive them, examine them for exceptional errors, log them in as received, and file them. The data is not included on any database as the BAR information is, and there is no analysis of the data, such as a comparison of the new jobs created versus the job data reported on the BARs. Further, discussions with DED officials indicated that they do not know whether the individual zones are calculating the data reported in the ZARs the same way.

Our review of ZARs and the review work done at individual zones by OSC indicated the ZARs are not capturing consistent and accurate information as required. We also identified differences among the zones as to how they are completing the ZARs. As a result, DED lacks necessary information in order to effectively monitor and, where necessary, to take appropriate action with the zones.

DED's Manual and ZAR instructions briefly describe how zone officials should complete each section of the ZAR. However, we determined that these descriptions are not detailed enough to ensure consistent reporting, thereby resulting in wide variations in interpretation and reporting by the zones. OSC reviews of 11 zones supports this conclusion by identifying variations in the way the zones completed the ZARs. For example, according to DED officials, the new jobs created section on the ZAR should be calculated by subtracting the total number of jobs on the prior year's BARs from the number of jobs on the current year's BARs. Those reviews found that some zones calculate the number of jobs created by only adding up all of the jobs reported on the current year's BARs for businesses entering the Program that year. Another zone only reports jobs created by businesses if they increased jobs, and does not net out the jobs lost by other businesses in the Program during the same period.

We conducted our own analysis of employment data collected on the summary BAR reports produced by DED versus the employment data on the ZARs. Of 52 zones from which BARs and ZARs were submitted in 2000 and 2001, we found that the jobs created matched for only two zones. For the remaining 50 zones we found differences in reported new employment figures between the BARs and the ZARs. These differences ranged from a difference of 11,113 jobs where the ZAR's data exceeded the BARs' data at one zone to a difference of 26,575 jobs where the BARs' data exceeded the ZAR's data at another zone.

There were similar inconsistencies among zones as to how they completed other sections of the ZARs including what should be counted and reported as a new business; what was to be included in the jobs and businesses retained figures section;

and what should be reported as the amount of private capital leveraged.

These inconsistencies exist and are allowed to continue because DED officials only use the ZAR information on a limited basis and they have not examined the ZARs for inconsistencies in reporting by different zones. While DED officials noted that they include instructions with the ZAR templates on how to complete each section and provide training to zones on a regular basis, the instructions and training are not clear enough to ensure consistent completion of the ZARs.

In addition, the ZAR is not designed to capture certain tax credit information necessary for evaluating Program effectiveness. Section 963 of the GML requires that certain information regarding tax credits claimed by businesses be included in the ZARs. We reviewed the ZARs for 2001 and 2002, and found that they did not include the required tax credit information, such as the investment and wage tax credits. Further, there is no information about utility cost discounts or local benefits captured. The ZARs do contain a section for information on 485-e Real Property Tax Exemptions, as well as a section for information on property tax increments. Aggregate totals for each zone should be captured on the ZARs.

The overall result is that the inconsistent information reported on the ZAR, together with the inadequate tax credit information provided, renders the ZAR ineffective as a monitoring tool. Since zones complete the reports in different ways, one zone cannot be compared to another zone. Further, ZAR data cannot be compared to BAR data for a zone because these reports are inaccurate and do not contain the same categories of information; consequently, they cannot be used as a reasonableness check of reported data. According to DED, the ZARs are primarily used to determine how administrative funding for zones will be distributed. The ZARs capture extensive information, but DED's review of all of the information submitted by the zones is confined to a brief review document that simply checks that the required reports were submitted on time and "yes" or "no" answers as to whether zones were making progress toward their goals.

**Recommendations**

10. Use the ZARs as a monitoring tool, and take action where appropriate when zones are not meeting their planned goals.

11. Provide more complete instructions and training to zone coordinators on the completion of the ZARs.

12. Test on a sample basis to ensure all zones are completing the ZARs as instructed.

13. Compare data reported on the ZARs to the BARs and follow up on material differences identified.

14. Modify the ZAR to increase its effectiveness as a monitoring tool by including similar (aggregate) information to that of the BARs.

    (In response to our draft report, DED officials indicate that steps are being taken to implement Recommendations 10 through 14.)

