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

From The Office Of State Auditor
Claire McCaskill

The Missouri Certified Capital Company Tax Credit and the New Enterprise Creation Tax Credit are projected to create an average of 422 jobs for 15 years, but result in a net reduction of about $126 million in state revenue.

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PERFORMANCE AUDIT

Office of
Missouri State Auditor
Claire McCaskill

July 2004

The Missouri Certified Capital Company Tax Credit and the New Enterprise Tax Credit Programs Are Not an Effective Use of State Tax Credits

This audit analyzed the economic impact of two of Missouri's tax credit programs: the Missouri Certified Capital Company Tax Credit (CAPCO) program and New Enterprise Tax Credit (NECA) program. Auditors found the economic activity spurred by each of these programs did not offset the cost of the programs to the state.

CAPCO program will not produce enough state revenue to offset costs of credits

The program was established in 1996 and authorized tax credits to insurance companies that made investments into venture capital firms (CAPCOs). The insurance companies received $1 in tax credits for each $1 loaned to a CAPCO. The CAPCO program will use $140 million in tax credits while only generating $23.6 million in projected revenues and creating an average projected 293 jobs for 15 years. This results in a net reduction in state revenue of $116.4 million over the life of the program.

Fourteen of the thirty-seven companies receiving investments went out of business

Thirty-seven companies have received investments totaling nearly $89 million through December 31, 2003. Fourteen of these companies have gone out of business. Of the 37 companies: 29 were in the St. Louis area, 6 in Kansas city, and one each in Springfield and Willow Springs.

CAPCOs will collect $35 million in fees

The CAPCOs have collected or accrued about $21.3 million in management fees since 1997 and fees will total $35 million by 2008. If the CAPCOs reach the mandated 100 percent investment threshold by 2008, each dollar of management fees will have yielded four dollars of qualified investments.

New Enterprise Creation Tax Credit does not create enough economic activity to offset the state tax credits used

The NECA program will use $16.8 million in tax credits while generating $7.3 million in projected state revenues. It is projected the program will cost the state $9.5 million and will create an average of 129 jobs over 15 years. The NECA program is in the early phase of its life cycle and should be closely monitored.

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

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Missouri State Auditor

Honorable Bob Holden, Governor
and
Members of the General Assembly
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State law (Section 620.1300, RSMo 2000) mandates the State Auditor's Office perform cost-benefit analyses on the 34 tax credit programs administered by the Department of Economic Development. This is the fourth such report and includes a detailed economic impact study of the Missouri Certified Capital Company Tax Credit program and the New Enterprise Creation Tax Credit program. The analyses included obtaining necessary data to sufficiently evaluate the program's state economic impact. Information was also obtained to assess management controls over the program.

We concluded the Missouri Certified Capital Company Tax Credit program is an inefficient and ineffective tax credit program. We concluded the New Enterprise Creation Tax Credit program, while not likely to provide net benefit to the state, should be continued at the present funding levels.

Claire McCaskill
State Auditor

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RESULTS AND RECOMMENDATIONS

1. The Missouri Certified Capital Company Tax Credit Program Is an Inefficient and Ineffective Use of State Tax Credits

An economic impact analysis indicates the Missouri Certified Capital Company Tax Credit (CAPCO) program is an inefficient and ineffective use of state tax credits. The CAPCO program will use $140 million in tax credits (reduces future revenues to the state) while only generating $23.6 million in projected revenues and creating an average projected 293 jobs for 15 years. This results in a net reduction in state revenue of $116.4 million over the life of the program.

Background

Sections 135.500 through 135.529, RSMo 2000 and RSMo Cumulative Supp. 2003, authorized $140 million in tax credits to insurance companies that made investments into venture capital firms (CAPCOs). The program was established in 1996 and authorized tax credits amounting to $50 million in 1997, $50 million in 1998, and $40 million in 1999. The insurance companies received $1 in tax credits for each $1 loaned to a CAPCO. The credit could be claimed against the premium tax imposed upon policy premium income of the insurance companies. The credits could be claimed at up to 10 percent of the authorized amount per year over a 10-year period, unclaimed credits could be carried forward indefinitely and the credits were transferable and sellable to other insurance companies.

The specific entity type, capitalization, funding mechanisms, interest rates and payback periods on long term debt, collection of management fees, and method of financial reporting varied by CAPCO. The following discussion is based upon the practices used by the majority of CAPCOs.

The insurance companies made $140 million in long-term guaranteed loans that yielded a return of about 300 basis points (3 percent) higher than US government debt securities with similar maturities. The loans were to be repaid by a combination of payments from the CAPCOs and the redemption of the tax credits over the 12-year life of the program. The CAPCOs purchased about $56 million of US government zero coupon treasury strips and pledged them as collateral on the loans from the insurance companies to provide adequate security for payment of their portion of the loans.

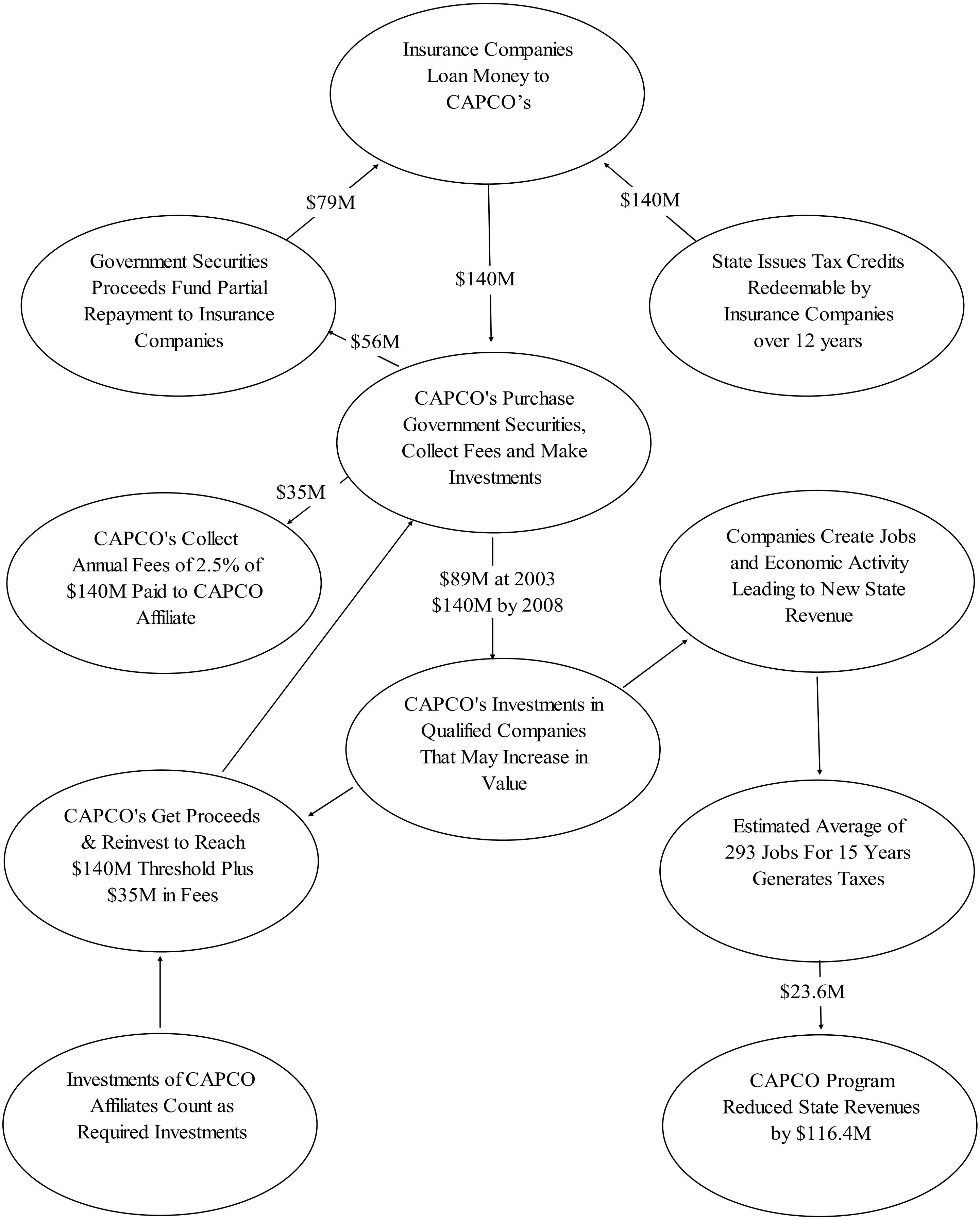
The Department of Economic Development (DED) certified eleven CAPCOs owned by five financial services firms whose owners invested about $11 million. The CAPCOs are allowed to impose an annual management fee of up to 2.5 percent on the certified capital although some charged slightly lower fees. The initial funding available for qualified investments was about $84 million.

