

A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit

Arizona Department of Commerce

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Debra K. Davenport
Auditor General

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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

September 26, 2003

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. Gilbert Jimenez, Director
Arizona Department of Commerce

Transmitted herewith is a report of the Auditor General, A Performance Audit and Sunset Review of the Arizona Department of Commerce. This report is in response to a May 14, 2002, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Arizona Department of Commerce disagrees with most of the findings related to modifying, transferring, or eliminating its major functions. However, it agrees with all of the findings related to the tax credit programs it administers. All of the report recommendations are directed at the Legislature and do not require action by Commerce at this time. We have attached a brief reply to Commerce's response to address some statements in the response.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on September 29, 2003.

Sincerely,

Debbie Davenport
Auditor General

Enclosure

PROGRAM FACT SHEET

Arizona Department of Commerce

Services:

According to its vision statement, the Arizona Department of Commerce strives to be “the positive force that creates networks of stakeholders and partners who work to enhance the prosperity of Arizona’s businesses and residents.” In addition to staff dedicated to Administration, the Department carries out its efforts through four major divisions:

- **Community Development**—Provides technical and financial assistance to towns, cities, counties, and tribal communities on land-use planning, public infrastructure, and zoning;
- **Global Business Development**—Encourages retention, expansion, and location of business across the State while it supports entrepreneurs, small businesses, and minority- and women-owned enterprises;
- **Workforce Development**—Shapes policies that support coordination of workforce programs state-wide and administers job training grants; and
- **Planning, Research, and Policy**—Supports the development of a long-range, state-wide economic agenda, and serves as Commerce’s central point of current economic data and coordinates projects that inform economic development policies.

Mission:

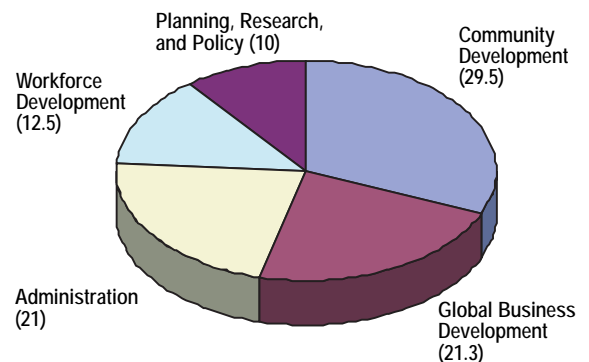
To create vibrant communities and a globally competitive Arizona economy, through leadership and collaborative partnerships.

Facilities:

While previously leasing space in a privately owned building, in March 2003, the Department relocated to the Capitol Complex Executive Tower. The Department also leases space in Taipei, Taiwan, and in Guadalajara, Mexico, for the combined amount of \$39,280 for two foreign trade offices.

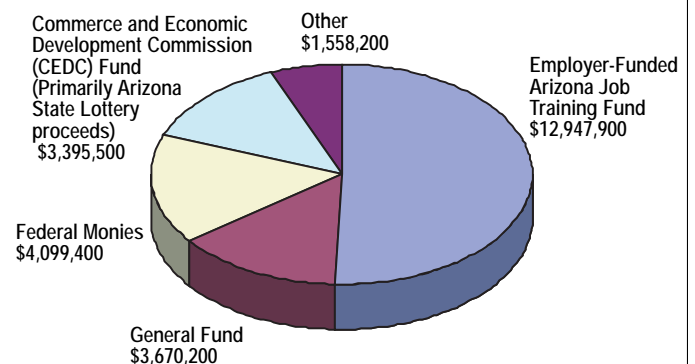
Program staffing:

94.3 FTE (as of January 1, 2003, includes 16.45 vacancies)



Program revenue:

\$25,676,200 (fiscal year 2003)



Equipment

In addition to owning standard office equipment, the Department leases nine vehicles from the Department of Administration at a cost of \$3,815 per month. The Department also owns a hot air balloon, purchased in 1990 at a cost of \$13,592, which is used by the Arizona Film Commission, a unit within Commerce, to promote Arizona at film-related and nationally televised events.

Department Core Goals (fiscal years 2003 through 2005)

1. Provide accurate, timely information on Arizona's economy and business practices to support sound public policy and the development of the State's long-term economic strategy.
2. Create and support local initiatives designed to enhance community vitality.
3. Build and develop the State's economic foundations to improve Arizona's global competitiveness.
4. Attract and retain high-quality jobs, increase capital investment, and grow strategic industries.
5. Model effective, efficient, and responsible government delivering services in a fiscally prudent manner consistent with the highest standards of ethical conduct.

Adequacy of performance measures:

Commerce should improve its performance measures in the following areas:

- **Measures Not Focused on Results**—The Department should reduce its number of performance measures and focus on those that address results. The Department has established 226 performance measures in its FY 2003-05 Strategic Plan, many of which report its service efforts but fail to report results. For example, some programs, such as International Trade and Investment, measure the number of visits to its Web site. However, the program's four performance measures regarding online visits fail to measure the results achieved by accessing these pages, such as the number of businesses assisted online.
- **Measures Do Not Reflect Department's Performance**—The Department should report only those results that are achieved substantially by its individual efforts. For fiscal year 2002, the Department reported that it helped 59 businesses relocate or expand in the State. However, sometimes the Department's role is limited to accepting a telephone inquiry from the business, referring the business to a local economic development entity for location assistance, and remaining available to discuss any state-wide issues with the business.

SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona Department of Commerce (Commerce) pursuant to a May 14, 2002, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the Sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

Commerce is responsible for promoting and enhancing the State's economic growth and development, including encouraging international trade and investment; collecting and distributing economic and business-related information to the public; supporting the expansion of current businesses; and attracting new businesses to the State. Additionally, Commerce assists communities with economic planning and facilitates the State's workforce development system.

The Department's organization consists of four divisions and an administrative group. First, the Community Development Division provides technical and financial assistance to political subdivisions and communities on land-use planning, public involvement, public infrastructure, and zoning. Second, the Global Business Development Division encourages expansion and location of businesses across the State and maintains four foreign trade offices. Next, the Workforce Development Division supports the Governor's Workforce Development Council, which supports efforts to prepare participants for work, and administers apprenticeship programs and the Arizona Job Training Program, a program that helps fund job training assistance to Arizona businesses. Further, the Planning, Research, and Policy Division serves as a clearinghouse for economic issues. Finally, Commerce's administration supports Commerce's planning and operational needs by providing guidance, services, and technical assistance to executive management and department divisions.

Commerce's functions can potentially be eliminated, modified, or transferred (see pages 7 through 28)

The Legislature should consider terminating 4 of 13 major functions carried out by Commerce, primarily because other programs providing similar services already exist.¹ Another four functions are also available elsewhere, and the Legislature may

find there are some benefits to providing these functions, either through Commerce or some other agency. The Legislature should retain the five remaining functions because they do not duplicate other programs, or they do not require state appropriations. However, eliminating most or all of the eight functions may leave insufficient reason to retain Commerce. If so, the remaining functions can be transferred to other state agencies.

Auditors identified four functions that could be eliminated because these services are available elsewhere, or Commerce's role is very limited or may be reduced. These four are as follows:

- **Small Business Services**—Similar services are available from other federal, state, and private sources. While Commerce no longer provides one-on-one business counseling, Small Business Services provides the public with user-friendly online information on starting a business, works to develop state-wide policies that concern small businesses, and assists women- and minority-owned businesses through meetings, referrals, and outreach activities. However, the federal government's Small Business Administration has a network of ten small business development centers and satellite offices across the State, including two women's business centers, which provide similar services and assisted over 7,000 people in 2002. In addition, information on doing business with the State, and within Arizona counties, along with finding businesses to purchase, is also available from a variety of public and private sources, such as the Arizona Department of Administration's State Procurement Office, the Arizona Department of Revenue, business brokers, and business advocates, such as the National Federation of Independent Businesses.
- **Apprenticeship and Pre-Apprenticeship**—The apprenticeship function can be transferred back to the federal government for administration, and the pre-apprenticeship function—a highway construction training program—can be transferred to the Arizona Department of Transportation (ADOT). Apprenticeship Services approves and registers all apprenticeship programs in the State, and provides certificates to apprentices who complete these programs. Arizona petitioned for the U.S. Department of Labor's approval to administer this function in 1978. However, the State does not receive any federal funding to administer the program. The State could return this function to the federal government, which administers the program in 23 other states. The Pre-Apprenticeship Training Program for Highway Construction Careers offers a 6-week training program for minorities and women in highway construction trades and is funded by the ADOT using federal pass-through monies. This function was placed in Commerce because of its close association with the apprenticeship function. If responsibility for apprenticeship is returned to the federal government, retaining pre-apprenticeship in Commerce is unnecessary.