# ZONE AND BUSINESS APPLICATIONS

DED needs to improve its zone application review process. We found that DED officials are not required to document their decisions regarding which applications to recommend for zone designation. Regarding DED's review of business certification applications, we found that DED is following established procedures, but DED needs to establish additional performance criteria for use in reviewing applications.

## *Zone Applications*

Once the Legislature authorizes the establishment of new zones, DED solicits cities, counties, towns and villages for zone designation applicants. In accordance with Section 10.1 of the New York Codes, Rules and Regulations (CRR), DED receives and reviews applications and makes recommendations to the Zone Designation Board (ZDB). Title 5, Chapter 2, Part 10 of the CRR and Section 958 of the GML contain factors that DED may consider in determining which applicants to recommend to the ZDB. In addition, DED officials told us that need, commitment, and readiness are the three broad criteria they consider when determining which zone applicants they recommend.

The ZDB is made up of nine members. Members include the Commissioner of Taxation and Finance, the Director of the Budget, and the Commissioner of Labor. In addition, the Governor is allowed to appoint two members and the President of the Senate, Speaker of the Assembly, and the minority leaders of both the Senate and Assembly may each appoint one person. The minority leader appointments are non-voting members of the Board, and the Governor selects the Chairperson of the Board.

At the Program level, DED has developed an application that seeks to address the relevant economic development criteria, in addition to the specific unemployment or poverty criteria, which qualify an applicant to be a zone. In addition, teams of two DED Program associates prepare a briefing memo to summarize the main points from the applications that are associated with the economic development criteria. Each briefing memo ends with a summary evaluation of the strengths and weaknesses of the application. Once the Program associates complete the briefing memos and the DED Program Director reviews them, they are forwarded to a team of senior DED officials. The senior DED officials review the briefing memos and make recommendations to the ZDB. The ZDB, which also receives copies of the briefing memos for all applicants, is responsible for making the final decision on zone designations.

We found that the senior DED officials do not document the bases for their recommendations to the ZDB. The process of deciding which zones to recommend is particularly important because, as DED officials noted to us, all their recommendations to the ZDB have been approved.

For the most recent round of zone designations, which occurred in 2002, there were 25 applicants for 6 legislatively-authorized zones. In reviewing the briefing memos prepared by the DED Program associates, we concluded that the 25 applicants had received either positive (6), negative (9), or inconclusive (10) evaluations. We did not identify, and DED officials confirmed, documented comments or a methodology on the briefing memos or on any other documents, to support why senior DED officials recommended some zone applications to the ZDB and not others.

However, we noted instances where senior officials, without any documented justification, recommended applications to the ZDB, contrary to what would have been expected based on the evaluations of the Program associates. The ZDB then approved these applications. As a result, it is possible for applicants to receive zone designation, even though DED documents do not support it.

When we reviewed the minutes to the ZDB's meetings, we noted that the meetings were very brief and that there were no details about the positive or negative aspects of an application recommended by the senior DED officials. In addition, there were no discussions of the other applications forwarded to the ZDB.

DED officials noted that many factors go into deciding which zone applicants to recommend to the ZDB. They indicated that some factors are not quantifiable, including the competence of the zone administrator, the likelihood of potential projects and their success, and the location of proposed zones in relation to existing zones. DED officials noted that referral decisions often rely on the knowledge of senior officials with a global and statewide view of fluid economic situations in various parts of the State. As a result, it would be difficult to prepare a standardized checklist of items to review. Nevertheless, it is our position that DED needs to develop a process that requires the senior DED officials to document their decisions to ensure the best applicants receive zone designation.

**Recommendation**

15. Develop a process that requires the documentation of decisions by senior DED officials regarding recommendations of zone applicants to the Zone Designation Board.

    (In response to our draft report, DED officials indicate that it will take the recommendation under consideration.)