The CAPCOs were required to meet specified thresholds for qualified investments. By the end of the second year after receiving the certified capital, at least 25 percent of the certified capital had to be placed in qualified investments. The threshold increased to 40 percent after 3 years and 50 percent after 4 years. Failure to meet these thresholds could have resulted in recapture of previously issued tax credits. All CAPCOs met these investment threshold requirements.

The companies receiving the investments from the CAPCOs had to be headquartered in Missouri, unable to obtain conventional financing and have no more than 200 employees with 80 percent employed in Missouri. Prior to August 28, 2003, the company must have had gross sales in the most recent fiscal year preceding the investment of less than $4 million if in existence less than 3 years, less than $3 million if in existence more than 3 years, or less than $5 million if the company was located in a distressed community. These requirements were changed during the 2003 legislative session. Companies receiving qualified investments after August 28, 2003, had to meet much less restrictive limitations used by the federal Small Business Administration to classify a business as a small business concern. Specific industry limitations are set forth in 13 CFR 121.201. The investments related to the $40 million in tax credits authorized in 1999 had to be made in companies located in distressed communities. No company can receive investment from any one CAPCO that exceeds 15 percent of that CAPCOs certified capital. The proceeds of CAPCO investments can be reinvested in qualified investments and shall count toward any investment threshold requirement.

Before any liquidating distributions (a return of invested funds) can be made to the CAPCO owners other than the management fees, operational expenses and debt repayments, each CAPCO is required to make investments totaling 100 percent of their certified capital. After attaining the 100 percent qualified investment threshold, the CAPCO may be decertified and no longer would be subject to regulation by the DED. Also after reaching this threshold, no tax credits may be recaptured. In 2003 the legislature allowed CAPCOs to count investments made by an affiliate of the CAPCO toward the investment threshold as if the CAPCO had made the investment. The affiliate, a qualified investing entity, must be registered in Missouri, be a wholly-owned subsidiary of a certified capital company or otherwise be affiliated with and under common control of a certified capital company and must be designated as a qualified investing entity by the certified capital company. The DED must approve each investment by a qualified investing entity prior to the investment. The following diagram depicts the flow of the monies and tax credits under the CAPCO program.

CAPCO MONEY FLOWS



Purpose

The authorizing statute does not explicitly state the purpose for the Missouri Certified Capital Company Tax Credit program; however, the program, as established by the statutes, is an effort to expand the venture capital industry in the state and provide critical funding to small Missouri companies in need of seed, startup or early stage funding and to foster job creation or retention within those companies.

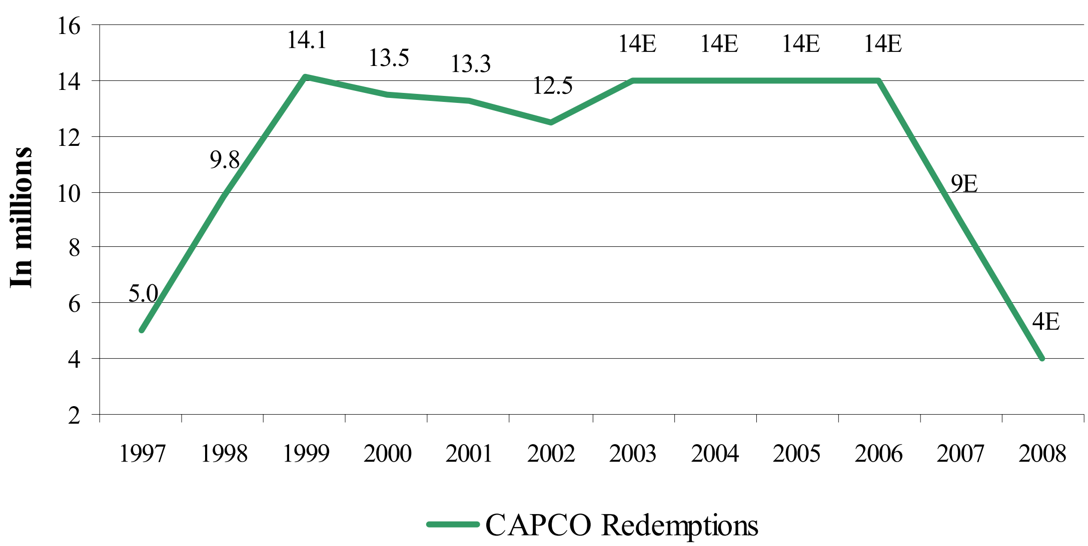
State taxes impacted

The tax credits are only redeemable against the state premium tax liability incurred by an insurance company pursuant to the provisions of Section 148.320, 148.340, 148.370 or 148.376, RSMo 2000, and any other related provisions, which may impose a tax upon the premium income of insurance companies after January 1, 1997.

Direct economic impact

If measured strictly by the amount of redeemed credits, the Missouri Certified Capital Company Tax Credit program has reduced state premium tax revenues approximately $68.2 million through calendar year 2002. Almost all of the outstanding tax credits, $71.8 million, will be redeemed by 2008 with some minimal carryover to future years. Figure 1 indicates the redeemed credits by year since the inception of the program, with estimated redemptions through fiscal year 2008.

Figure 1: CAPCO - Program Redemptions by Calendar Year

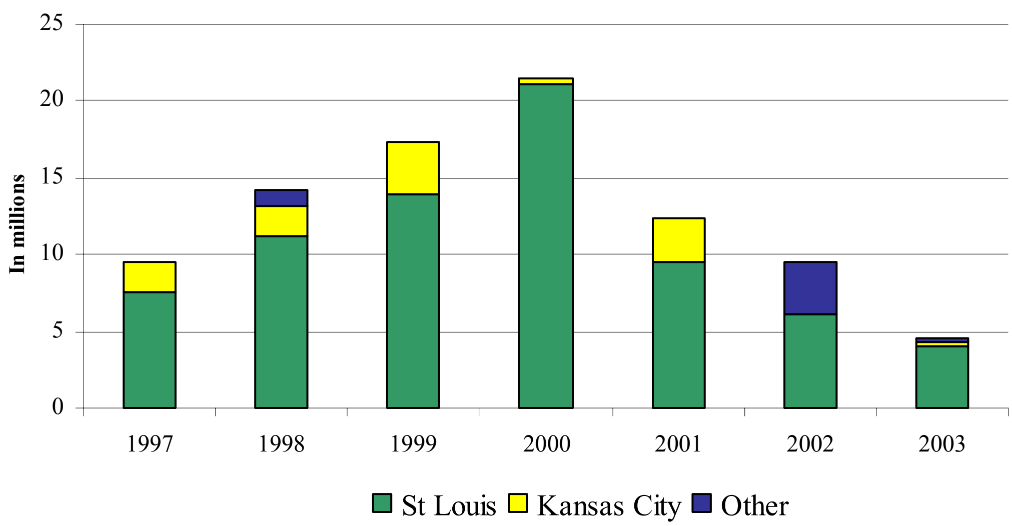


Source: Department of Insurance 1997 - 2002, Auditor estimated 2003 - 2008

Thirty-seven companies have received investments totaling nearly $89 million through December 31, 2003. Twenty-nine of those companies were located in the St. Louis metropolitan area. Six companies were located in the Kansas City metropolitan area. One company was located in Springfield and one company was located in Willow Springs. Fourteen of the 37 companies have gone out of business. *See Appendix II, page 22* for a map showing the location of the 37 companies.