- **Economic Information and Research**—This function could be eliminated because information retained at Commerce is already available from many other sources throughout Arizona, and other sources have additional economic research and analysis that is unavailable from Commerce. Under A.R.S. §41-1504(A), Commerce acts as a central point of collection for economic data and coordinates research projects and analysis on economic development issues for the State. It also disseminates this information to the public. However, much of the information Commerce publishes is already available from sources such as the U.S. Census Bureau, the Arizona Department of Revenue, and the Arizona Tax Research Foundation. Further, other organizations, such as the Arizona Department of Economic Security and Arizona State University, maintain additional economic information unavailable from Commerce. Moreover, Commerce’s role is generally not to perform its own research, but rather to coordinate the efforts of others.
- **Growing Smarter functions**—The Legislature can eliminate Commerce’s role in the State’s Growing Smarter program, since its review role is only generally defined in statute as advisory and could be reduced. Under Growing Smarter, all Arizona cities and counties must adopt comprehensive, long-range plans that address issues such as land use, open space, growth, and water resources. A.R.S. §§9-461.06 and 11-806 require Commerce to receive copies of the plans and any amendments made to existing plans before they are adopted by the cities or counties. It also provides technical assistance with Growing Smarter and planning. Because the statute does not describe the extent of the review or comment, Commerce’s role is advisory only, and cities and counties are free to ignore Commerce’s suggestions. Further, Commerce’s review and technical assistance roles could be reduced, since the majority of cities and counties are required by statute to submit their plans by December 31, 2003. After that time, Commerce will review amendments or new plans.

Auditors identified four other programs that, like three of the first four, are largely available elsewhere. In the case of these four, however, there may be advantages to retaining a state function in some form:

- **International Trade and Investment Office**—The Legislature could eliminate this office, retain its functions, or ensure that Commerce charges for a portion of the costs of its export promotional services. The Office promotes Arizona products and services for export, and markets Arizona to foreign companies as a location for expansion. However, the federal government and other private entities provide many similar services, sometimes for a fee. Commerce maintains that no other entities work to bring foreign investment into the State, and other entities would not exclusively serve Arizona clients. Commerce has statutory authority to charge for services and is already doing so for certain functions, such as hosting trade shows and trade missions. Should the Legislature decide to retain this

function, the State could also charge a fee for other office services as well, making this function more self-supporting.

- **Business Attraction and Development and the Office of Innovation, Technology and Entrepreneurship**—The Legislature could eliminate this function, or as an alternative, retain only its role as a primary source of contact for companies seeking to relocate to Arizona. Business Attraction and the Office of Innovation market the State nationally and internationally, and promote technology transfer, research, and development in Arizona. However, approximately 300 local and state-wide economic development organizations also offer many of these services, and literature suggests state programs designed to attract business have only a limited impact. Some of this function could be retained because of its state-wide approach to business attraction. According to Commerce and Arizona businesses, Commerce provides significant value because it is a single source for businesses to obtain impartial information about potential sites and the State's business climate.
- **Rural Development**—This function could be eliminated, but doing so may have consequences for some projects. Rural Development helps rural communities with technical and financial assistance for downtown revitalization, economic development, and business retention and expansion through its Main Street and Rural Economic Development Initiative (REDI) programs. However, these grants are generally small, and other sources such as the State Historic Preservation Office and private fund-raising are available for financial assistance. Without REDI and Main Street assistance from Commerce, rural communities might not be able to carry out some projects, while others might take longer due to the need to look for other sources of funding.
- **Arizona Film Commission**—The Legislature could eliminate this function or combine the Commission with the Office of Tourism. The Commission assists production companies that approach it about filming in Arizona. However, the Arizona Production Association, a state-wide trade association, already publishes a guide that helps production companies find services from private suppliers, and 22 local communities such as Tucson, Benson, Kingman, and the Navajo Nation maintain film offices. Commerce argues that the Film Commission is justified because revenues from companies filming in the State exceed the Commission's budget. If the Legislature elects to keep the Commission, it could transfer the Commission to the Office of Tourism because both groups work to enhance the State's visibility and the Office of Tourism already is involved in assisting noncommercial film projects. An Office of Tourism official acknowledges that the merger is feasible.

Commerce's other five major functions should be retained because they provide valuable services to Arizona businesses, workers, cities, or counties, or do not require state appropriations. However, all five could potentially be transferred to other

agencies, and the Legislature could eliminate Commerce's administration functions if it decides to sunset the Department of Commerce.

- **The Arizona Job Training Program**—This function is unique, funded primarily by business, and is intended to improve the effectiveness of the workforce. It can be modified so that it is completely self-supporting. This program could be transferred to the Department of Economic Security (DES) because federal policies support combining job training programs, and DES operates the majority of the State's other job training programs.
- **Staff Support for the Governor's Workforce Development Council**—The Council's duties are required by the federal government in order to allocate federal monies for programs that improve the quality of the State's workforce. Staff support for the Council could be transferred to DES because DES administers these programs.
- **Energy Office**—The Energy Office receives more than \$5 million each year from the federal government and uses no state monies. It could be transferred to the Arizona Department of Housing. The Department of Housing's mission is to facilitate affordable housing in Arizona, and the Energy Office's role in reducing buildings' energy consumption could fit well within this mission.
- **Private Activity Bond Function**—This function should be retained because it helps make bond funds available for projects in Arizona cities and towns. The program could be transferred to the Commerce and Economic Development Commission, which serves the State by investing in state-wide economic projects.
- **Arizona Military Airport Regional Compatibility Project**—The Project, which is currently funded primarily by a federal grant, serves a role by looking at military air base land use from a state-wide perspective. It could be transferred to any one of a number of executive agencies.
- **Agency Administrative Functions**—If the Legislature elects to sunset the agency, it could eliminate Commerce's agency-wide support functions such as the Director's Office, Human Resources, and its communications functions.

Legislature should consider evaluating tax credit programs before they are renewed or altered (see pages 29 through 37)

The Legislature should consider evaluating current tax incentive programs before they are renewed, extended, or expanded, terminating those that are not proven

effective. Commerce administers five tax incentive programs. While complete data is not available for release due to the Department of Revenue's (Revenue) confidentiality statutes, businesses claimed at least \$65 million in income tax credits alone from tax years 1994 to 2000 and hold an additional estimated \$60 million in unused income tax credits that could be used on future returns. However, research suggests that targeted incentives such as those used in the Commerce-administered programs have little impact on economic growth. For example, literature studying enterprise zones, which is Commerce's largest incentive program as measured by the number of credits used, found there was no significant impact of these zones in increasing firm births, expansions, relocations, or income; job creation; or reducing unemployment. In fact, a recent study of Ohio businesses found that enterprise zone incentives in that state actually resulted in 20 percent fewer jobs being created. Researchers point out that other factors besides tax incentives play a larger role in economic development. For example, the labor market is far more important in business investment decisions. In Arizona, one report noted that tax incentives were ranked 14 out of 17 as a factor in business location decisions.

In addition to this limited impact on economic development, there are drawbacks to government incentives. First, they can be costly. One comprehensive study of 75 enterprise zones in 13 states determined that state and local governments lost approximately \$59,000 per job. Further, incentives could have other unintended consequences, such as the state's inability to enforce provisions to recoup its investment should the companies leave; the diversion of resources from state and local governments that could go to support other government services; and lack of growth because capital and labor are simply moved from one place to another.