## *Business Applications*

Once zones are designated, businesses within the zone may apply to become recognized as certified businesses. The process for certifying businesses is known as joint certification. DED plays a role, in conjunction with the joint certification officer at the local level and with DOL, in certifying businesses. The joint certification officer is designated by the applicant municipality and may not be a member of the ZAB. He or she is responsible for jointly certifying businesses in conjunction with the Commissioner of DED and the Commissioner of the Labor Department. The business seeking certification must complete an application and submit it to the joint certification officer, who reviews the application. If approved, it is forwarded to DED. DED sends the application to DOL, which determines whether the applying business is in compliance with the applicable labor laws. DED performs the final review of the application, which involves determining whether the applying business meets the qualifying criteria contained in the GML. These criteria include, among other things, whether the business enterprise is reasonably likely to create new employment or prevent a loss of employment in the zone. DED officials noted that applying businesses do not need to meet all of the criteria contained in the GML to be eligible, except that any business not complying with the worker protection laws criteria would not be certified. If the business meets the necessary requirements, DED officials will prepare the certification document.

We found that DED has been following established procedures in approving the certification of businesses. DED has developed a business certification application along with a process for reviewing it in conjunction with the local zone administrators and the Commissioner of Labor, that seeks to addresses the main criteria noted in the GML. We selected a sample of 116 business applications to determine whether they were properly completed and approved as required. In general, the applications were on file, completed, and had the required approvals from the local joint certification officer, DOL, and DED.

However, the GML does not stipulate what specific job creation and investment criteria need to be met for certification, and DED has not developed or promulgated criteria. As a result, we identified businesses that planned to create few to no jobs and make little or no investment and they were still approved. DED should establish specific, objective, and quantifiable criteria for certifying businesses. Also, by conducting cost-benefit analysis estimates before certifying the application, DED may be able to identify situations where businesses would receive tax benefits that exceed the benefit provided to the community in the form of investment and increased jobs.

## Recommendations

16. Establish specific, objective, and quantifiable criteria for certifying businesses.

    (In response to our draft report, DED officials indicate that they will implement this recommendation.)

17. Conduct cost/benefit analysis estimates before certifying the application to identify situations where businesses would receive tax benefits that exceed the benefit provided.

    (In response to our draft report, DED officials indicate that the Executive Budget proposal offers solutions focused on making tax credit calculations more proportional to the benefits to be received.)

# MAJOR CONTRIBUTORS TO THIS REPORT

Frank Houston

Carmen Maldonado

Robert Mehrhoff

Steve Goss

Todd Seeberger

Brian Krawiecki

Vicki Wilkins

Maria Harasimowicz

Cindy Herubin

Natasha Verela

Paul Bachman

Empire State Development

**Charles A. Gargano**
Chairman
and Chief Executive Officer

March 31, 2004

Mr. Frank J. Houston
Audit Director
Office of the State Comptroller
Division State Services
123 William Street – 21st Floor
New York, NY 10038

Dear Mr. Houston:

We are in receipt of your March 1, 2004 correspondence relaying the draft audit report (2003-S-41) on the Department of Economic Development's (DED) administration of the Empire Zones Program. We are pleased to offer our response within the 30-day comment period to be included in the final version of the audit.

The Empire Zones (EZ) program is one of the most successful economic development attraction tools in the nation. In 2002, the EZ program helped attract 812 new facilities and business expansion projects, up from 75 in 1994. This program has been in existence since 1986 and has grown over the past 17 years as a direct result of a dozen or more law changes. Changes in tax law can and do have a direct impact on the program's benefits and costs. In 2000, very significant enhancements of the EZ benefits were approved, known as the Qualified Empire Zone Enterprise (QEZE) credits, consisting of NYS Sales Tax Exemption, Real Property Tax Credit and Tax Reduction credit.

QEZE credits first became available to businesses in 2001, shortly before the terrible 9/11 attacks on our State and Nation, and the national economic downturn that followed. The EZ program was critical in maintaining economic health and encouraging the rebound in job creation and investment New York State is currently experiencing. Despite our many attempts to educate your office on these points, it appears there is an unwillingness to acknowledge the facts of the program. Your audit suggests businesses should not only be excluded from receiving benefits, but should be permanently penalized. This reflects a basic misunderstanding of the program in at least two fundamental areas:

First, unlike grants that are tied to specific job commitments, businesses do not get benefits based only on projections. The law requires that businesses be rewarded retrospectively for their actual performance.