Several companies received initial and follow-on investments from individual CAPCOs. The companies operated in the telecommunications, medical instruments, computer software, internet technology, printing, food, pet food, auto engine remanufacturing, credit and finance, and miscellaneous business services industries. Many companies received investments from more than one CAPCO and some companies received investments from CAPCOs controlled by more than one investment firm. Apparently, there was a lack of qualified companies seeking investments from the CAPCOs that were acceptable to the CAPCOs. We noted one company that received funding from five CAPCOs. We noted one company received 15 investments from seven CAPCOs. Figure 2 indicates the total qualified investments by calendar year by location since the inception of the program.

Figure 2: CAPCO - Qualified Investments by Calendar Year by Location



Source: Department of Economic Development data

The CAPCOs have collected or accrued about $21.3 million in management fees since 1997 and fees will total $35 million by 2008. Each CAPCO is entitled to an annual management fee of 2.5 percent of their total certified capital. If the CAPCOs reach the mandated 100 percent investment threshold by 2008, each dollar of management fees will have yielded four dollars of qualified investments.

Total economic impact

We used the Regional Economic Models, Inc. (REMI), Policy Insight Multi-region Model Version 5.5[1] to analyze the total economic impact of the CAPCO program on the state's

[1] *See Appendix I, page 21* for more detail on this model.

economy. This version includes 53 industry sectors and divides the state into 15 regions. The model compares the baseline forecast of the state economy with an alternative forecast that takes into account the effect of the tax credit program. The REMI analysis and reports are based upon calendar year. The key outputs from the model are as follows:

- Growth in total employment
- Growth in gross state product
- Fiscal impact

Modeling Assumptions

Two types of variables in the model were changed to create the alternative forecast: 1) government spending and 2) capital costs of the industries receiving increased revenues or new investments as a result of the CAPCO program.

We used the following assumptions and inputs to reflect the related economic activity. Total state government spending was reduced by the maximum tax credits redeemable in each year from 1997 to 2008. In total, state government spending was reduced $140 million. This variable was allocated to all regions. The capital cost of the insurance industry was reduced to reflect the estimated additional $23 million in revenues the insurance companies would earn due to the higher return on the CAPCO loans. The reduced capital cost was allocated to all regions over the 12-year program life. The capital cost of the credit and finance industry was reduced to reflect the $35 million in new fees that would be collected by the CAPCOs. This variable was allocated to the regions in which the CAPCOs are located over the 12-year program life.

The capital costs of the various industries in which the companies that received investments from the CAPCOs operated were reduced to reflect the lower cost of debt and equity financing. Normal venture capital firms would have required significantly higher expected rates of return or would not have made the financing available. We made the assumption that the future investments would be made to reach the $140 million threshold required by statute. If the CAPCOs are unable to meet the threshold from their own funds, the economic activity and job creation attributable to the CAPCO program would be significantly lower. This variable was changed to record the actual investments by year, region within the state and industry of the actual investments made by the CAPCOs through 2003. Future investments were allocated to the regions and industries using the same allocation pattern as the actual investments.

Modeling Results

The CAPCO program creates a projected average of 293 jobs for 15 years. Job growth peaked in 2002 at 552 jobs. By 2012, jobs resulting from the program will decline to zero as the effects of the CAPCO investments dissipate. The model predicts the average annual salary of the created jobs to be $49,806. The new jobs were located in the regions receiving the investments, primarily the St. Louis metropolitan area, while other regions in the state lost jobs due to economic migration. Each of the 293 jobs will cost the state $31,854 per year in tax credits, and those jobs will yield additional state revenues (net of increased state expenditures) of $5,370 per year from income and sales taxes making the net cost to the state, $26,484 per year for 15 years.

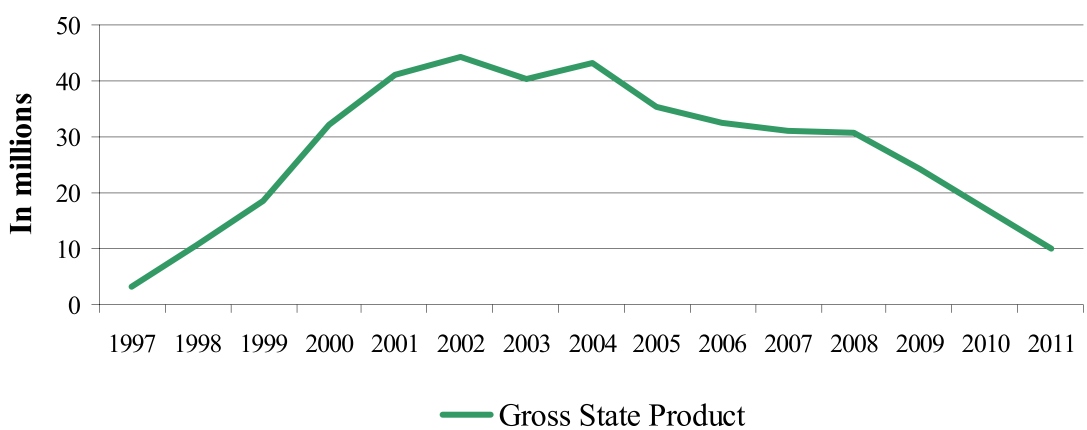
In addition, the CAPCOs will collect management fees of about $7,964 per year on the investments necessary to create each job for 15 years. Figure 3 shows the predicted change in employment.

Figure 3: CAPCO - Predicted Change in Employment

Source: REMI economic model

Gross state product increases and peaks at an increase of $44 million in 2002 and declines steadily to $10 million in 2011. The increase in gross state product totals $414 million through 2011. The change in gross state product continues to decline to less than $1 million in 2015. Figure 4 shows the predicted change in gross state product.

Figure 4: CAPCO - Predicted Change in Gross State Product

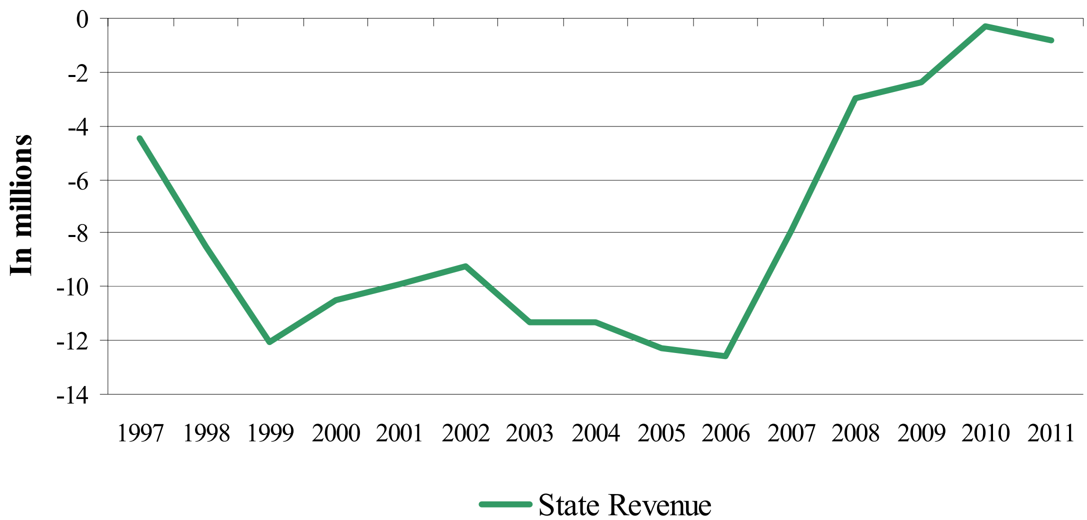


Source: REMI economic model, Chained 1996 $[2]

[2] Bureau of Economic Analysis measure of real output and prices calculated using chain-type annual-weighted indexes allowing for the effects of changes in relative prices and composition of output over time.