The Legislature should consider taking a number of steps necessary to evaluate the effectiveness of Commerce-administered tax incentive programs. Other states have taken steps to review their tax credit programs to determine whether they are cost-effective. For example, two West Virginia organizations reviewed the state's 22 tax incentives for their effectiveness and recommended half of them be eliminated. However, Revenue's confidentiality statutes currently limit the state's ability to accurately estimate the costs of these programs. Therefore, the Legislature should follow steps taken in other states to modify Revenue's statutes to allow more complete disclosure of income tax incentives' impact on the State. Once this is done, the Legislature should require an analysis of Commerce's Enterprise and Military Reuse Zones as they expire to determine their cost-effectiveness, and require the elimination of those that are not cost-effective. Further, if the Legislature elects to expand or extend any of Commerce's tax incentive programs, it should consider a similar analysis. Finally, the Legislature should consider requiring a cost-effectiveness analysis of the credits before adopting new tax incentives.

Other pertinent information (see pages 39 through 42)

During the audit, auditors gathered information about combining the organizational structures of the Arizona Department of Commerce and the Arizona Office of Tourism. In 35 states, economic development and tourism functions are organized as one agency. However, several states have organized these functions into separate agencies, and other states have adopted an altogether different structure for tourism and economic development agencies, including where the functions are separated in various state agencies or performed by private sector companies. Economic development and tourism officials from Arizona and other states had differing perspectives regarding the relative advantages and disadvantages of various organizational structures for tourism and economic development functions. Some suggested that combining the two functions could result in cost savings from shared marketing efforts and reductions in staff. However, these officials cautioned that savings from staff reductions are likely to be limited. Some tourism stakeholders also expressed concerns over the possible loss of prominence that Tourism could face if it is combined within a single economic development agency.

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INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona Department of Commerce (Commerce) pursuant to a May 14, 2002, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the Sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

Overview of Commerce's functions

The Department was established by the Legislature in 1985 with responsibilities for promoting and enhancing the State's economic growth and development. Its duties include encouraging international trade and investment, collecting and distributing economic- and business-related information to the public, supporting the expansion of existing businesses, and attracting targeted businesses to Arizona. In addition, it assists communities with economic planning and facilitates the State's workforce development system by supporting the Governor's Workforce Development Council.

To perform its responsibilities, as of January 1, 2003, the Department was organized and staffed as follows:

- **Community Development Division (29.5 FTE)**—Provides technical and financial assistance to political subdivisions and communities. It provides development guidance and technical assistance in land use and zoning; contributes basic technical and financial assistance for public infrastructure projects to rural communities; promotes programs to reduce energy costs in government, commercial, and residential buildings; offers energy information to support reduced utility costs for low-income residents; and supports community organizations in their economic development practices. The division consists of Community Planning, the Greater Arizona Development Authority, the Energy Office, and Rural Development.
- **Global Business Development Division (21.3 FTE)**—Works to help Arizona businesses market their products and services in international markets by providing

Commerce promotes Arizona's economic development.

assistance with exports to foreign countries, market research, and organization of foreign trade shows. It also markets the State to attract new and expanding businesses, encourages the film business within Arizona, and offers assistance and resources to speed entrepreneurship growth throughout the State. The division consists of the International Trade Office, the Arizona Film Commission, Business Attraction and Development, Small Business Services, and the Office of Innovation, Technology, and Entrepreneurship.

- **Workforce Development Division (12.5 FTE)**—Supports the coordination of workforce programs state-wide. The Workforce Policy Office assists the Governor's Workforce Development Council with coordination of the State's workforce development initiatives, such as establishing goals for development of employment and training systems. The division also includes apprenticeship services, a pre-apprenticeship highway-construction trades program for women and minorities, and the Arizona Job Training Program, which provides grant money to businesses for employee job training.
- **Planning, Research, and Policy Division (10 FTE)**—Serves as the State's clearinghouse for economic information, manages strategic research, and provides and distributes information and analyses of trends, best practices, opportunities, market issues, and department/program impacts related to economic issues within the State. It consists of Research and Information, the Legislative Liaison, and Communications.
- **Administration (21 FTE)**—Supports the Department's planning and operational needs by providing guidance, services, and technical assistance to executive management and department divisions. Services provided include accounting and budgeting, human resources, information technology, procurement, financial management, and administering five tax credits. This division also provides administrative support for the Commerce and Economic Development Commission (CEDC), a commission that administers a fund providing financial assistance to support the State's economic development efforts.

Within the Department of Commerce are the CEDC and the Greater Arizona Development Authority (GADA), which are separate agencies that operate under their own statutes. CEDC is a six-member Commission that administers the Arizona State Lottery-supported CEDC Fund, which will have an estimated FY 2003 balance of approximately \$3.6 million. The CEDC provides financial assistance to support the State's economic development efforts and is staffed by two Commerce employees. GADA assists local and tribal governments and special districts with the development of public infrastructure. It uses its \$20 million bond authority to leverage funding, accelerate project development, and lower the costs of project financing.

As of January 1, 2003, the Department had 94.3 FTEs, including 82.9 FTEs in authorized positions and 11.4 FTEs in other positions that were funded through nonappro-

riated sources such as federal grants and contracts. As of January 1, 2003, the Department had 16.45 FTE vacancies among its positions.

Budget

During fiscal year 2003, Commerce received an estimated \$27.5 million in total revenues, of which almost \$4 million was from the General Fund. However, the largest amount of revenue was from the federal government and other state agencies. This included over \$13.4 million for the Workforce Development Division received from the Arizona Job Training Fund, and more than \$5 million for the Energy Office programs from the federal government (see Table 1, page 4). Additionally, Commerce received over \$2.8 million in monies from the Commerce and Economic Development Commission. These monies are from two Arizona State Lottery games and registration fees for securities sold in Arizona, and are used to support the State's economic development efforts as well as the operations of three Commerce divisions. The Legislature may redirect CEDC monies for any purpose, including the State General Fund.

During fiscal year 2003, Commerce received \$27.5 million in revenues.

Commerce's fiscal year 2004 General Fund and Arizona Job Training Fund appropriations are less than in fiscal year 2003. Specifically, the Legislature reduced Commerce's General Fund appropriations by \$340,500, a reduction of approximately 9 percent. According to one Commerce official, the agency plans no reduction in services as a result of these budget changes. Further, the Legislature enacted a law allowing the State to transfer monies from the Department's Job Training Fund to the Department of Economic Security's JOBS program, which provides job training for welfare clients. The Legislature and the Governor approved a \$3.7 million transfer from the Job Training fund to JOBS in fiscal year 2004, and transferred an additional \$2.5 million from the fund to the state's General Fund.

Audit scope and methodology

This audit focused on the need for Commerce's functions, its overall responsibilities, and whether the Legislature should consider eliminating or transferring Commerce's programs. In general, auditors found that even though Commerce attempts to attract businesses and enhance economic development, research suggests many factors beyond a state agency's control influence business location decisions. These factors include labor force costs, educational level of workers, and access to transportation. This report contains two findings and associated recommendations as follows:

- The Legislature should consider taking action on several Commerce functions because they are unneeded, duplicated elsewhere, or can be transferred.²

Table 1 Schedule of Revenues, Expenditures, and Changes in Fund Balance by Program¹
Years Ended June 30, 2002, and 2003
(Unaudited)