**Empire State Development Corporation**
633 Third Avenue New York, New York 10017-6754 Tel 212 803 3700 Fax 212 803 3715

* See State Comptroller's Notes, page 51

Second, the EZ program is designed to encourage future growth, particularly when the economic climate is the most challenging. For this very reason, the law clearly states that we cannot de-certify a businesses if performance is impacted by "economic circumstances or conditions which such business could not anticipate or which were beyond its control."[1] The program is already designed to anticipate short-term difficulties due to business cycle fluctuations, and as a result, a business may be able to claim benefits in a particular taxable year and not in others when it is unable to perform as required under the program.

* Note 2

It is important that the Empire Zone program continue to evolve and be improved over time. The upcoming legislative sunset date, July 31, 2004, provides a perfect opportunity to critically review the entire program once again. On January 20, 2004, the Executive Budget included a comprehensive legislative package designed to make to many aspects of the program more efficient and effective.

A meaningful analysis in any audit report must include a review of the current statute and consideration of serious proposals to improve it. This is particularly important to undertake before making recommendations on the program. Unfortunately, this audit did not take the time to review the 9-point plan released on November 16, 2003, or the specific details of the legislative package included in the Executive Budget proposal publicly presented many weeks prior to the close of the audit. This failure resulted in a missed opportunity by your office to consider the comprehensive solutions contained in the reform proposal.

* Note 3

Therefore, as part of this response we will once again provide your office with summary information on this aspect of the Executive Budget proposal. Please do not hesitate to request any additional detail you may require. We hope that the comprehensive solutions contained in the Executive's package will be fairly included in your final report.

Our response to the draft audit report will also focus on the recommendations contained within it. Many of the issues raised in this audit have been previously addressed by DED through preliminary comments, which are not reflected or addressed in this report. As we indicated in the preliminary responses, there are statements in the audit report that reflect an apparent misunderstanding of the basic elements of the program as prescribed in the Tax and General Municipal Law. These flaws are similar to those we pointed out in our January 28, 2004 unsolicited response to the draft audit report of the 8 local zone administrations "Effectiveness of the Empire Zone." Any report on a State program is fundamentally weak if it fails to understand the guiding statutes that support it. Our responses to the recommendations will repeat the same references to failures of the audit to understand the facts behind different aspects of the program.

One of the major criticisms of the findings contained in this draft audit report, similar to statements found in final reports on the local zone administrations, is that the auditors apparently misunderstand the basic elements of how the current program operates with

[1] GML §959(a)

* See State Comptroller's Notes, page 51

respect to a business enterprise receiving tax credits. First, a business must be located in an EZ. Second, it must become certified (approved by local zone, DED and the NYS Department of Labor) and remain certified by, among other things, submitting annual reports to DED[2]. In general, certification confirms the applicant is located in an Empire Zone, is in compliance with labor law requirements, and is predicated upon a projection of job creation, investment, or another form of an enhancement of the economic climate of the zone. However, no business receives benefits based on these projections. Third, the business must submit separate tax forms to the NYS Department of Taxation & Finance every year to claim credits. These filings (subject to audit) attest to the business' actual job creation, investment and other data regarding the previous year as a basis for claiming individual tax credits[3].

* Note 1

Empire Zone benefits, including QEZE, are performance based only and determined every year as part of the business' State tax filing[4]. **Tax law calculations <u>do not</u> recognize projections made by a business.** Irrespective of any projections made on the businesses certification application, tax benefits are only conferred retrospectively for actual jobs created (or qualified business activity applicable to a specific program benefit). **It is inaccurate to claim a business received benefits based on projections because projections are meaningless in terms of the benefits conferred by the Department of Taxation & Finance.** To claim otherwise is misinformed at best, and misleading at worst.

* Note 1

Each taxable year a business must first pass the employment test in order to have access to the QEZE credits and second must calculate the "employment increase factor" to determine the level of QEZE benefits it will receive. In order to pass the employment test, the average number of employees in the taxable year must be equal to or greater than the base period, which is a five year average. A business can not access QEZE benefits if its employment level falls below the five year average. Examples of how benefits are calculated under existing law, and under the Executive budget proposal, are incorporated in the responses to the audit recommendations.