The model predicts a total negative impact on state revenues of $116.4 million ($140 million in tax credits - $23.6 million in increased state revenues). As the economic activity and job creation related to the CAPCO program occur, additional state taxes are collected through income and sales taxes and additional state expenditures are required to provide government services to expanding companies and increased population. In addition, state revenues are reduced due to the redemption of the tax credits. Additional state revenues net of the attendant increases in state expenditures were not enough to offset the expected tax credit redemptions in any year resulting in an overall decrease in state revenues. Figure 5 shows the net impact upon state revenues.

Figure 5: CAPCO - Predicted Change in State Revenue



Source: REMI economic model, Fixed real 2001$

Other Issues

In 2003, the legislature revised one of the primary requirements of the CAPCO program. The statutory change allows the CAPCOs to count investments made by an affiliate of the CAPCO toward the investment threshold as if the CAPCO had made the investment. Prior to that revision, each CAPCO had to make qualified investments equal to 100 percent of its certified capital before the CAPCO could make liquidating distributions to its general and limited partners. In response to our survey, 8 of 11 CAPCOs indicated that it was uncertain if they would be able to reach the 100 percent threshold without taking advantage of the 2003 legislative change. In order to meet that threshold, the CAPCOs must generate adequate returns from their investments to cover the management fees of $35 million, as well as an estimated $10 million of organization and investment recruitment and other operating expenses and the $140 million of tax credits. In order to meet the 100 percent threshold requirement, the CAPCOs would have to generate returns of investment and returns on investments totaling at least $185 million.

As of December 31, 2003, the CAPCOs made qualifying investments totaling nearly $89 million. However, many of the companies receiving the investments filed bankruptcy, went out of business or defaulted on their loans from the CAPCOs. Some of the surviving businesses recovered from bankruptcy or are in the process of recovering from bankruptcy. The CAPCOs lost all or nearly all of their investments in those companies. As of December 31, 2003, the CAPCOs valued their qualified investments at $24.3 million. Based upon the poor results of the investments made through 2003, it is highly likely that some CAPCOs would not be able to meet the 100 percent investment requirements without taking advantage of the 2003 legislative change.

The legislature also revised the criteria that restricted CAPCO investments to companies with revenues less than $5 million. The revision changed the investment limitation criteria to allow investments into companies with net after tax incomes of less than $6 million or a net worth up to $18 million. This change allowed the CAPCOs to shift their investment focus from early and seed stage to late stage and mature companies. These types of companies would generally be able to attract investments from readily available sources other than the venture capital industry. The combined effect of the two statutory changes resulted in the state subsidizing investment activity that may have occurred anyway.

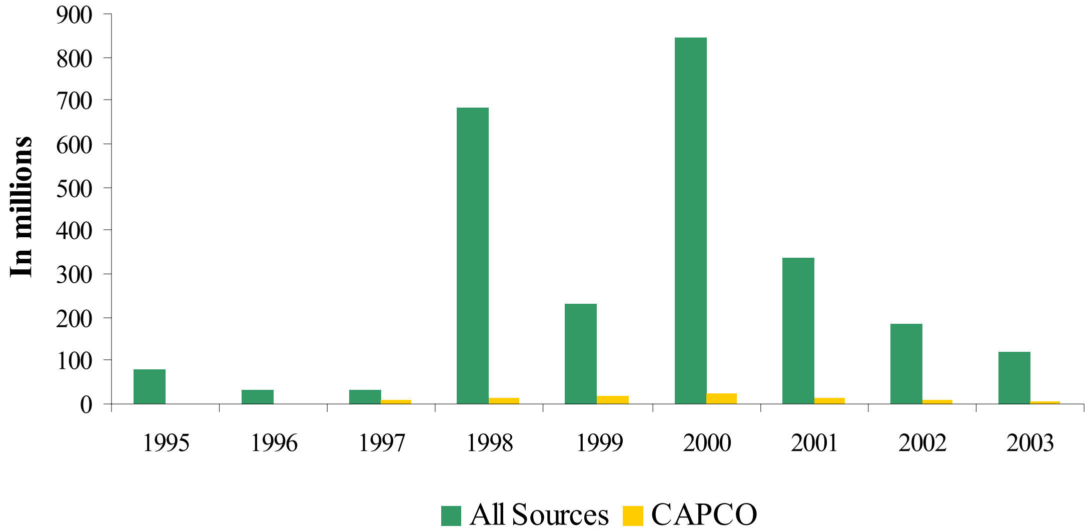
The CAPCO program allows the investment into the qualifying company to be in the form of a loan or other debt. The effective interest rates charged by one CAPCO on two loans exceeded 20 percent. One CAPCO loaned $2.25 million to a qualified company. The loan carried a variable 6 to 12 percent interest rate and was due 24 months after the loan. The loan was repaid within 8 months. This investment resulted in $2.25 million in qualified investments that counted toward meeting the investment thresholds while generating approximately $25,000 in interest earnings for the CAPCO. The company receiving the loan did not place any direct employees on its payroll. Since each dollar of the funds available for qualified investments was generated by a state tax credit of one dollar, this transaction, in essence, cost the state $2.25 million.

Proponents of the CAPCO program often point out the “leverage effect” of the CAPCO investments. It is clear that several of the companies that received CAPCO investments also were able to obtain concurrent or subsequent financing from other investors. A few of those companies have received total investments of over $100 to $500 million. However, we have been unable to identify any direct link between the CAPCO investments and any concurrent or subsequent investments by other entities.

As noted above, it appears one implicit goal of the tax credit program was to enhance and expand the venture capital industry within the state. We obtained venture capital investment data for Missouri from 1997 to 2003 as reported on the MoneyTree Survey website.[3] Venture capital funding in the state for the period totaled $2.5 billion with the CAPCO financing providing only about 3.5 percent of the funding. In 1995 and 1996, venture capital funding in Missouri totaled about $115 million which indicates that Missouri businesses had access to at least some venture capital prior to the creation of the CAPCO program. The following chart shows total venture capital funding and CAPCO provided funding.

[3] (www.pwcmoneytree.com) presented by PricewaterhouseCoopers, Thomsom Venture Economics and the National Venture Capital Association

Figure 6: Missouri Venture Capital Funding 1995 to 2003



Source: PricewaterhouseCoopers MoneyTree Survey and Department of Economic Development data

We acknowledge the venture capital industry has suffered because of the weak economy and the downturn in technology and communications industries and the lack of opportunity to successfully exit from their investments through initial public offerings (IPO's), mergers or acquisitions. However, even if the CAPCO program had been operating in a better economic climate, it is highly unlikely significant additional economic activity or employment, above that predicted by the REMI model, would have been created or the cost to create those jobs would have been significantly reduced. The REMI Policy Insight model incorporates historical data going back until 1969 in its regional forecast. These historical trends effect the direction and magnitude of behavioral responses in the model and therefore, have consequences on simulation results.

Twelve of the companies that received investments under the CAPCO program also were provided over $7.5 million in benefits or investments from other tax credit programs and DED grants including the New Enterprise Creation, Rebuilding Communities, Capital, Job Training, Brownfield, Business Facility and the CDBG Action Fund programs.

Conclusion

The Missouri Certified Capital Company Tax Credit program is an inefficient and ineffective tax credit program. Based on the assumptions used when entering the Missouri Certified Capital Company program data into the model, the program will cost the state over $116.4 million and will create an average of 293 jobs for 15 years. The CAPCOs will collect $35 million in fees. The investment activity and job creation through 2003 occurred primarily in the St. Louis metropolitan area. The program would result in a total increase in gross state product of $414 million over the 12-year life of the program. However, that economic activity and the jobs created will not produce enough additional state revenue to offset the cost of the tax credits.

The CAPCOs invested nearly $89 million and those investments were valued at $24.3 million as of December 31, 2003. Most of the CAPCOs will not be able to reach the 100 percent investment threshold without taking advantage of the statutory changes made in 2003.