	2002				
	Community Development	Global Business Development	Workforce Development and Job Training	Planning, Research, and Policy ¹	Finance and Administration
Revenues:					
State General Fund Appropriation	\$ 1,356,395	\$ 1,701,285	\$ 318,915	\$ 905,347	\$ 1,219,220
Intergovernmental	2,759,498	95,708	15,189,873	251,800	
Lottery proceeds ²	232,920	692,839		1,048,141	
Motor vehicle taxes	11,255,598				
Interest and other ²	<u>2,004,791</u>	<u>1,153,158</u>	<u>888,085</u>	<u>1,274,788</u>	<u>865,154</u>
Total revenues	<u>17,609,202</u>	<u>3,642,990</u>	<u>16,396,873</u>	<u>3,480,076</u>	<u>2,084,374</u>
Expenditures and other uses:					
Personal services and employee-related	1,486,104	1,600,581	547,119	683,938	1,160,662
Professional and outside services	427,676	1,158,552	2,019	120,072	61,772
Aid to organizations	9,289,255		3,273,615	1,083,629	
Travel, other operating and equipment	<u>532,607</u>	<u>1,199,163</u>	<u>139,479</u>	<u>1,917,827</u>	<u>88,457</u>
Total expenditures	11,735,642	3,958,296	3,962,232	3,805,466	1,310,891
Net operating transfers out ³	<u>8,147,762</u>		<u>10,550,070</u>		<u>281,010</u>
Total expenditures and net operating transfers	<u>19,883,404</u>	<u>3,958,296</u>	<u>14,512,302</u>	<u>3,805,466</u>	<u>1,591,901</u>
Excess of revenues over (under) expenditures and net operating transfers ⁴	<u>\$ (2,274,202)</u>	<u>\$ (315,306)</u>	<u>\$ 1,884,571</u>	<u>\$ (325,390)</u>	<u>\$ 492,473</u>
	2003				
	Community Development	Global Business Development	Workforce Development and Job Training	Planning, Research, and Policy ¹	Finance and Administration
Revenues:					
State General Fund Appropriation	\$ 524,900	\$ 1,181,628	\$ 304,676	\$ 692,401	\$ 966,588
Intergovernmental	3,902,166		12,487,855		
Lottery proceeds ²	337,171	1,242,079		899,950	
Interest and other ²	<u>951,516</u>	<u>614,078</u>	<u>592,872</u>	<u>332,613</u>	<u>645,718</u>
Total revenues	<u>5,715,753</u>	<u>3,037,785</u>	<u>13,385,403</u>	<u>1,924,964</u>	<u>1,612,306</u>
Expenditures and other uses:					
Personal services and employee-related	1,464,746	1,381,121	668,868	776,348	1,188,526
Professional and outside services	1,089,673	1,059,112	74,091	604,815	72,837
Aid to organizations	3,389,134		4,213,401	719,107	
Travel, other operating and equipment	<u>509,816</u>	<u>773,984</u>	<u>234,188</u>	<u>197,349</u>	<u>609,513</u>
Total expenditures	6,453,369	3,214,217	5,190,548	2,297,619	1,870,876
Net operating transfers out ³	<u>8,258,082</u>		<u>4,835,280</u>		
Total expenditures and net operating transfers	<u>14,711,451</u>	<u>3,214,217</u>	<u>10,025,828</u>	<u>2,297,619</u>	<u>1,870,876</u>
Excess of revenues over (under) expenditures and net operating transfers ⁴	<u>\$ (8,995,698)</u>	<u>\$ (176,432)</u>	<u>\$ 3,359,575</u>	<u>\$ (372,655)</u>	<u>\$ (258,570)</u>

¹ Excludes financial information of the Greater Arizona Development Authority because it is a legally separate entity. Further, the Community Development program estimates for 2003 exclude Clean Air Fund activity because the Fund and its functions were transferred to the Arizona Department of Environmental Quality in August 2002. However, the Planning, Research, and Policy program includes Commerce and Economic Development Commission (CEDC) financial activity because the Department essentially controls the Commission's finances.

² The CEDC provides Lottery proceeds and a portion of interest and other revenues to the programs.

³ Amounts are primarily transfers to the State General Fund or other state agencies as required by law.

⁴ Excess of revenues under expenditures was or will be paid from each program's available fund balances.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* for the years ended June 30, 2002 and 2003.

- The Legislature should consider modifying the Department of Revenue's confidentiality statutes so that the true costs of Commerce's income tax incentive programs can be identified. Further, the Legislature should consider requiring a cost-effectiveness analysis before Commerce renews each Enterprise Zone and/or the Legislature and Governor renew each Military Reuse Zone, terminating those zones that are not proven effective, and before renewing or revising any Commerce-administered tax incentive program. Finally, before new tax incentives are adopted, the Legislature should consider conducting a cost-benefit analysis of the proposed incentives.

In addition to these findings and recommendations, the report also presents information related to different models of how economic development and tourism function are structured in the 50 states, as well as key issues concerning combining these functions into one organization.

Auditors used various research methods to study the issues addressed in this report, including interviewing Commerce staff and outside stakeholders, and reviewing Commerce's financial information, statutes, and rules. Auditors also reviewed annual reports, meeting minutes, and Commerce's strategic plan, in addition to attending meetings such as the Governor's Rural Development Conference and a Growing Smarter Executive Committee meeting. Auditors also used the following specific methods:

- Auditors reviewed literature in economic development and job creation from a variety of sources, such as the *International Journal of Economic Development* and the *New England Economic Review* to determine the effectiveness of government economic development efforts (see End Notes, pages a-v through a-vii for a complete listing). To assess the level of potential function duplication and evaluate whether those functions should be eliminated, modified, or transferred to other entities, auditors interviewed members of economic development groups such as the Arizona Association for Economic Development, Arizona Chamber of Commerce, Greater Phoenix Economic Council, and Arizona university representatives in economic development. In addition, auditors interviewed representatives of other state agencies, including the Departments of Economic Security, Education, Environmental Quality, Tourism, and Transportation. Auditors also consulted federal government representatives from the United States Department of Labor's Bureau of Apprenticeship and Training Western Region, the United States Departments of Energy and Commerce, the United States Department of Defense, and the Small Business Administration to determine the extent to which Commerce's functions are duplicated, and evaluate whether the functions should be eliminated, modified, or transferred.

- To determine the effectiveness of tax credit incentives and whether their outcomes benefit the State, auditors reviewed publications on tax credits and other incentive programs (see End Notes, pages a-v through a-vii), legislative testimony from the Arizona Tax Research Association, and available tax credit data from Commerce and the Department of Revenue, and reviewed and assessed the Arizona Department of Revenue's confidentiality statutes. In addition, auditors contacted representatives from six companies and two site selection firms to evaluate the impact of the enterprise zone tax credit on companies' location decisions. Auditors also interviewed one researcher with expertise in the tax incentive field to obtain his perspective on the impact of government tax incentives on economic growth. Further, auditors attended a meeting of the Joint Legislative Income Tax Credit Review Committee.
- To determine how states organize their tourism and economic development functions, auditors reviewed information provided by the Department of Commerce, information from other states' Web sites, and the Travel Industry of America's 2000-2001 Survey of U.S. State and Territory Tourism Offices. To obtain their perspectives on the benefits and disadvantages of these structures, auditors contacted representatives of Arizona's economic development and tourism industries, as well as officials from tourism and economic development agencies in Florida, New Mexico, Utah, and Washington.

Two entities that work within Commerce were not reviewed during this audit because they have separate sunset legislation: the State Energy Code Advisory Commission and the Solar Energy Advisory Council.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the director and staff of the Arizona Department of Commerce for their cooperation and assistance throughout this audit.

FINDING 1

Commerce's functions can potentially be eliminated, modified, or transferred

The Legislature should consider a number of options related to 13 major functions carried out by the Department of Commerce. Four functions can be eliminated because other programs that provide similar services already exist, or because Commerce's role is very limited. Four other functions are similarly duplicated elsewhere and could also be eliminated, but unlike the first four, there are stronger reasons for retaining these as a state function in some form. Finally, while five Commerce functions are definitely important or unique enough to be retained, all of them could be potentially transferred to other agencies if these remaining programs did not constitute enough of a reason to retain Commerce.

Four functions could be eliminated

Four of Commerce's functions can be eliminated because other agencies can or do provide these services or because Commerce's role is limited or may be reduced. (See Table 2, pages 8 through 9.)