In addition, the audit report indicates how a "loophole" was closed in 2002 by implementing a "new business test" to prevent a business from reincorporating, hiring just one employee and receiving maximum benefits. However, the report also indicates that businesses already in the program were not addressed by this corrective action. The Executive budget seeks to address this issue by targeting businesses that took advantage of the loophole before it closed. These businesses already in the program, as well as businesses that become certified in the future, would be subject to a more proportional employment increase factor.

---

[2] To qualify for a sales tax refund on construction materials and the RPTL 485-e abatement, a business enterprise only needs to be located within the boundaries of the zone.
[3] RPTL 485-e abatement does not require the submission of tax forms to the NYS Department of Taxations and Finance.
[4] RPTL 485-e, the sales tax refund on construction material and the utility discount are not received by way of the State income tax filing. However, the sales tax refund on construction material is processed through filings with the NYS Department of Taxation and Finance.

* See State Comptroller's Notes, page 51

Furthermore, unlike the misleading findings in the local zone administrations audit that claimed costs of the program were unknown, this audit does acknowledge that there are different types of information on the program. Aside from the data collected by the Business Annual Reports (BARs), **the Comptroller's office has unique access to the Department of Tax and Finance records containing individual tax filing information, which is the basis for claiming credits and determining the true cost impact to the State of New York.** To be clear, BAR's are not the basis for the benefits conferred by Taxation and Finance, they are simply DED's tool for monitoring the program because tax secrecy provisions do not allow DED access to tax filing information. However, the Executive budget reform package implements an interagency reporting system that combines program information from many sources to be reported in the aggregate by Tax and Finance. This enhances the reporting on the program while protecting tax payers from undue violations of privacy. These are just two more examples of the comprehensive solutions offered by the Executive Budget proposal that more effectively address many of the legitimate issues of the program raised over the past several months.

New York State, along with the nation, is rebounding from the economic downturn. I hope this particular audit will bring informed constructive input that can used be to improve the Empire Zones program, creating more jobs and opportunities for the hardworking New Yorkers we serve. Therefore, please do not hesitate to contact us with any follow up questions or concerns.

Sincerely,

Charles A. Gargano
Chairman
and Chief Executive Officer

cc: Honorable Alan Hevesi, NYS Comptroller

## Executive Budget Empire Zone Proposal

The Executive budget proposal includes legislation that would:

- ✓ Extend the authorization for the program from 2004 to 2009.

- ✓ Reduce the benefit period for businesses that enter the program on or after April 1, 2004 from 15 years to 10 years. Businesses currently in the program would not be affected.

- ✓ Link the value of State tax credits that reimburse businesses for local property taxes and other taxes paid (QEZE Real Property Tax Credit and QEZE Tax Reduction Credit) to the number of new jobs created. Under current law, some businesses that create only one new job can claim a 100 percent property tax reimbursement. Under the new legislation, businesses would be required to create 100 new jobs to claim a 100 percent reimbursement. Lower job growth would be rewarded with proportionately lower reimbursements. For example, 50 new jobs would result in a 50 percent reimbursement. The legislation provides for an appeals process that will enable benefits to continue for existing businesses that have legitimately created new jobs.

- ✓ Reward significant investment in distressed census tracts. The legislation would allow Empire Zone credits to be taken in limited circumstances where significant new investment occurs in distressed areas, with fewer than 100 new jobs. For example, restoration of a commercial building in a distressed urban area may require millions of dollars of investment, but create fewer than 100 jobs.

- ✓ Require local administrators to target their Empire Zone acreage within specific static areas defined by "super" boundaries, consistent with a local development plan, to promote neighborhood-wide revitalization.

- ✓ Attract regionally significant economic development projects by creating an annual one square mile pool of flexible zone acreage. This acreage will be available to support projects outside of the New York metropolitan region that create at least 300 new jobs but cannot be accommodated within regular Zone boundaries, or projects in distressed census tracts anywhere in the State that create at least 100 new jobs and fall outside of regular Zone boundaries. An additional one square mile is dedicated for the Agri-business Opportunity Zone program, which would be subject to specific criteria tailored to the businesses in the proposal.