Recommendation

We recommend the Department of Economic Development and the General Assembly let the Missouri Certified Capital Company Tax Credit program expire without authorizing any additional tax credits.

Department of Economic Development Response

Under current statutes no additional credits can be authorized and to do so would require a change in law. It should be noted that using different assumptions when entering data into the economic model would result in increased revenues above that calculated by the State Auditor for the Certified Capital Company Tax Credit (CAPCO) program. For example, the Auditor's evaluation of the CAPCO program assumes no outside private or leveraged investment and that no new jobs remain after the investment has ended. It is likely that CAPCO investment in a company would encourage some co-investments and follow-on investments, although not every dollar invested in a company should be attributed to the CAPCO's investment. Further, it is likely that some of the new jobs created during the investment period would remain after the investment has ended.

Auditor's Comment

During the research phase of our cost-benefit analysis, we noted two general approaches to economic modeling for tax credit programs. The conservative approach is to include only the direct investments and reductions in state revenues resulting from the tax credit program. The second approach is to include all direct investments made by the CAPCO's and ALL investments from all other sources that may or may not have been influenced by the CAPCO investments or CAPCO management. We chose the first approach, in part, because the documentation available at DED did not contain sufficient information to determine any relationship between CAPCO direct investment and any follow-on investments.

We noted the DED when preparing cost benefit analysis to be included in annual Form 14 budgetary reports submitted to the legislature only modeled the value of direct investments. We also noted that the economic studies using the second approach appeared to be funded, at least in part, by the CAPCO's or organizations having CAPCO's as primary supporters.

After receiving DED's response, we performed a second test simulation doubling the amount of investments from the statutorily required $140 million to $280 million to determine what effect it would have if you assume the CAPCO's attracted $140 million from other sources as a result of the state's investment. The results of this simulation indicated the CAPCO program would still cost the state $98 million and create only about 560 jobs.

2. The New Enterprise Creation Tax Credit Program Does Not Create Sufficient Economic Activity To Offset The State Tax Credits Used

An economic impact analysis of the New Enterprise Creation Tax Credit (NECA) program indicates the program will not generate sufficient economic activity to offset the state tax credits used. The NECA program will use $16.8 million in tax credits while generating $7.3 million in projected state revenues. It is projected the program will cost the state $9.5 million and an average of 129 jobs for 15 years will be created.

Background

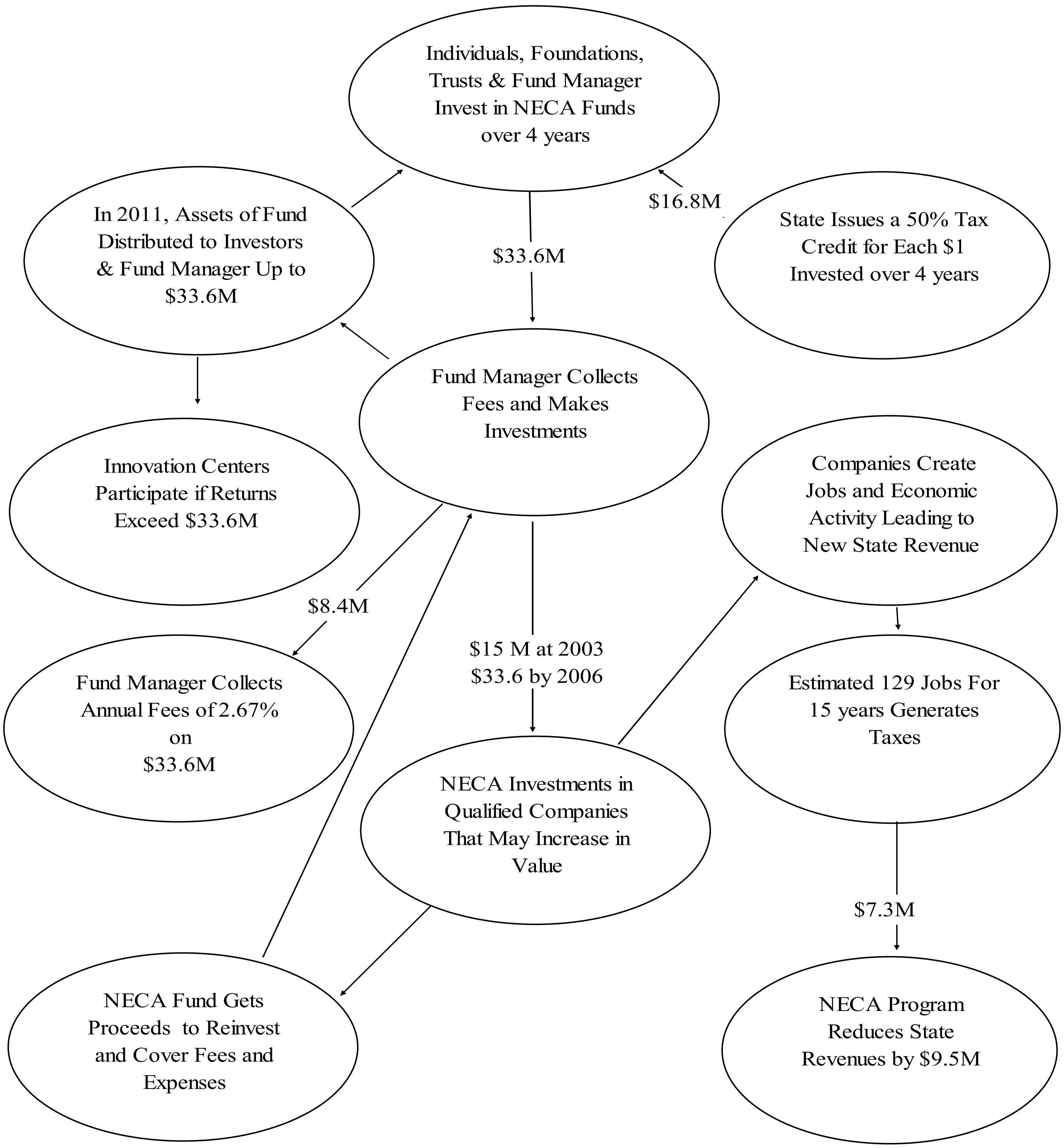
Sections 620.635 through 620.653, RSMo 2000, effective July 8, 1999, authorized the establishment of the Missouri Seed Capital Investment Board and the issuance of up to $20 million in tax credits, not to exceed $5 million in any year, to individuals, companies, or financial institutions that made qualified investments into a qualified fund. That fund was established under the Missouri seed capital and commercialization strategy developed by the Missouri Innovation Centers and approved by the board on June 23, 2000. For each dollar of qualified investments (Fund A), one dollar in tax credits would be issued. Each investor was also required to place a matching investment in a companion fund (Fund B) but did not receive any tax credit for that investment. Only Fund A carries statutory restrictions on types and amounts of investments that can be made. Twenty-five percent of the committed investments must be placed into the funds for 4 years.

Prolog Ventures, LLC was selected as the fund manager. The program was unable to attract sufficient investment to fully use the available tax credits. A total of $16.8 million in tax credits will be issued if all investors fully fund their commitments totaling $33.6 million. The fund manager is the general partner of the Fund and the investors are Class I limited partners. The four Missouri Innovation Centers were also granted Class II limited partnerships without having to make any investment.

Investments made from Fund A are restricted. A company receiving the investments from Fund A must be an independently-owned and operated business headquartered and located in Missouri. The business must be involved or intend to be involved in commerce for the purpose of manufacturing, processing or assembling products, conducting research and development, or providing services in interstate commerce. The business cannot have had a positive cash flow in the fiscal year preceding the investment. The business must remain headquartered in Missouri for at least 3 years or be subject to repayment of the investment. The investment strategy is to focus on life sciences and information technologies in seed or early stage companies. No more than 10 percent of qualified capital may be invested in any one company.