Small Business Services

What it does—Small Business Services serves the public primarily through an Internet-based service that provides information on how to start a business in Arizona and access business assistance resources, such as licensing information or procurement opportunities within the State. This user-friendly "virtual representative" software application was implemented in May 2002. According to Commerce, periodic updating takes staff about 2 hours

Small Business Services

(Fiscal Year '03)

Staff:

4 FTE ¹

Expenditures:

General Fund	\$ 12,400
CEDC Fund	<u>407,700</u>
Total	<u>\$420,100</u>

¹ Does not include this function's share of the FTE representing the director who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

Table 2 Arizona Department of Commerce Functions, FTEs, and General Fund and Commerce and Economic Development Commission (CEDC) Fund Expenditures¹, Fiscal Year 2003

Function	A.R.S. Section	Description	FTE ²	Recommendation	Fund	Amount
Small Business Services	41-1504 and 41-1505.08	Promotes the development of small, minority-, and women-owned businesses through the use of the "virtual representative" software application. Acts as a small business advocate within state government.	4 ⁶	Eliminate	General Fund CEDC Fund	\$ 12,400 407,700
Apprenticeship Services	41-1504	Combines on-the-job training with related classroom instruction in cooperation with the U.S. Department of Labor to produce skilled workers.	4	Eliminate	General Fund	146,500
Pre-Apprenticeship Services	None ³	Provides training to minorities and women for highway construction trades.	1	Transfer to ADOT		0
Economic Information and Research	41-1504	Collects and disseminates economic data and research.	3.8	Eliminate	General Fund CEDC Fund	361,000 ⁴ 89,500
Growing Smarter Functions	9-461.06 and 11-806	Evaluates communities' Growing Smarter Plans, and provides technical assistance on plans to cities and counties.	2.2 ⁶	Eliminate	General Fund CEDC Fund	9,700 124,200
International Trade and Investment Office	41-1504 through 41-1504.02	Assists Arizona businesses to expand into foreign markets and attracts foreign investment into the State. Includes four international trade offices operated under contract.	5 ⁶	Eliminate, retain, or ensure that fees are assessed	General Fund CEDC Fund	330,600 842,000
Business Attraction and Office of Innovation	41-1504, 41-1552 through 41-1552.05, and 41-1514.02	Markets the State to attract new and expanding businesses, with emphasis on information technology, aerospace, bioscience, and environmental industries. Emphasizes Arizona's technology-focused entrepreneurs.	9 ⁶	Eliminate or retain state-wide point of contact	General Fund CEDC Fund	539,500 541,300
Rural Development	41-1505.02 through 41-1505.03	Provides technical and financial economic development assistance to communities. Includes the Main Street Program and the Rural Economic Development Initiative.	4.5 ⁶	Either eliminate or retain	General Fund CEDC Fund	295,400 ⁴ 177,700
Arizona Film Commission	None ⁵	Encourages film business within Arizona. Provides customer service to the film and television industry.	2.5 ⁶	Eliminate or retain and combine with Office of Tourism	General Fund	299,000
Arizona Job Training Program	41-1541 and 41-1543 through 41-1544	Offers grants to employers for employee training. Funded by a 0.1 percent wage tax paid by businesses.	2	Retain but make self-sufficient	General Fund	158,200

Continued

Table 2 Arizona Department of Commerce Functions, FTEs, and General Fund and Commerce and Economic Development Commission (CEDC) Fund Expenditures¹, Fiscal Year 2003
Concluded

Function	A.R.S. Section	Description	FTE ²	Recommendation	Fund	Amount
Staff Support for the Governor's Workforce Development Council	41-1542	Provides staff and policy assistance for the Governor's Workforce Development Council.	5	Retain; or transfer to the Department of Economic Security		\$0
Energy Office	41-1504 and 41-1509 through 41-1511	Provides energy information and policy advice to the Governor and Legislature. Implements 17 programs to encourage energy efficiency and renewable energy usage.	17 ⁶	Retain; or transfer to the Department of Housing		0
Private Activity Bond Administration	35-901 through 35-913	Allocates the private-activity tax-exempt bonding authority to qualified issuers.	1	Retain; or transfer to CEDC		0
Arizona Military Airport Regional Compatibility Project	Laws 2001, Ch. 318 §3	Develops land-use plans for areas around Arizona military airports.	2.8 ⁶	Retain or transfer to another executive branch agency	General Fund CEDC Fund	12,300 177,900
Agency Administrative functions	41-1504	Provides agency-wide assistance to Commerce divisions and functions; also includes agency Communications and Legislative Liaison functions.	24.2	Retain or, if Commerce is terminated, eliminate	General Fund	1,297,900

¹ Includes only the Department's fiscal year 2003 expenditures from the General Fund and CEDC Fund, because expenditures from other funds are from monies restricted for specific purposes. Those other funds include the Private Activity Bond Fund, Arizona Job Training Fund, Federal Fund, and Oil Overcharge Fund. The General Fund expenditures are funded from legislative appropriations, and the CEDC Fund expenditures are legislatively appropriated from two Arizona State Lottery games and securities fees. The Legislature can redirect these funding sources for other purposes.

² Full Time Equivalent (FTE) staff funded by all Department sources, including those restricted for specific purposes.

³ Pre-Apprenticeship Services has no statutory authority, but exists through interagency agreement with the Arizona Department of Transportation.

⁴ Excludes 2003 expenditures from a one-time appropriation received in 2002 for the Arizona Partnership in a New Economy.

⁵ Arizona Film Commission was not created by statute.

⁶ FTE total does not include the function's share of the FTE for the director who oversees this function.

Source: Auditor General staff analysis of the Arizona Department of Commerce organization chart as of January 2003, and the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* for the year ended June 30, 2003..

per week. Because of cutbacks in staff since June 2002, Small Business Services reports it is no longer able to provide one-on-one counseling. According to Small Business Services, it interacts with the public by giving visitors a guide for starting and operating a business and written directions about how to utilize its online service, and referring callers to its Web site through a recorded message. From July 2002 to April 2003, Commerce reports that it received 390 walk-in contacts, answered or returned over 6,000 calls, received 600 written requests for information, had nearly 16,000 online visitors, distributed 12,000 electronic reports from its virtual representative, and followed up on 152 contacts. According to Commerce, Small Business Services also functions as a small business advocate by facilitating open communication between the Governor and small businesses, and by working to develop state-wide policies related to small businesses. Finally, Small Business Services supports a variety of minority- and women-owned business services such as the Arizona Minority Business Development Center, a center operated by the Arizona Hispanic Chamber of Commerce, by assisting with meetings, referrals, and outreach activities, and by inclusion in Commerce's Web site.

Why it can be eliminated—Various other agencies provide similar services, suggesting that this function is duplicative and could be eliminated. At the federal level, the federal Small Business Administration (SBA) provides assistance through its network of ten small business development centers (SBDCs) located in community colleges throughout the State. Eight of these ten SBDCs are located in rural areas of the State, and three additional satellite centers serve the State. In working with clients, the SBDC counselors use their own resources as well as Commerce's online "virtual representative" and provide one-on-one assistance, such as making appointments by phone, taking walk-ins, and arranging training classes at the community colleges. According to SBDC officials, over 7,000 people received small business assistance during calendar year 2002. This includes 3,500 people who received business counseling, and other clients who, for a minimal fee, received over 38,000 hours of business training through the community colleges. Additionally, SBA provides financial assistance by guaranteeing loans from lending institutions and technical assistance through its women's business centers and SCORE (Service Core of Retired Executives). SBA's Web site includes information about business licenses and tools for obtaining legal help, buying businesses and franchises, and selecting business locations. Further, SBA operates two women's business centers located in Phoenix and Tucson that provide information to women business owners such as how to apply for federal contracts, finance their business, or obtain support for women with disabilities.

Other agencies at the state and county level, as well as private organizations, also provide similar business information. For example, Web sites with information on state services such as business licensing and procurement information are available from the State of Arizona's Web site, as well as the Arizona

Small Business Services could be eliminated because various agencies also provide similar services.

Corporation Commission, the Arizona Department of Revenue, and the Arizona Department of Administration's State Procurement Office, and several counties have information online about doing business within their boundaries, such as obtaining licenses for businesses. For example, the Department of Revenue's Web site contains information valuable to businesses, such as links to various licensing requirements and content information for over 50 state agencies. Additionally, for persons seeking to buy existing small businesses, business brokers can assist clients by locating businesses for sale and referring them to professional accountants and lawyers for processing financial and legal matters pertinent to a sale. Further, libraries with business sections, such as the Phoenix Central Library, provide databases, reference books for business owners, government documents, and current events listings of seminars and workshops. Finally, business membership organizations, such as the Arizona Small Business Association and the Arizona Chapter of the National Federation of Independent Businesses, also advocate for the needs of small businesses.

