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VERMONT EMPLOYMENT GROWTH INCENTIVE PROGRAM
FACTS ABOUT BACKGROUND GROWTH
CALCULATION AND UTILIZATION

Prepared for the Joint fiscal Committee
By the Vermont Economic Progress Council

Summary:
Based on more than a decade of program operation, the use of long-term, sector-based background growth factors fulfills the legislative intent of not providing incentives for the first dollar of desired activity without introducing biases into the fiscal cost-benefit analysis procedures. Such biases would ultimately and unintentionally discourage job creation from small and recently embarked business endeavors - a part of the Vermont economy that the VEGI program is better equipped to encourage than the previous program. The current practice of sector-based, long–term (15 years, which approximates the last 2 full business cycles) hurdle rates for background growth is an economically sound process that has worked well, even under the old EATI program. It represents a ***standardized approach*** for all potential applicant companies so there is a "level playing field" for all applicant companies - whether large or small, existing old, existing new, or start-up. Measuring companies against a benchmark established by the industry total of the applicant and its peers is ***the most equitable and efficient*** solution for a successful program. A company-specific background growth rate approach would be biased against younger companies and companies that have already begun the process of expanding, two prime strategic economic development target population where state incentives could make a significant, positive difference.

Questions and Answers:

Q. Why is background growth calculated and deducted from new qualifying payroll before calculating the annual VEGI incentive amount?

A. The purpose of the VEGI program is to provide an incentive for economic activity that would not occur except for the incentive and which is above and beyond what would normally occur or would occur anyway. The "But For" criterion ensures the former, the cost-benefit model, by measuring and accounting for "background" or "organic" growth ensures the latter. Even economic activity that is occurring because of an incentive may include some hiring that probably would have occurred as the natural business growth of a company. Of course, this is not the case with start-ups or companies new to Vermont. However, statute requires that all applications be treated uniformly, so background growth is calculated for ***all*** applications.

Q. How is background growth calculated?

A. A background growth rate schedule is calculated annually using a statewide, 15-year average rate of change, by North American Industrial Classification System (NAICS) sector, at the 2- and 3-digit level. The rate schedule is published each January on the VEGI website and the rates are utilized throughout the calendar year. The rate for each applicant is determined using the NAICS code for the activity the applicant intends to undertake in Vermont.

This results in sector-based background growth rates that range from 0 – 7 percent. The rates are applied against base full-time payroll to calculate the level of new, qualifying payroll that must be created ***before*** any incentive is calculated.

Q. How is the Background Growth Rate applied?

A. For existing Vermont businesses, the background growth rate is applied to the base year full-time payroll and is compounded over the five year incentive period to calculate an amount of new qualifying payroll that must be created before an incentive amount is calculated. The amount of background growth payroll is subtracted from the new qualifying payroll actually created and the difference is used to calculate the incentive amount earned that year.

For businesses that have no historic Vermont payroll data (business start-ups and businesses new to Vermont), background growth is calculated utilizing the qualifying payroll for Year 1 in the following formula: (Year 1 qualifying payroll) times (Year 1 qualifying payroll minus the applicable background growth rate). The result becomes the Year 0 or "base year" payroll and the background growth rate is applied to the base year payroll and compounded over the five year incentive period.

Q. Are there other ways to calculate background growth?

A. Yes. The historic growth of the applicant company payroll could be utilized to calculate a background growth rate. Other company-specific indicators - such as employment, sales, and revenue history - could also be utilized to calculate a combined factor growth rate.

Q. Why is an "industry average" method used in the VEGI program? Did VEPC choose it?

A. No. VEPC did not choose one methodology over another. The industry average method is utilized because it is the methodology recommended by economists familiar with the purpose, design, and fiscal protections built into the VEGI program and is the methodology approved for use by the General Assembly (through the Joint Fiscal Committee).

Several different methodologies for calculating background growth were discussed and debated at length back in 1998 by economists, legislators, stakeholders, and many others involved in the process that created the Economic Advancement Tax Incentive program, the precursor to the VEGI program. That process involved the Act 60 Oversight Committee (legislators), with input from the legislature's economist, a Cost-Benefit Model Advisory Committee consisting of a wide variety of stakeholders, the VEPC Board, and VEPC's consulting economists. The recommendation at that

time was to utilize the industry average method. That methodology was approved by the General Assembly when it approved the cost-benefit model design and subsequent updates to the cost-benefit model over the past ten years.