The statute allows an annual management fee of up to 3 percent of committed capital. The approved fee is 2.67 percent or $450,000 per year through 2008 and then declines 10 percent per year until the fund is dissolved. The fund manager will collect about $4.2 million in fees from each fund over the 10-year fund life. The fund life may be extended up to 2 years if necessary for orderly dissolution and if approved by the fund manager and the majority of Class I investors. At the end of the fund life, the assets of the fund will be distributed to the general partner (1 percent) and the Class I limited partners (99 percent) in proportion to their investments up to the full amount of their initial investment (including recovery of expenses charged against their capital accounts during the fund life). Additional profits, if any, will be distributed 60 percent to the Class I limited partners, and 20 percent to the general partner and 20 percent to the Class II limited partners. At this time, it is too early to predict if any proceeds will be distributed to the innovation centers. The following diagram depicts the flow of monies and tax credits under the NECA program.

NECA MONEY FLOWS



Purpose

Section 620.650, RSMo 2000, indicates the sole purpose of the qualified fund (Fund A) is to make qualified investments. Those investments must be made into Missouri companies meeting the established criteria discussed above.

State taxes impacted

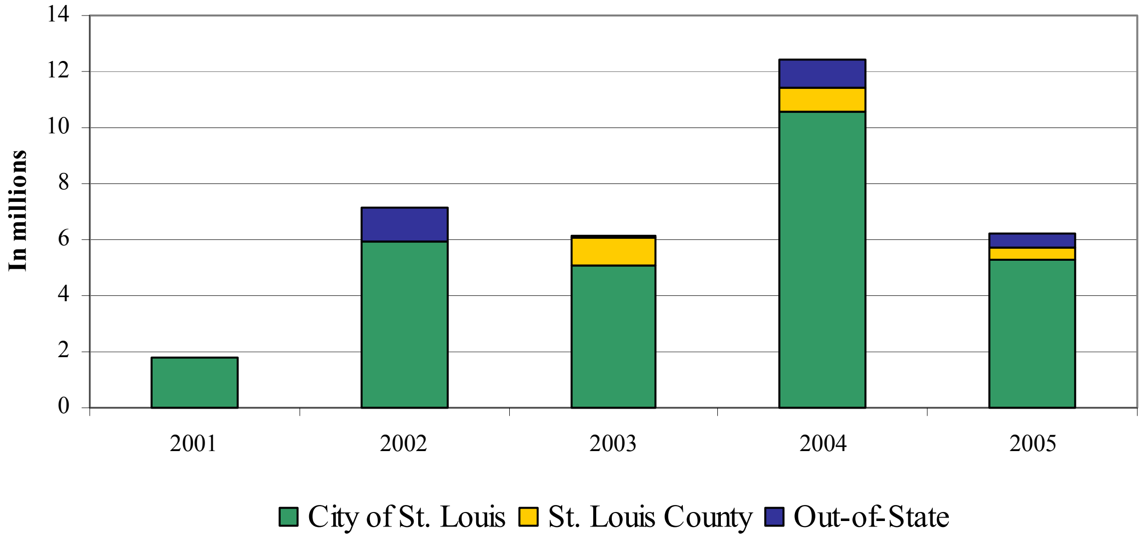
The tax credits may be redeemed against state income tax, corporate franchise tax, financial institution tax, or insurance premium tax. The tax credits may be transferred or sold and unused credits may be carried forward up to 10 years.

Direct economic impact

If measured strictly by the amount of issued credits, the New Enterprise Creation Tax Credit program will reduce state tax revenues about $4.2 million per year for 2002 through 2005 or a total of $16.8 million. The DED Customer Management System database indicates total redemptions of $3.8 million for state fiscal years 2001 to 2003. Those redemption amounts were entered by the Department of Revenue. The Department of Insurance redemptions are not entered into the DED system. The Department of Insurance reported redemptions of $2 million for calendar year 2002 and $168,750 for calendar year 2001. It does appear that actual redemptions will be slightly less than the maximum and some tax credits will be carried forward to subsequent years.

Eleven companies have received qualified investments of $8.6 million from Fund A and $6.4 million from Fund B. Two of the companies receiving a Fund B investment were located out-of-state. Eight companies were located in the city of St. Louis and one was located in St. Louis County. *See Appendix II, page 22* for a map showing the location of the companies. The companies operated in the medical instruments, information technology and biopharmaceuticals industries. The fund manager estimated the remaining funds would be invested by the end of 2005 and investments would be made in a pattern similar to existing investments. Figure 7 indicates the total investments by calendar year by location since the inception of the program and estimated investments for 2004 and 2005.

Figure 7: NECA - Qualified Investments by Calendar Year by Location



Source: Department of Economic Development data, 2004 and 2005 Estimated by fund manager

The fund manager has collected management fees from both Funds A and B totaling $1.4 million through 2003. Through the 10-year fund life, management fees of both funds will total about $8.4 million. Each dollar of management fees will have yielded four dollars of investments.

Total economic impact

We used the REMI to analyze the total economic impact of the NECA program on the state's economy. This version includes 53 industry sectors and divides the state into 15 regions. The model compares the baseline forecast of the state economy with an alternative forecast that takes into account the effect of the tax credit program. The key outputs from the model are as follows:

- Growth in total employment
- Growth in gross state product
- Fiscal impact

Modeling Assumptions

Three types of variables in the model were changed to create the alternative forecast: 1) government spending, 2) personal income and 3) capital costs of the industries receiving increased revenues or new investments as a result of the NECA program.

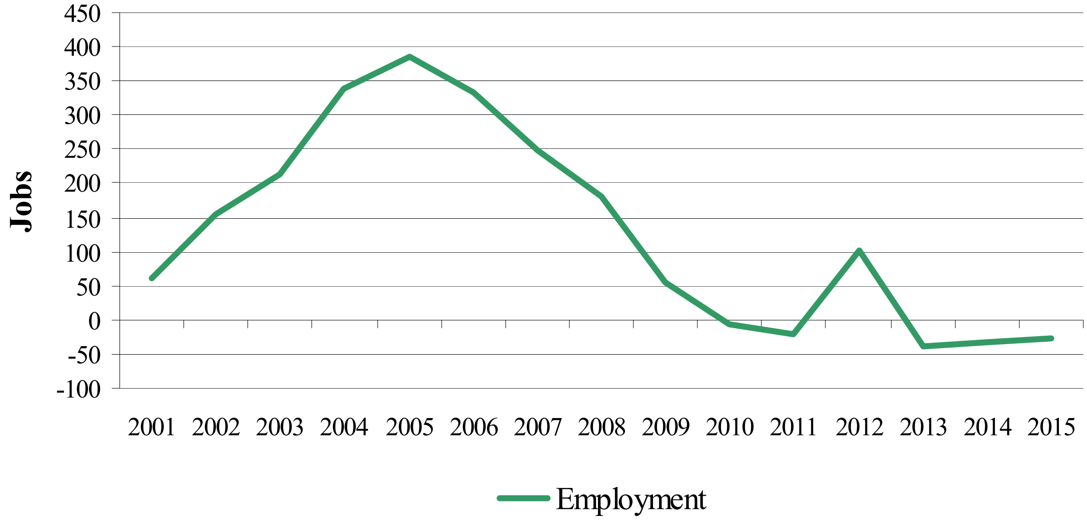
We used the following assumptions and inputs to reflect the related economic activity. Total state government spending was reduced by the maximum tax credits redeemable in each year from 2002 to 2005. Total state government spending was reduced $16.8 million. This variable was allocated to all regions. Personal income was increased in 2002 to 2005 to reflect the redemption of the tax credits and increased in year 2012 to reflect the effects of a distribution of the anticipated return on investments. We estimated the 2012 distribution using a 5 percent compounded rate of return on the total investments of both funds over the fund life. The personal income was allocated to the St. Louis metropolitan area as that appeared to be the primary source of the investments. The capital cost of the credit and finance industry was reduced to reflect the $8.4 million in management fees and was allocated to the St Louis region over the 10-year program life.