Apprenticeship and Pre-apprenticeship Services

What it does—Apprenticeship Services' goal is to combine on-the-job training with related classroom instruction to produce skilled workers. Commerce administers Apprenticeship Services under agreement with the United States Department of Labor by approving and registering all apprenticeship programs in the State. Apprenticeship Services also provides completion certificates for apprentices who complete a registered apprenticeship training program and places their names in the U.S. Department of Labor's national database. During calendar year 2002, Commerce reports that the State issued 461 certificates to trained individuals allowing them to find a job in various trades. Currently, there are more than 100 registered apprenticeship programs in Arizona that provide training in areas such as agriculture, fishing, mining, construction, and communications. Individual employers, employer associations, or labor or management sponsors operate the training programs in an effort to produce highly skilled workers to meet employer demands. In fiscal year 2003, Commerce requested and received a 1-year allocation of \$125,000 from the Governor's Workforce Development Council to support its operations.

Why it can be eliminated—The Legislature could eliminate Apprenticeship Services because the federal government is obligated to provide these services if the State does not do so and currently has staff in place that work on the program. In 1978, Arizona petitioned the Department of Labor's Bureau of Apprenticeship and Training (Bureau) for the ability to administer it, even though no federal funding accompanied the transfer of responsibility. Currently, Arizona

Apprenticeship Services (Fiscal Year '03)

Staff:

4 FTE

Expenditures:

General Fund

\$146,500

Total

\$146,500

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

Apprenticeship Services could be eliminated because the federal government must provide these services.

The Pre-Apprenticeship Program could be transferred to ADOT since it provides training in highway construction.

needs legislative reauthorization to continue its participation. However, if Arizona does not take action, an official in the Bureau office that oversees this function stated that the federal government will be obligated to staff the operation in order to continue to meet the needs of businesses and workers, as it does for 23 other states at federal expense.

If it is eliminated—If the Legislature eliminates Apprenticeship Services, it should retain and transfer the Pre-Apprenticeship Training Program for Highway Construction Careers to the Arizona Department of Transportation (ADOT). This federally funded function offers a 6-week training program for minorities and women in highway construction trades. Funded by ADOT using federal pass-through monies, Commerce records show 79 students completed the program during the 18-month period ending June 2002. The training curriculum includes classes in trades such as electrical, plumbing, and carpentry and is provided by various schools, such as the Maricopa Skill Center in Phoenix and the University of Arizona PHASE program (Project for Homemakers in Arizona Seeking Employment). To support this function, the U.S. Department of Transportation periodically grants funds to ADOT, which then transfers a portion to Commerce. For example, in fiscal year 2003, ADOT received \$336,000. ADOT uses these funds to pay the schools for training, and according to a Commerce official, Commerce is allocated \$68,000 for one FTE who reports to ADOT and is responsible for processing the applications, advertising, and making marketing presentations.

If the Legislature elects to transfer responsibility for the apprenticeship function to the federal government, ADOT is the logical agency to assume responsibility for the pre-apprenticeship function. An ADOT official said that the function was placed in Commerce because of its close association with the apprenticeship function. However, if the apprenticeship function is transferred to the federal level, retaining the pre-apprenticeship function in Commerce is unnecessary.

Because the federal grant can be used to support the function, one ADOT official stated that ADOT could assume it with no cost to the State.

Economic Information and Research
(Fiscal Year '03)

Staff:

3.8 FTE

Expenditures:

General Fund	\$361,000
CEDC Fund	<u>89,500</u>
Total	<u>\$450,500</u>

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

Economic Information and Research

What it does—The Economic Information and Research function acts as the State’s central point of economic data collection and coordinates research projects, including analysis of economic development issues for the State. A.R.S. §41-1504(A) requires that Commerce conduct research and establish and maintain a central repository and clearinghouse for all data relating to Arizona’s economy. Auditors interviewed three individuals familiar with Commerce’s research and analysis role: a lobbyist, a researcher for the Arizona Board of Regents, and an economic consultant. All three found it valuable. Although

Commerce does collect state-wide economic data and facilitate economic research, much of this information is available elsewhere. Commerce also coordinates the analysis of some of this data, such as it did in the *Arizona Statewide Economic Study 2002*, funded by the Commerce and Economic Development Commission. This study analyzed and presented the State's current economic conditions as well as emerging trends. The research division also publishes information such as the number of businesses in Arizona and includes on Commerce's Web site profiles of Arizona communities containing population data from the U.S. Census Bureau, labor information from the Arizona Department of Revenue, and tax rates obtained from the Arizona Tax Research Foundation.

Why it could be eliminated—The information Commerce maintains is already available from other sources, and some of these sources have additional economic information and research and analysis that is unavailable from Commerce. For example, the Department of Economic Security publishes historical unemployment data as well as labor and industry employment forecasts. Further, each of the state universities provides electronic access to information related to Arizona's economy. For example, Arizona State University provides the Arizona Economic Data Center, which allows Internet users to search its library for a variety of data, including United States Department of Commerce economic data on Arizona. Similarly, the University of Arizona provides publications on current economic information and analysis of Arizona's economy. Further, Commerce's role is generally not to perform its own research, but rather to coordinate research conducted by other entities, such as business, government, university, and civic groups. For example, Commerce contracted with many industry experts for its 2002 Statewide Economic Study. Therefore, this type of research and analysis could be conducted elsewhere. For example, the Flinn Foundation, a private, nonprofit foundation, commissioned an economic analysis of the bio-science industry in Arizona, comparing Arizona with other successful states. Since all of this information is available to businesses, media, and the general public over the Internet, or from private sources, Commerce's role of disseminating this information to the public is not needed.

Economic Information and Research could be eliminated because the information is available elsewhere.

Growing Smarter Functions

What it does—Under the State's Growing Smarter Act, all cities and counties are required to adopt comprehensive, long-range plans for development that address issues such as land use, open space, growth, and water resources. These plans are developed and adopted by

Growing Smarter (Fiscal Year '03)

Staff:

2.2 FTE¹

Expenditures:

General Fund	\$ 9,700
CEDC Fund	124,200
Interagency Agreement Fund	<u>40,000</u>
Total	<u>\$173,900</u>

¹ Does not include this function's share of the FTE representing the director, who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, organization charts as of January 2003, and data from the State's Human Resource Management System. Numbers are rounded.

Commerce's participation related to Growing Smarter could be eliminated since its role is limited.

communities after receiving public comment and input from various government agencies, including Commerce. A.R.S. §§9-461.06 and 11-806 require Commerce to receive review copies of the plans, and any major amendments made to existing plans, before they are adopted by the cities or counties. During fiscal year 2002, Commerce reviewed 42 city and county plans. Commerce also provides other services to support the State's Growing Smarter program, such as issuing \$60,000 in grants from the Commerce and Economic Development Commission, holding two workshops each year that assist cities and counties in developing their plans, and providing technical assistance about Growing Smarter to cities and counties. Auditors contacted a county development official and a representative of the Grower Smarter Oversight Council, which performs functions such as monitoring the progress of cities and counties in developing their plans. Both individuals commented that Commerce provides valuable technical assistance. Commerce also provides staff support for the Growing Smarter Oversight Council.

Why Commerce's participation can be eliminated—The Legislature could eliminate Commerce's participation, since its review role is only generally defined in statute, is advisory only, and may diminish when all cities and counties have developed their plans. Specifically, statute requires that Commerce receive a copy of these plans and amendments for review. Statute does not describe the extent of the review or comment. As a result, in many cases, Commerce staff suggest wording or organizational changes for the plans submitted by the cities and towns. However, Commerce does not have authority to require these changes, and cities and counties may adopt their plans or amendments without incorporating Commerce's suggestions. Further, the majority of cities and counties are required by statute to have their plans adopted by December 31, 2003, after which Commerce's role will be to review major amendments to city or county plans, review new plans if cities or counties develop them, or review original plans for those cities that do not have a December 31, 2003, deadline. While this may reduce the need for Commerce's review and technical assistance, Commerce and the representative from the oversight council believe this will have little or no impact on Commerce's workload. According to this representative from the council, Commerce will continue to provide expertise and information to cities and counties that is unavailable from any other agency.