- ✓ Improve State and local oversight. Local administrators will be required to develop and comply with detailed Zone Development Plans to ensure that valuable Zone benefits are used strategically to reward businesses that create new jobs in a community or make critical investments to help revitalize distressed areas. The legislation will allow the State Tax Department, Department of Labor and Empire State Development to improve program oversight, evaluation and reporting.

Response to Recommendations

**Recommendation #1** - Implement a system to assess the cost effectiveness of the Program, zones and businesses based on:

- complete and accurate data on all tax credits at the State and local level and utility discounts; and
- expected and actual business performance in adding jobs, including the level of wages paid and investments made.

**Response #1** – We do collect a significant amount of information via BARs and utilize it to monitor job and investment performance by businesses. This data was a very valuable resource in constructing many elements of the 9-point Plan to improve the program, including the proposal to improve the proportionality of benefits to performance and the proposal to create an interagency reporting system. The later provision requires the Department of Economic Development and the Department of Taxation and Finance to report on program performance, including but not limited to, the number of participating taxpayers and the total benefits claimed. Furthermore, the proposal requires the Commissioner of Economic Development in conjunction with the Commissioners of Labor and Taxation and Finance to establish performance measures for determining the economic and revitalization impacts of the Empire Zones program.

**Recommendation #2** - Implement a system to take corrective action when performance falls below acceptable levels and to take enforcement actions such as decertification when performance does not improve. Focus attention on the business receiving a relatively high proportion of the tax credits.

**Response #2** - First, an understanding of the tax law applicable to this program clearly reveals that program benefits are performance based. Tax law calculations do not recognize projections; they are in fact meaningless in terms of benefits conferred by the Department of Taxation and Finance. Irrespective of any projections made on the businesses certification application, tax benefits are only conferred for actual jobs created (or qualified business activity applicable to a specific program benefit). * Note 1

For example, let us consider a business that currently has 50 employees and wants to expand its operations in the zone and create 30 new jobs. It created 20 jobs rather than

* See State Comptroller's Notes, page 51

the 30 that was projected on its certification application. Assuming the base period average was 50, the QEZE employment test would be met in this example. The QEZE employment increase factor would only allow benefits to be claimed on the 20 net new jobs actually created. They receive what the calculation set in Tax law allocates in QEZE credits for a company that started with 50 employees and grows to 70 (70-50 = 20 net new jobs, then 20 is divided by 50 = 40% of QEZE). If they then reduced their workforce by 10, there is still a net job increase of 10 jobs so that business would then qualify for 20% of QEZE (10 over 50). If that business lost another 15 jobs it would not be possible to claim QEZE benefits because the business would fail the employment test; taxable year employment is less that the five year average base period.

However, as your auditors were aware, the Executive budget proposal seeks to improve the Empire Zone program. One of the elements of the Executive's proposals is to change the employment increase factor to make the net new jobs over a factor of 100. Using the same business in the example above, the 20 net new jobs created would access only 20% of QEZE (20 over 100) as compared to 40% under current law as explained above. While maintaining the performance basis of the program, the Executive's proposal makes benefits more proportional to the performance. This proposed remedy is reflective of an understanding of the fundamental mechanics of the program that allows accurate identification of the cause and effect of particular factors and identification of solutions to solve them when necessary.

It is also important to understand that throughout the business' 14 year benefit period it may experience fluctuations in employment levels due to various economic circumstances such as being awarded a large contract or losing a large customer. As a result of such fluctuations, the business may be able to claim benefits in a particular taxable year and unable to in others. De-certification would only serve to penalize a business during a time when it may require help the most and take away the potential for further incentives for growth in New York State. Lastly, the statute limits de-certification to cases where there was a failure to report, labor law violations, etc. and we do de-certify based on those provisions. However, the law clearly states that we cannot de-certify if failure to perform was due to "economic circumstances or conditions which such business could not anticipate or which were beyond its control"[5].

* Note 2

**Recommendation #3** - Modify the BAR to increase its effectiveness as a monitoring tool by including complete and actual information, such as the increase in jobs, the types and quality of jobs created, pay rates of new employment, and the actual tax and other benefits received.