The capital costs of the various industries in which the companies receiving the investments operated were reduced to reflect the lower cost of capital associated with the NECA investments as compared to the higher capital costs demanded by normal venture capital firms. We made the assumption that the future investments would use all available funding by 2005 and those investments would be made in similar industries and locations as the investments actually made through 2003. This variable was changed to record the actual investments by year, region within the state and industry of the actual investments made through 2003. Future investments were allocated to the regions and industries using the same allocation pattern as the actual investments. We included a total of $30.4 million of investments made or anticipated to be made in Missouri companies. We excluded actual and anticipated investments of $3.2 million in out-of-state companies since there would be no identifiable benefit to the state arising from out-of-state investments.

Modeling Results

The New Enterprise Creation Tax Credit program creates a projected average of 129 jobs for 15 years. Job growth peaks in 2005 at 385 jobs. By 2011, jobs resulting from the program will decline to zero with a slight increase in 2012 before turning negative as the effects of the program dissipate. The average annual salary of the created jobs as predicted by the model was $40,462. The new jobs were located in the St. Louis metropolitan area, while other regions in the state lost jobs due to economic migration. Each of the 129 jobs will cost the state $8,682 per year in tax credits and those jobs will yield additional state revenues (net of increased state expenditures) of $3,772 per year from income and sales taxes making the net cost to the state, $4,910 per year when using a 15 year projection. In addition, the fund manager will collect management fees of about $4,341 per year for each job. Figure 8 shows the predicted change in employment.

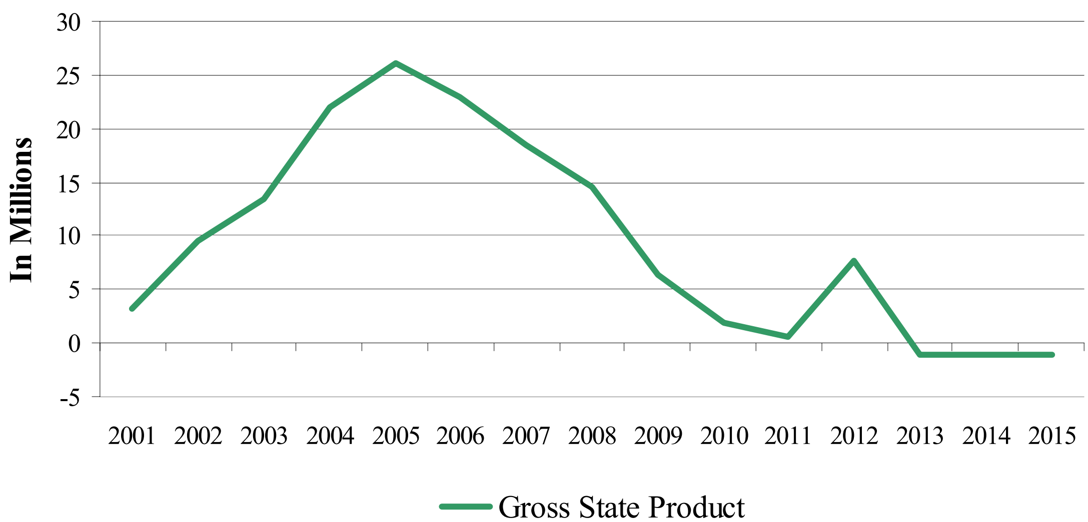
Figure 8: NECA - Predicted Change in Employment



Source: REMI economic model

Gross state product increases and peaks at an increase of $26 million in 2005 and declines steadily to $.6 million in 2011 with an increase in 2012 before turning negative as effects of the program dissipate. The increase in gross state product totals $143.6 million through 2015. Figure 9 shows the predicted change in gross state product.

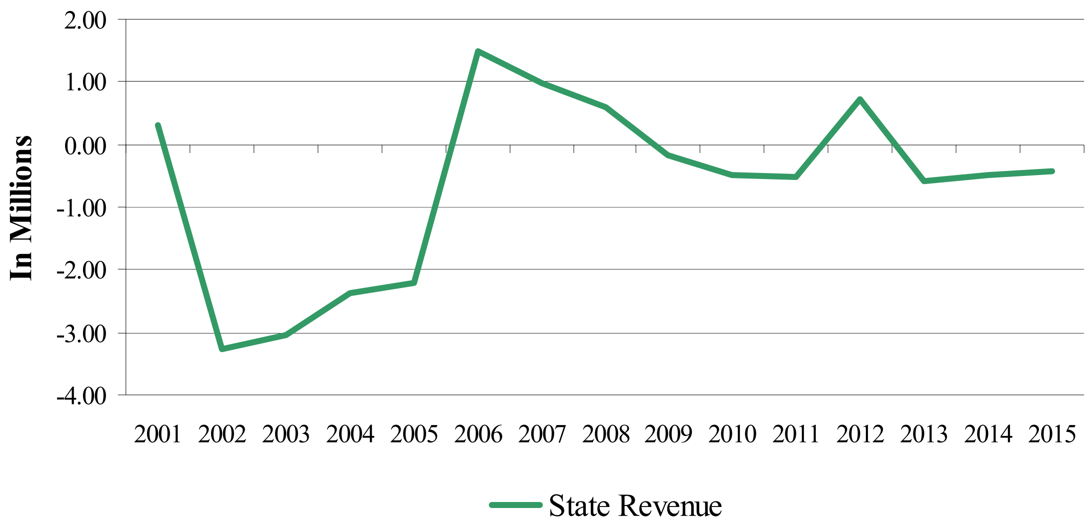
Figure 9: NECA - Predicted Change in Gross State Product



Source: REMI economic model, Chained 1996$

The model predicts a total negative impact on state revenues of $9.5 million ($16.8 million in tax credits - $7.3 million in increased state revenues). The NECA program will have a positive effect on state revenues in only 5 of 15 years. Figure 10 shows the net impact upon state revenues.

Figure 10: NECA - Predicted Change in State Revenue



Source: REMI economic model, Fixed real 2001$

Other Issues

Three of the companies that received investments under the NECA program also received funding through the CAPCO program totaling about $11.4 million. Two of the companies also participated in other tax credit programs, Rebuilding Communities, Seed Capital and the Capital tax credit programs and received benefits or investments of about $500,000 from those programs.

Conclusion

The New Enterprise Creation Tax Credit Program does not generate sufficient economic activity to offset the tax credits used. Based on the assumptions used when entering the NECA program data into the model, the results show the NECA program will cost the state $9.5 million and create about 129 jobs for 15 years. The investment activity and job creation through 2003 occurred in the St. Louis metropolitan area. The fund manager will collect fees of about $8.4 million.

The NECA program is in the early phase of its life cycle. At this time, the program should be allowed to continue without additional funding.

Recommendation

We recommend the Department of Economic Development and the General Assembly closely monitor the New Enterprise Creation Tax Credit program at this time.

Department of Economic Development Response

The Department of Economic Development will continue to administer the program as provided by current law including the changes in the law resulting from the passage of SB 1099. DED has the similar concerns related to the assumptions used when entering data into the economic model as noted in the CAPCO audit response.

In efforts to improve the reporting requirements and monitoring of all tax credits administered by DED and other departments, the Department worked with the Governor and the General Assembly in the passage of the Tax Credit Accountability Act of 2004. The Tax Credit Accountability Act of 2004 (contained in SB 1099 and enacted during the 2004 Legislative Session) provides for additional reporting requirements by tax credit recipients that will assist in verifying compliance and in assessing the value of tax credit programs. The act further provides for penalties to be assessed against a noncompliant taxpayer and for fraud in the application process.

Also during the 2004 Legislative Session, the Department requested and the Governor recommended five audit positions be funded in FY 2005 to allow the Department to develop a tax credit and incentive compliance unit in DED. This unit will focus its efforts on achieving the greatest return on the state's investments by improving the Department's accountability oversight related to tax credit and incentive programs administered by the Department. The Legislature cut two positions from the Governor's recommendations, but the remaining three positions will allow improved efforts in this area.

OBJECTIVE, SCOPE AND METHODOLOGY

Objective

Our objective was to perform a cost-benefit analysis and management review that would provide policymakers with sufficient information to evaluate the effectiveness and efficiency of the Missouri Certified Capital Company Tax Credit program and the New Enterprise Creation Tax Credit program. Both programs are administered by the Department of Economic Development.

