

ALAN G. HEVESI
COMPTROLLER



110 STATE STREET
ALBANY, NEW YORK 12236

STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

March 8, 2006

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

Re: Report 2005-F-32

Dear Mr. Gargano:

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 have followed up on the actions taken by the Department of Economic Development (DED) to implement the recommendations contained in our audit report, *Administration of Empire Zones Program* (Report 2003-S-41).

Background, Scope and Objective

The New York State Empire Zones Program (Program) was created in 1986. The Program assists economically-distressed parts of the State by giving tax and other incentives 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). Businesses that expand or relocate inside a zone are offered significant tax and other incentives to encourage economic development, business investment, and job creation. Benefits include income tax credits, real property tax credits, sales tax exemptions, wage tax credits, and utility rate reductions, among others. These tax benefits can reduce or sometimes even eliminate a company's tax liability. The Program is administered at the State level by DED. As of December 2005, DED had certified over 9,400 businesses for participation within 72 designated zones located in 51 of New York State's 62 counties.

Our initial report, issued April 26, 2004, examined DED's administration of the Program for the period April 1, 1999 through January 31, 2004. The objectives of our audit were to determine whether DED fulfilled its required role in reviewing applications submitted under the Program (applications for zone designation and certification of a zone business); whether DED monitored the performance of certified businesses and the individual zones, and took corrective action when businesses or zones did not perform as required; whether DED independently verified information

reported by businesses and zones; and whether DED reviewed the cost-effectiveness of the Program.

Our report found that DED's administration of the Program needed improvement to ensure that taxpayer moneys devoted to the Program produce the results intended by the Legislature. DED did not perform cost-benefit analyses to determine if achievements in the form of new jobs and investments were commensurate with the State and local tax credits and utility cost discounts provided by the Program. We also identified weaknesses in the Program reporting systems that prevented 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.

In addition, we determined that DED needed to improve its zone application review process. We found that DED officials were not required to document their decisions regarding which applications to recommend for zone designation. Regarding DED's review of applications submitted by businesses to become zone certified, we found that DED had not developed or promulgated specific job creation and investment criteria.

The objective of our follow up audit, which was conducted in accordance with generally accepted government auditing standards, was to assess the extent of the implementation, as of January 19, 2006, of the 17 recommendations included in our initial report.

Summary Conclusions and Status of Audit Recommendations

We found that DED has made progress in correcting the problems we identified in our initial audit. However, additional improvements are still needed. Of the 17 recommendations included in our initial report, 8 have been implemented, 4 have been partially implemented, 4 have not been implemented, and 1 is not applicable at this time due to changes in legislation.

Follow-up Observations

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.*

Status - Partially Implemented

Agency Action - DED has not prepared an overall cost benefit analysis of the Program. Instead, DED has calculated a cost-per-job amount based upon State tax credits reported by businesses. This amount, however, uses the total number of jobs reported by all certified businesses, rather than the number of new jobs created through participation in the Program. In addition, although DED does capture expected and actual business performance in

regards to new jobs, the level of wages paid, and the investments made by businesses, DED does not capture all costs, such as local tax credits or utility discounts.

Subsequent to the issuance of our initial report, Chapter 63, Laws of 2005 was enacted which modified the application process for new businesses requesting certification. This legislation requires each new business to prepare a cost benefit analysis projection of the first five years of operation. However, this analysis is also incomplete since it too does not incorporate projected local tax benefits or utility discounts.

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 businesses receiving a relatively high proportion of the tax credits.

Status - Not Implemented

Agency Action - DED does capture performance information on certified businesses. However, DED officials indicated that they do not monitor businesses performance against their original goals since there is a provision in the law which prevents decertification of a business which has not met its goals as a result of economic circumstances and other conditions which the business has no control over. While we agree that some businesses may assert that their failures are due to such circumstances, DED's lack of monitoring provides an opportunity for businesses to continue to be certified while not achieving their performance goals when failure to perform is not due to such mitigating factors.

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.

Status - Partially Implemented

Agency Action - The 2004 Business Annual Report (BAR) form was modified to include information on the number of jobs, the pay rates of the new employees, and the State tax benefits received by the business. However, the form does not incorporate other benefits received, such as local tax or utility credits. As a result, DED still does not know the total benefits businesses are receiving from participating in the Program.

Recommendation 4

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

Status - Implemented

Agency Action - Instructions provided with the 2004 BAR are more complete than those provided in 2002. In addition, DED provides BAR training to Zone Administrators annually with the expectation that the Zone Administrators will provide training to the businesses within their zones. DED has indicated there has been a reduction in the number of errors on the BARs which have been submitted for 2004.

Recommendation 5

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

Status - Implemented

Agency Action - DED has implemented an online database which Zone Administrators can use to input BAR reports directly to DED. This process has improved the timeliness of BAR information provided to DED.

Recommendation 6

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

Status - Implemented

Agency Action - With the implementation of the online submission of BAR information, DED has greatly reduced the decertifying process. The decertification process was completed in September 2005 for businesses which failed to provide a 2004 BAR. In contrast, the decertification process for businesses not submitting a 2002 BAR was not finalized until June 2004.

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.

Status - Not Implemented

Agency Action - DED does not monitor business performance against employment goals for certified businesses within the zones. DED's position is that the business attests to meeting its performance goals when it signs the Program application and ultimately, if the business does not create any jobs or make any investments, then it would not be able to claim any tax credit. However, each business is certified under the expectation that certain goals will be achieved which will benefit the zone. If a business is not meeting the expected goals, it may be receiving benefits of the Program without contributing toward the zone's overall goals.