**Response #3** - The BAR form is currently an effective tool for monitoring job and investment performance by businesses. Further, the business' attest to the completeness and accuracy of the information provided. Nonetheless, as with any form, it can be improved. Last year the Department has updated and improved the certification

[5] GML §959(a)

* See State Comptroller's Notes, page 51

application, added elaborate instruction guidelines and held regional workshops across the state to train local coordinators how to assist businesses to fill the form out accurately.

This year the Department has developed a new form that includes many of the recommendations. However, because the BARs are sent to all businesses in April of each year so that the information can be collected and compiled for inclusion in the Zone Annual Reports, not all businesses will be able to provide actual tax information at that time. Whether the tax information provided is actual tax claims made or estimates will vary from business to business depending upon whether they file taxes on April 15$^{th}$ or August 15$^{th}$ for individual filers, or March 15$^{th}$ or September 15$^{th}$ for corporate filers. Again, it is important to remember that BAR's are not the basis for benefits conferred by Taxation and Finance and are simply a monitoring too for the Department because we do not have access to tax filings due to secrecy provisions. However, the Executive's proposal for an interagency reporting system will improve the ability to report on the program.

* Note 4

**Recommendation #4** - Provide more complete instructions and training to businesses on the completion of the BARs to help ensure they are properly completed.

**Response #4** - The Department annually conducts numerous conferences, seminars and workshops for zone coordinators, local officials, consultants, business, and other interested parties. The Department will continue to evaluate the program's procedures, instructions and training and will make whatever adjustments are necessary.

**Recommendation #5** - Address BAR data entry delays by investigating the use of time saving approaches, such as scan able documents and online BAR reporting.

**Response #5** - The Department began the process of developing an online BAR reporting system before the audit began and informed the auditors of such. The Department expects the system to be operational in the near future.

**Recommendation #6** - Act timely to decertify a business that does not submit its BAR as required.

**Response #6 -** The Department does revoke the certification of any business that does not send in a BAR in accordance with due process, such as notice and the right to an appeal. The Department will continue to strive for better efficiency and quality assurances.

**Recommendation #7** - Perform analysis of BAR data collected to evaluate the performance of certified businesses in the Program, such as whether they have met employment goals.

* See State Comptroller's Notes, page 51

**Response #7** – The Department has a database that contains BAR information. From this database program staff can run queries to periodically review elements of the program. The response to recommendation #2 is also applicable to this recommendation.

**Recommendation #8** - Verify the information reported on BARS to Tax Department information on a sample basis.

**Response #8** – The Executive's Budget proposes an interagency reporting system that will integrate BAR data with Tax Department information. While DED does not have access to individual filing due to tax payer secrecy provision, the Tax Department may compare BARs to tax filings.

**Recommendation #9** - Act timely to decertify businesses identified through analysis as having recurrent performance shortfalls (e.g., not meeting employment projections).

* Note 1

**Response #9** - As explained in the Department's response to recommendation #2, de-certification is not necessary since the benefit calculations in the Tax law restrict benefits to job creation and not job projections.

**Recommendation #10** - Use the Zone Annual Reports (ZARs) as a monitoring tool, and take action where appropriate when zones are not meeting their planned goals.

**Response #10** - The Department formed an ad hoc committee comprised of local zone coordinators and Department staff to develop a new format for the ZARs. This new format includes a more complete set of instructions to ensure consistency of reporting. Training is scheduled for the Spring Zones Conference in April 2004. Currently, the ZARs are used as a monitoring tool. The reports were structured to gather the information required under the zones law. Department staff uses the reports, along with other criteria stipulated in the zone administrative contracts, as a basis for end-of-year interviews with the zones to discuss performance related issues. The ensuing year's allocations of administrative funds are based on these performance reviews. Finally, the reports are sent to the Governor, Legislature and State Comptroller every year as required by statute.

In addition, the Executive's Budget proposal seeks to strengthen State approval of cohesive local development plans and implement a new Zone Report Card. Together, these improvements ensure that Zone decisions are consistent with State and local economic development goals, enhancing local accountability while maintaining local decision making authority. The Executive's Budget also allows for intermediate penalty provisions for poor performing zones before revocation of the municipality's zone designation is considered.

**Recommendation #11** - Provide more complete instructions and training to zone coordinators on the completion of the ZARs.