Various options exist for four functions

The Legislature should consider a range of options for four other Commerce functions. These functions could be similarly eliminated because they are largely available elsewhere, but for each of these functions, auditors also identified some advantages to the State continuing to carry them out, though not necessarily through Commerce. As a result, the discussion of these four functions includes options other than eliminating them.

International Trade and Investment Office

What it does—According to Commerce, the International Trade and Investment Office (International Trade) promotes Arizona products and services for export and markets Arizona to foreign companies as a location for expansion. The export-related promotional services include counseling businesses about marketing abroad, gathering market research, providing assistance to businesses in finding trading partners, and organizing trade shows and trade missions to introduce businesses to international markets. Marketing Arizona to foreign companies involves issuing targeted mailings, conducting presentations, and hosting trade shows. International Trade carries out its activities through four contracted foreign offices located in Taiwan, Japan, Mexico, and the United Kingdom. The offices were established between 1987 and 1995. International Trade also maintains an office in Phoenix, staffed by five Commerce employees. Commerce reports that during fiscal year 2002, International Trade conducted 727 substantive export and trade-related technical assistance sessions that helped 333 companies, individuals, or organizations. A technical assistance session includes a range of activities, from a telephone call to spending an entire day with a company during a trade mission.

Auditors identified three options for this function: eliminating it entirely, retaining it, or ensuring that Commerce charge for export promotional services as permitted by law.

Why it could be eliminated—This function could be eliminated because other government and private entities provide some similar services. The United States Department of Commerce, Export Assistance Centers provide export promotional services similar to Commerce but for a fee. Two Export Assistance Centers, located in Phoenix and Tucson, are part of a world-wide network of 150 offices in 83 foreign countries, far surpassing Arizona's 4 foreign offices. The Export Assistance Centers offer counseling, market research, contact facilitation, and other trade promotion activities. According to a Commerce-commissioned study prepared by Arizona State University's College of Business, the federal government might better handle some of the activities currently performed by Commerce, such as export counseling, technical assistance, and country risk analysis, and Arizona should not duplicate these efforts. Commerce states that the Export Assistance Centers duplicate Commerce's export promotional services only at a basic level, and the two Arizona Assistance Centers do not focus on the needs of Arizona businesses. However, a review of the products and services offered by the Export Assistance Centers in the four countries where Arizona maintains a foreign office and discussions with officials knowl-

International Trade and Investment Office (Fiscal Year '03)

Staff:

5 FTE¹

Expenditures:

General Fund	\$ 330,600
CEDC Fund	<u>842,000</u>
Total	<u>\$1,172,600</u>

¹ Does not include this function's share of the FTE representing the director who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

International Trade could be eliminated since other government and private entities offer similar services, or Commerce could enact cost-saving measures.

edgeable of the products and services offered by the centers indicates that not only do the centers provide services similar to Commerce, they also offer some services that Commerce does not provide, such as video conferencing with groups of prescreened international business prospects. Further, the Federal Export Assistance Centers support Arizona businesses. Specifically, the manager of one of these Centers estimates that 90 percent of his time is focused on Arizona companies.

One difference between the Export Assistance Centers and Commerce, however, is that whereas Commerce's services are free, the Export Assistance Centers charge for their services. For example, scheduling 4 to 5 one-on-one appointments with selected potential business partners in Mexico, including the services of an escort/interpreter, is \$600 a day.

Additionally, private consultants, such as Ernst & Young, provide export assistance to businesses for a fee. Further, export assistance is available to Arizona businesses through the Tucson-Mexico Trade Office, operated by the City of Tucson, to those businesses working with Mexico.

Why it might be worth continuing—Commerce maintains that International Trade should be retained for two main reasons;

- **No other marketing entity for business expansion into Arizona**—Commerce points out that no other entity markets Arizona to foreign companies as a location to expand their businesses. However, it was not until fiscal year 2002 that Commerce separately reported the number of foreign companies that relocated to the State. That year, Commerce reported that two international companies moved to Arizona.
- **Other programs not focused solely on Arizona**—Commerce states that the Export Assistance Centers do not work solely on behalf of Arizona businesses. However, according to the manager of the Tucson Export Assistance Center, the centers located specifically in Arizona focus on Arizona companies. Further, it appears that nothing precludes a center from being able to work effectively for multiple clients. For example, while Commerce's contracted foreign offices do not work for other states, the European office does work for multiple businesses, as well as Commerce.

How it could be retained but modified—The Legislature could also consider a third alternative for this function—retaining the current four offices and directing Commerce to enact cost-saving measures, including charging for a portion of the costs of export promotional services as permitted by law. Although A.R.S. §41-1504.01 currently authorizes Commerce to assess fees to businesses for export promotional services, Commerce has not charged such fees. Commerce does charge for participation in trade shows and trade missions; however, these fees pertain only to the cost of the show or mission. According to Commerce, in fiscal year 2002, it collected \$49,000 for these events. Commerce does not

charge companies when it arranges meetings with foreign companies, or to develop company-based economic research. The federal Export Assistance Centers charge for their services. A United States Department of Commerce official explained that, while these fees are less than the full cost of the services provided, charging a fee separates out the truly export-ready companies from those who are not serious.

Business Attraction and Development and Office of Innovation, Technology, and Entrepreneurship

What it does—Business Attraction and Development (Business Attraction) markets the State nationally and internationally to attract new and expanding business development with an emphasis on four industries that Commerce has identified as a priority: information technology, aerospace, bioscience, and environmental technology. Four full-time employees within Business Attraction in Phoenix work with the four targeted industries to encourage new businesses to locate within the State and to assist existing businesses to expand, while two full-time employees in the State’s northern and southern areas work with businesses seeking to locate or expand there. Business Attraction also acts as the primary state-wide contact for businesses seeking information about relocating to the State. According to one Commerce official, when a business calls, Commerce does one of two things, depending on whether the business wishes to locate in a metropolitan or a rural area of the State. For businesses seeking to locate in a metropolitan area, Commerce refers the call to a local economic development entity, such as the Greater Phoenix Economic Council, and may also provide additional assistance, such as providing technical assistance or additional information as necessary. For businesses seeking to locate in a rural area, Commerce actively assists the business by showing them potential sites for relocation, educating them on business incentives and lifestyle, and arranging appointments with economic development groups to discuss issues such as labor availability. In this way, Commerce concentrates on assisting rural communities who might not be as well equipped as metropolitan areas to handle business attraction and retention efforts.

According to Commerce, the Office of Innovation, Technology, and Entrepreneurship (Office of Innovation) provides special emphasis to Arizona’s technology-focused entrepreneurs. In October 2002, the Office of Innovation was awarded a federal Small Business Innovative Research (SBIR) grant to create an Arizona Federal and State Technology Transfer Program (AZFast). The program, scheduled to be completed in September 2003, uses \$100,000 in fed-

Business Attraction and Office of Innovation (Fiscal Year ‘03)

Staff:

9 FTE¹

Expenditures:

General Fund	\$ 539,500
CEDC Fund	<u>541,300</u>
Total	<u>\$1,080,800</u>

¹ Does not include this function’s share of the FTE representing the director who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

eral funds and is matched by \$100,000 from the Commerce and Economic Development Commission. These funds are used for workshops and education to promote technology transfer, research, and development in Arizona.

Auditors identified two options for this function: eliminating it entirely or retaining the function only as a central point of contact for businesses outside the State seeking to locate in Arizona.

Why it could be eliminated—There are two main reasons why this function could be eliminated:

Business Attraction and Office of Innovation could be eliminated, or retained with a state-wide point of contact.