Scope and Methodology

Our review of the tax credit programs is mandated by Section 620.1300, RSMo 2000 that states, in part, "a cost-benefit analysis shall be prepared (by the state auditor) to evaluate the effectiveness of all programs operated by the department of economic development for which the department approves tax credits, loans, loan guarantees, or grants."

To measure the economic impact of the program on the state economy, the State Auditor's Office purchased a secondary user license to a dynamic econometric modeling program called Policy Insight developed by Regional Economic Models, Inc. (REMI) of Amherst Massachusetts. The Missouri Development Finance Board holds the primary user license of the model. The REMI model forecasts the economic and demographic effects of policy changes or external events, such as added investments, jobs or additional state spending, on a regional economy and presents the results on a year-by-year basis. We used the REMI Missouri multi-region, 53 industrial sector version 5.5 which was issued in early 2004 and includes historical economic data up to year 2000 in our analysis.

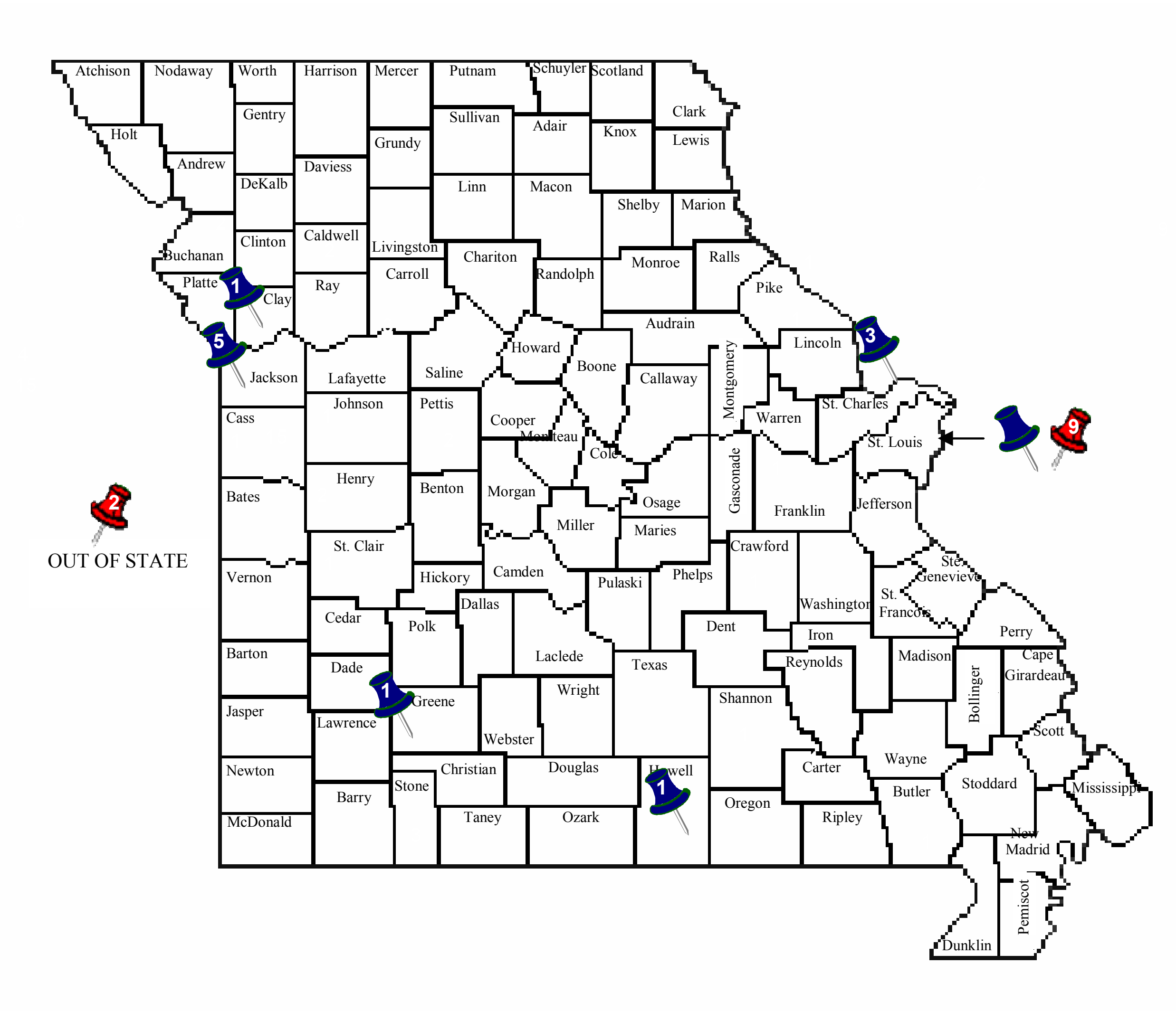
Department of Economic Development officials provided us with various reports, listings, and schedules of investments related to these two tax credit programs since their inception. The information included the entities and individuals who made investments into the venture capital firms and received tax credits, information about the venture capital firms, and the name, location, and industry of the companies receiving the investments.

We also obtained summary reports from the Department of Insurance and the Department of Revenue of the tax credits authorized, issued and redeemed. We received additional information from the venture capital firms in response to our request.

To complete our economic impact analysis, it was necessary to make several assumptions regarding program activity for future years. These assumptions were based on discussions with department and venture capital company officials and their expectations for the programs. If these program expectations change, the underlying assumptions would be different and cause the results to change.

GEOGRAPHIC DISTRIBUTION OF INVESTMENTS

This map shows the geographic location and number of companies receiving investments as of December 2003 under the two programs reviewed.



 Represents Missouri Certified Capital Company Tax Credit Program

 Represents New Enterprise Creation Tax Credit Program

TAX CREDIT REVIEW STATUS

Tax Credit Program	Review Status
Certified Capital Companies (CapCo) (cap. expired) § 135.500	Reviewed in 2004
New Enterprise Creation § 620.635	Reviewed in 2004
Community College New Jobs Training Bonds § 178.894	Reviewed in 2003
Brownfield Jobs/Investment § 447.700	Reviewed in 2002
Brownfield Remediation § 447.700	Reviewed in 2002
Historic Preservation § 253.545	Reviewed in 2002
Qualified Research Expense § 620.1039	Reviewed in 2002
Seed Capital (cap expired) § 348.300	Reviewed in 2002
Youth Opportunities and Violence Prevention § 620.1100	Reviewed in 2002
Film Production § 135.750	Reviewed in 2001
Rebuilding Communities § 135.535	Reviewed in 2001
Small Business Incubator § 620.495	Reviewed in 2001
Winery and Grape Growers § 135.700	Reviewed in 2001
Affordable Housing Assistance § 32.111	To be reviewed
Brownfield Demolition § 447.700	To be reviewed
BUILD Missouri Bonds § 100.700	To be reviewed
Business Facility § 135.100	To be reviewed
(Capital) Small Business Investment (cap expired) § 135.400	To be reviewed
Community Development Bank § 135.400	To be reviewed
Development § 32.105	To be reviewed
Dry Fire Hydrant § 320.093	To be reviewed
Enterprise Zone § 135.200	To be reviewed
Family Development Account § 208.755	To be reviewed
Guarantee Fee § 135.766	To be reviewed
Individual Training Account § 620.1400	To be reviewed
Mature Worker Child Care § 620.1560	To be reviewed
MDFB[4] Development and Reserve § 100.250	To be reviewed
MDFB Export Finance § 100.250	To be reviewed
MDFB Bond Guarantee Credit § 100.286	To be reviewed
MDFB Infrastructure § 100.250	To be reviewed
Missouri Low Income Housing § 135.350	To be reviewed
Neighborhood Assistance § 32.100	To be reviewed
Neighborhood Preservation § 135.535	To be reviewed
Transportation Development § 135.545	To be reviewed

Source: Auditor prepared

[4] MDFB – Missouri Development Finance Board