* See State Comptroller's Notes, page 51

**Response #11** - The Department formed an ad hoc committee comprised of local zone coordinators and Department staff to develop a new format for the Zone Annual Report. This new format includes a more complete set of instructions to ensure consistency of reporting. Training is scheduled for the Spring Zones Conference in April 2004.

**Recommendation #12** - Test on a sample basis to ensure all zones are completing the ZARs as instructed.

**Response #12** - Department staff will continue to thoroughly reviewing all reports submitted for accuracy and completeness.

**Recommendation #13** - Compare data reported on the ZARs to the BARs and follow up on material differences identified.

**Response #13** - The new format for the Zone Annual Report is designed to more fully and accurately integrate the information from the BARs into the Zone Annual Reports. Specifically, portions of the ZARs will be completed for each zone prior to sending out such reports. The completed fields will be information compiled by the Department from the BARs, e.g. number of jobs, investments, etc.

**Recommendation #14** - Modify the ZAR to increase its effectiveness as a monitoring tool by including similar (aggregate) information to that of the BARs.

**Response #14** – As discussed in response #10 & #13, The Department formed an ad hoc committee comprised of local zone coordinators and Department staff to develop a new format for the ZARs. This new format includes a more complete set of instructions to ensure consistency of reporting and to accurately integrate the information from the BARs into the ZARs. Specifically, portions of the ZARs will be completed for each zone prior to sending out such reports. The completed fields will be information compiled by the Department from the BARs, e.g. number of jobs, investments, etc.

In addition, the Executive's Budget proposal seeks to strengthen State approval of cohesive local development plans and implement a new Zone Report Card. Together, these improvements ensure that Zone decisions are consistent with State and local economic development goals, enhancing local accountability while maintaining local decision making authority. The Executive's Budget also allows for intermediate penalty provisions for poor performing zones before revocation of the municipality's zone designation is considered.

**Recommendation #15**- Develop a process that requires the documentation of decisions by senior DED officials regarding recommendations of zone applicants to the Zone Designation Board.

**Response #15** - The Department will take the recommendation under consideration quantifiable. It is important to note, as the audit report states, the program does utilized a uniform procedure to extract information from the zone designation application to be included in a briefing memo for the Department's senior staff and all members of the zone designation board. Also as noted, many factors go into deciding which zone applicants to recommend to the designation board, such as the likelihood of potential projects and their success. Furthermore, referral decisions often rely on the knowledge of senior officials with a global and statewide view of fluid economic situations in various parts of the State.

**Recommendation #16** - Establish specific, objective, and quantifiable criteria for certifying businesses.

**Response #16 -** There are 72 unique Empire Zones located around the State. Significant job creation and investment in one part of the State may not be considered significant in another part. In addition, certain types of businesses or industries one zone desires to target may not be practicable or feasible in another zone. Therefore, since its inception, the program has always provided the participating municipalities' local control and decision making.

To further strengthen and enhance the program while maintaining such local control, the Executive Budget proposal requires each zone to submit to the Commissioner of Economic Development a current zone development plan and related policies. The zone development policies would include, among other things, criteria for certification based on thresholds for investments and job creation for different types of businesses within different areas of the zone. These documents would be utilized by the Department as part its review of local zone requests for boundary revision and business certification application approvals. Failure to submit an approved policy will result in the Department withholding the approval of boundary revisions and business certifications until it is in place.

**Recommendation #17** - Conduct cost/benefit analysis estimates before certifying the application to identify situations where businesses would receive tax benefits that exceed the benefit provided.

**Response #17** - Empire Zone benefits, including QEZE, are performance based only and determined every year as part of the business' State tax filing[6]. Tax law calculations <u>do not</u> recognize projections made by a business. Irrespective of any projections made on the businesses certification application, tax benefits are only conferred retrospectively for actual jobs created (or qualified business activity applicable to a specific program benefit). * Note 1

[6] RPTL 485-e, the sales tax refund on construction material and the utility discount are not received by way of the State income tax filing. However, the sales tax refund on construction material is processed through filings with the NYS Department of Taxation and Finance.

* See State Comptroller's Notes, page 51

The Executive Budget proposal recognizes that benefits are driven by tax law formulas and offers solutions directly focused on making credit calculations more proportional to the benefits to be received.