The alternatives for calculating background growth were again debated in 2006 by the VEGI Technical Working Group (which included four economists, including the economist advising the General Assembly) when changes and updates to the cost-benefit model were considered before implementing the VEGI program. The industry average method was again recommended as the best alternative. The industry average methodology was included in a presentation on cost-benefit model updates needed to implement the VEGI program to the Joint Fiscal Committee in November 2006. The JFC approved the recommended changes to the cost-benefit model at their November 6, 2006 meeting (see Page 2 of the meeting minutes: http://www.leg.state.vt.us/jfo/Minutes%20&%20Agendas/11-09-06%20Minutes.pdf), including the use of the industry average methodology for calculating background growth.

Q. Why was the industry average methodology recommended? Is it superior to other methodologies?

A. The economists that recommended the industry average methodology consider both the industry average and the company-specific methods of calculating background growth as theoretically similar methodologies, but not equal in practice. They determined that the industry average method has more beneficial aspects, best fits the overall intentions and statutory requirements of the program, protects participant confidentiality, and maintains the goal of balancing efficiency, consistency, and effectiveness with appropriate fiscal controls.

Q. What are some of the positive and negative aspects of the two methodologies?

A.

- **Favors larger, older companies over small or new companies:** From a modeling perspective, the company-specific data approach favors those companies with larger number of employees or those with a longer history of operation over smaller or new, start-up companies. This is an unavoidable outcome of this approach since "relative percent increases" would be much higher for smaller or start-up companies due to their relatively small number of employees (i.e. 1 new employee for a 2 person firm represents a +50% increase versus a gain of 1 employee for a 100 employee firm which would come in at just +1.0% and appears miniscule to a large company). Also from a modeling perspective, the company-specific data approach would likewise put younger companies at a disadvantage in the program since these firms typically have faster growth in the early years of operation when their base is small. Both of these outcomes are counter to the original legislative intent of the incentive program to provide more incentive to smaller and newer companies.
- **Favors faster-growing companies within a NAICS**: On the other hand, the industry average method may give an advantage to companies that are growing faster than the average of their peer sector by using an industry average growth rate rather than their own rate of growth. It has been argued that applicants to the VEGI program are likely the better performing companies

in their sector or they would not be contemplating growth. While it may be true that a few of the better-known VEGI applicants are good performers in their sectors, this assumption is anecdotal and is not supported by the facts of existing program data. In fact, the program is so new that there is insufficient data to make any accurate assumptions about the types of businesses applying for incentives. However, based on existing application data, fifty-one percent of the VEGI applicants were either: new company start-ups, plant restarts, or companies recruited to Vermont. The past performance of these companies is irrelevant because they had no past performance in Vermont. Of the 19 applicants that were Vermont-based companies, five had only one year of previous payroll data, for various reasons. So the number of applicants that can actually be considered in this argument are 14 of the 40 applicants, or 35%. Of these companies, many are the leaders in their sector because they are the ***only companies in their sector in Vermont***. There is no statutory prohibition on authorizing incentives for a company that is doing well in Vermont. For most of these applicants, the decision to authorize incentives for these companies did not involve whether these companies would continue to do well, it was about whether their continued success and job growth would occur ***in Vermont***.

- **Disadvantages to Vermont-based applicants**: Both methods disadvantage Vermont-based applicants because they always have some level of background growth. The industry average method disadvantages them all equally. The company specific data method would further disadvantage fast growing Vermont companies or those with large levels of existing payroll. Use of the company-specific payroll data method would also set up a further disadvantage and additional burden to Vermont-based companies in the application process. Companies considering moving to Vermont, start-ups, and companies with only a few years of operations in Vermont would have to be considered using the industry average method since they have no history of Vermont payroll. To be consistent, as required by statute, 15 years of data would have to be provided by the Vermont-based applicants. This sets up an unfair additional burden for Vermont companies and puts them at a disadvantage. Using the industry-average method applies the same level of application burden on all applicants and applies a uniform rate of background growth to all applicants in the same NAICS.
- **Subjectivity and uncertainty added to program approval criterion that is now objective and certain**: The cost-benefit model criterion of the VEGI authorization process, including the background growth calculation, is designed to be entirely objective. If the industry-average method is used, it remains that way – the same 15 year industry average is used for all applicants in the same NAICS. Using company-specific data will require rules to encapsulate every possible scenario the analysts of the application may encounter. Otherwise, it will be a completely subjective decision requiring a high level of due diligence on each application over and above the current substantial amount of time spent per application. A sample of the variations the rules would have to address would include – changes in ownership, changes in business focus, changes in location, mass hirings/firings due to the business cycle, etc. The method for calculating background growth would have to be a clear guide in each of the above mentioned cases respective to time (i.e. in the last 1 year, 2 years, etc.). In addition, using company-specific data means that the calculation is subject to the data that is available for the applicant company, which varies widely depending on the life of the applicant company in Vermont. If 15 years of data is not