Recommendation 8

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

Status - Not Implemented

Agency Action - The Tax Department is required to provide a report to the Governor and the Legislature summarizing the tax credits claimed by businesses based on data reported on New York State tax returns. However, this information is not provided to DED. Therefore, DED can not verify data reported by the businesses participating in the Program.

Recommendation 9

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

Status - Not Implemented

Agency Action - DED's position is that it would be difficult to decertify a business due to failure to meet performance goals because of the provisions of General Municipal Law (GML) § 959, which states that a business can not be decertified if its failure to meet performance goals is due to economic circumstances or conditions which such business could not anticipate or which are beyond its control. While we agree that some businesses may assert that their failures are due to such circumstances, DED's lack of monitoring provides an opportunity for businesses to continue to be certified while not achieving their performance goals for reasons beyond those in GML § 959.

Recommendation 10

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

Status - Partially Implemented

Agency Action - DED has developed a Performance Monitoring System which includes a review of Zone Annual Report (ZAR) data, among other factors. The System has three components: Quality of Certification of Applications, Overall Assessment of Zone Performance, and Development Policies. These three components are evaluated separately and then combined to form a score that determines the amount of administrative funding the zone will receive. The second component, Overall Assessment of Zone Performance, is equal to 25 percent of the total score and includes evaluation of six different criteria, one of which is the zone's ability to meet its planned goals. As a result, each zone's ability to meet its self-identified goals can have only a minimal effect (about 5 percent) on its overall score and does not significantly impact its administrative cost funding. We, therefore, conclude that while DED is using the ZAR as a monitoring tool, it is not taking appropriate action when zones do not meet their planned goals.

Recommendation 11

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

Status - Implemented

Agency Action - We reviewed the 2004 ZAR instructions and training material presented at the 2004 Zone Administrators seminar. We determined that the 2004 ZAR instructions are complete and the training material presented at the 2004 seminar was adequate. The 2004 ZAR instructions included on the form are clear and precise. The ZAR training material explained how to complete each section of the ZAR report and how to handle data discrepancies. The new format is now easier to read and provides better direction than the 2002 ZAR.

Recommendation 12

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

Status - Implemented

Agency Action - DED reviews completion of the ZARs as part of its Performance Monitoring System and follows up with Zone Administrators to correct discrepancies and resubmit specific information. We selected a judgmental sample of 7 of the 72 zones' 2003 ZARs and found no exceptions that would lead us to believe that zones are not completing the forms as instructed.

Recommendation 13

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

Status - Implemented

Agency Action - We reviewed documentation provided by DED and determined that DED staff does perform comparisons of data reported on the ZARs to the BARs. We reviewed letters and e-mails sent by DED to the Zone Administrators which identified discrepancies between the ZARs and the BARs. This correspondence requested that Zone Administrators review the identified discrepancies and make necessary corrections.

Recommendation 14

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

Status - Partially Implemented

Agency Action - DED has modified the ZAR to include items similar to those captured on the BAR. In our review of the 2004 ZARs, we found the new format included several new categories of employment and capital investment data similar to those included in the 2004 BAR report. Specifically, the ZAR reports include aggregate FTE, Real Property Tax Credits, Capital Investment, and New Jobs data. However, data on wage tax credits, Qualified Empire Zone Enterprise (QEZE) Sales Tax Exemptions, QEZE Real Property Tax Credits, and QEZE Tax Reduction Credits are still not included in the ZAR, even though they are included in the BAR. DED officials indicate this information is captured from the BAR database and annually reported to the Legislature. However, the information captured on this report is not utilized to monitor zone performance.

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.

Status - Not Applicable

Agency Action - No new zones have been designated since 2002. In addition, when the Legislature passed GML §958 in 2005, it deemed 11 counties and 1 area in New York City to be eligible for Empire Zone designation. This legislation eliminated the previous process where competing applicants vied for zone designation. Since the competitive process has been eliminated, there is no need at this time for DED to make or document recommendations to the Zone Designation Board on the applications being processed.

Recommendation 16

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

Status - Implemented

Agency Action - New legislation passed in June 2005 requires that businesses applying for certification must submit a cost benefit analysis. The legislation defines the variables that must be factored into the analysis and calls for an estimate, for the first five years commencing in the year in which a business is certified, of the following:

- the amount of State tax credits under the Program that may be claimed by the applicant;
- the value of wages and benefits paid to all existing and projected employees at the location(s) for which such applicant is seeking certification; and
- the value of capital investments at such location(s).

Ultimately each zone will develop a specific benchmark for evaluating the cost effectiveness of businesses applying within their zone. In the meantime, DED has developed a standard

benefit-to-cost benchmark ratio of 15:1 which is currently used to determine business eligibility. If the benefit-to-cost benchmark is not reached by the business, the legislation lists other specific non-quantifiable, yet qualitative, criteria which DED may consider to allow a business to become certified. These non-quantifiable criteria are limited to three factors: distressed area, strategic industry or supply chain, or zone capital credit project.

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.

Status - Implemented

Agency Action - As discussed above, legislation passed in 2005 requires new business applicants to prepare a cost benefit analysis. We reviewed applications submitted by eight businesses approved to participate in the Program since the implementation of the new legislation and found each contained a properly prepared cost benefit analysis. Four of the businesses met the 15:1 benefit-to-cost benchmark established by DED, while the other four did not. In each case, we found the justification provided for each business that failed to meet the standard benchmark was consistent with the specified criteria.

Major contributors to this audit report include John Buyce, Christine Rush, Jacquelyn Keays-Holston and W Sage Hopmeier.

We would appreciate your response to this report within 30 days, indicating any actions planned to address the unresolved issues discussed in this report. We also thank the management and staff of DED for the courtesies and cooperation extended to our auditors during this process.

Very truly yours,

Frank J. Houston
Audit Director

cc: Robert Barnes, Division of the Budget