available, then an entirely new level of subjective analysis would be added to the review of an applicant's data that could not by its very nature be consistently applied across all applicant situations. As discussed above, determinations would have to be made on a case-by-case basis as to what the correct amount of historical data would be to calculate a sufficient company growth rate. Using this approach, at worst, each application would involve a subjective determination as to the appropriate length of time for the historical data series and at best would involve a different length of time depending on the life of the company. Further, a level of uncertainty is added because company-reported data would be used to calculate the background growth. Using the industry-average method, published data is used to calculate the annual rates. If a step is added verify provided payroll data through another state agency, yet another layer of complication and complexity is added to the program.

- **Inefficiencies and additional cost unnecessarily added to program**: Using company-specific data would require that 15 years of data to be provided, checked, and a rate of growth calculated. If a choice was required to be made between the higher of the rates resulting from the industry average and company-specific data, an additional step of calculating and comparing the two results would have to occur. This is counter to the legislatively-stated goal of balancing efficiency and fiscal control.
- **Statute requires that the cost-benefit model be applied in a "uniform manner"** (32 V.S.A. §5930a(d)). Not all applicants, such as start-ups or companies being recruited, can provide 15 years of Vermont payroll data. Applying a company's historical data, when available, but industry average data for start-ups, companies being recruited to Vermont, or relatively new companies, would result in application of the model in a manner that is not uniform.

Q. What is the incentive and fiscal impact of the current method for calculating background growth?

A. The companies that have been authorized to earn incentives, and remain approved, project the creation of 1,893 new jobs, over $82 million in new qualifying payroll, and $119 million in capital investments, because of the incentives authorized. About $22 million of the $82 million in new payroll is considered background growth. So even though these companies must create all $82 million in new payroll to earn ANY incentive, the $15.4 million in incentives they could earn are based on $60 million in new payroll. Therefore, if the incentives are earned, these companies will create $22 million in new qualifying payroll for which ***no*** incentive is paid, even though the jobs meet the qualifying definition. This economic activity will generate $43 million in new tax revenues (present value) for the state, which will net out to **$12 million in new revenues** the state never would have seen, after the full consideration and netting out of the resulting increase in state fiscal costs, including the value of the incentives.

Q. What would the difference have been using the company-specific method?

A. That is difficult to answer as we do not have 15 years of historic payroll data for any applicants. The average rate of annual payroll growth based on the historic data that was collected in the VEGI application process, for ***all*** applicants, is 8.4%. The average background growth rate applied was 4.1%. However, the 8.4% rate includes start-up companies and recruitments, for which

historic data does not exist. It is also based on only 3 years of historic data for the Vermont companies who have applied, if they existed that long.

If historic data for only existing Vermont applicants is included, the average rate of growth (based on 3 years of data) was 20%. Obviously, this is a much higher rate of growth than the average 4.1% applied overall. However, if the logic is applied that historic company-specific data should be the basis for background growth, then only Vermont-based companies, with existing payroll, would have background growth applied. If 20% is the average level of background growth to be applied, then almost ***no*** Vermont companies would be eligible to earn VEGI incentives, even if the activity they propose is absolutely incremental to Vermont. To illustrate, if a Vermont company has a base payroll of $10 million and their company-specific payroll growth rate is 20%, they would have to create more than $2 million in new qualifying payroll each year (about 53 new jobs @ $38,000) before any incentive could be calculated. This is despite the fact that all the new jobs they are proposing would be created because of the incentive.

On the other hand, according to this logic, start-ups and recruited companies would have no background growth calculated as they have no Vermont historic growth. This sets up an inequity not only in the volume of data that Vermont companies would need to provide, but in the ability for the State to provide an incentive for the growth of Vermont companies. Applying background growth uniformly for all applicants levels out the assumed background growth for all applicants, in favor of existing Vermont companies.