- **Similar services are provided elsewhere**—Many of the services that Business Attraction and the Office of Innovation provide are available from other local and private development agencies. For example, there are approximately 300 local and state-wide economic development organizations throughout Arizona, including the Greater Phoenix Economic Council, which provides assistance to businesses locating in Arizona, including identifying potential real estate sites. Other entities represent Tucson, Yuma, and Flagstaff; and rural organizations, such as the Graham County Chamber of Commerce and the Parker Area Economic Development Committee, represent their respective areas. Further, major utilities within the State have economic development programs, including Arizona Public Services' (APS) Building Bridges to Businesses program. This program focuses on business retention and expansion services, generally within the geographic area served by APS. Similarly, Salt River Project (SRP) works with local economic and regional development groups, including the Greater Phoenix Economic Council, to provide information on electric rates and service availability to businesses seeking to locate in Arizona.
- **Research suggests limited impact**—Research suggests that state-operated economic development efforts have a limited impact. Specifically, one report noted that economic development and employment generation is more likely to be successful if initiated at the community and local level rather than elsewhere.³ However, even efforts carried out at the local level may not be effective.⁴ One research effort that specifically measured the impact of state development organizations like Commerce concluded that state agencies promoting economic growth had no impact on wage growth in their states.⁵ The most important factors in economic growth (labor costs, availability of skilled labor, and natural resources, energy cost, and climate) are beyond the control of state and local governments.⁶ A recent study conducted by Elliott D. Pollack and Company for the Department of Commerce notes that Commerce helped to attract to Arizona or assisted 190 companies between July 1999 and June 2002.⁷ However, expansions

such as those by Cox Communications and Wells Fargo Home Equity Group were identified as being in the 190 assisted by Commerce. Moreover, the study did not explore whether these businesses would have expanded with or without Commerce's efforts.

How it could be retained, but modified—An alternative to eliminating the function entirely would be to retain only a central point of contact for businesses seeking to locate in Arizona, thereby eliminating such functions as showing businesses potential sites for relocation and arranging appointments for businesses with local economic development groups. The central point of contact function is important, because economic development officials contacted during the audit reported that businesses prefer to work with a neutral, state-wide contact that can provide impartial information about potential sites and answer questions about a state's business climate. Similarly, a Commerce official explains that Chambers of Commerce cannot carry out this function, since these organizations work on behalf of their member businesses. The central point of contact function could be provided either through individuals who answer businesses' telephone calls and direct them to local economic development entities, or through information maintained on a Web site. However, it would not provide in-depth services to individual businesses. For example, it would no longer provide site selection services for business wishing to relocate. Instead businesses could obtain these services through local economic development groups or other agencies.

Rural Development

What it does—Rural Development provides technical and financial assistance to rural communities for downtown revitalization, economic development, and business retention and expansion. The function operates two main grant programs: Main Street and the Rural Economic Development Initiative (REDI). Main Street, which in fiscal year 2004 is authorized to issue \$130,000 in grants from CEDC funds, offers both financial and technical assistance to rural communities seeking to revitalize their downtown business districts under an initiative developed at the federal level. Communities wishing to participate in Main Street must have a population of fewer than 50,000; commit to employing a full-time project manager; commit to a long-term operating budget; and have a downtown association. Commerce has verified that 19 Arizona communities met these requirements as of November 2002 and are, therefore, eligible to pursue state Main Street monies to assist a variety of local projects. Specifically, during fiscal year 2002, the largest grant, approximately

Rural Development (Fiscal Year '03)

Staff:

4.5 FTE¹

Expenditures:

General Fund	\$295,400
CEDC	177,700
Federal Fund	<u>259,000</u>
Total	<u>\$732,000</u>

¹ Does not include this function's share of the FTE representing the director who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, and organization charts as of January 2003. Error is due to rounding.

\$23,000, helped support a training program for nonprofit and Main Street board members. Additionally, according to one city official, Commerce awarded the Casa Grande Main Street program \$1,200 to hire an architect to prepare drawings combining three buildings owned by Sun State Bank into one. Once the architectural drawings were complete, the Bank proceeded with the remodeling project. The REDI grant program, which in fiscal year 2004 is authorized to issue a total of \$45,000 in matching grants, offers both technical and financial assistance to rural communities to develop an economic development program or project and evaluate community resources. Similar to Main Street, Commerce had approved, as of February 2003, 17 local governmental entities as qualified under REDI to compete for funds provided by the CEDC. To qualify, communities must demonstrate a commitment to economic development from the community and maintain a governing body to administer funds. Projects range from upgrading software to conducting market feasibility studies.

Auditors identified two options for this function: eliminating it entirely or retaining it.

Why it could be eliminated—Funding and technical support is available to rural communities from other sources. For example, the State Historic Preservation Office (SHPO) offers a local government assistance program that allows Arizona political subdivisions to apply to become Certified Local Governments. As of March 2003, there were 26 Certified Local Governments. Once certified, these entities are eligible for specialized assistance and grant funds for developing their own local preservation programs. In the year ending June 30, 2002, SHPO awarded nine such grants totaling more than \$370,000.

In addition, private fund-raising efforts have created funding for some rural development projects, although these efforts would need to increase if the Commerce Main Street program were eliminated. For example, the City of Casa Grande's Main Street program recently raised \$10,400 to supplement the \$5,000 it received from Commerce's Main Street program and the funding it received from other sources in order to build a new marquee for a building originally constructed in 1929. However, a Casa Grande Main Street official noted that without the funding it received from Commerce, the Casa Grande Main Street program would have had to raise the \$5,000 itself, thus taking longer to complete the project.

Why it might be worth continuing—While the Legislature could eliminate the Rural Development function and redirect the General Fund and CEDC monies for other purposes, the communities that Rural Development assists view the function as valuable. Without Main Street and REDI, these communities might not be able to carry out some projects, while other projects would take longer due to the need to locate other sources of funding. A Commerce official

acknowledged that some efforts that Main Street and REDI support in the rural communities could survive without Commerce, but notes that Commerce leverages the communities' efforts with the assistance offered by these grant programs.

Arizona Film Commission

What it does—The Arizona Film Commission provides free support to film and television production companies working in Arizona, including location scouting, permit processing, and liaison services. Commerce reports that, during fiscal year 2002, 92 projects were filmed in Arizona, while the Film Commission assisted 455 projects in some way.

In light of recent state budget cuts, the Film Commission has already halted marketing efforts to bring film projects to the State, a function it performed for many years. The Film Commission now focuses on providing customer service to the production companies who have approached the State on their own.

Auditors identified two options for this function: eliminating it entirely or combining it with the Office of Tourism.

Why it could be eliminated—There are two main reasons why this function could be eliminated:

- **Similar services are available from private sources**—Similar customer service functions are available to production companies from private sources for a fee. The Arizona Production Association (APA) publishes an annual state-wide directory listing verified production personnel, such as location scouts, costume designers, and hair stylists whose services are available to production companies for a fee. The directory also includes contact information for local chambers of commerce and film commissions, information on Arizona's child labor laws, and motion picture industry tax incentives. This directory is free to APA members, but costs \$20 for nonmembers.
- **Similar services are available from local film offices**—Additionally, 22 film offices throughout the State, in communities such as Benson, Kingman, and the Navajo Nation, provide similar free services as the Film Commission. Larger cities, such as Phoenix, also promote through the City's Web site that they offer scouting and liaison services, as well as information on accommodations, equipment, and crew. The Tucson Film Office also provides production manuals that include professional crews and information regarding local suppliers and filming in Tucson.

Arizona Film Commission

(Fiscal Year '03)

Staff:

2.5 FTE¹

Expenditures:

General Fund	\$299,000
Total	<u>\$299,000</u>

¹ Does not include this function's share of the FTE representing the director who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

Film Commission services are also provided by private sources and local film offices.

Why it might be worth retaining but combining with the Office of Tourism—The Legislature could consider retaining the Film Commission, but transferring it to the Office of Tourism (Tourism). Commerce maintains that the Film Commission should be retained because it generates revenue through dollars spent by production companies filming in the State, far exceeding the Office’s \$300,000 budget. However, Commerce takes credit for revenue generated that is not directly attributable to its efforts. Commerce also claims that many states and countries aggressively compete for these film production company dollars, and if the Film Commission is eliminated, these dollars will go to the more aggressive states and countries. However, many factors influence production companies to film in a particular location, including scenery, production costs, and availability of lodging. The actual impact of a state film commission is difficult to separate from these other factors. Finally, Commerce maintains that films shot in Arizona encourage tourism and bring more tourist dollars to the State. However, a variety of factors influence tourists to visit Arizona, one of which may include a film produced here.

If the Legislature elects to retain the Film Commission, it should consider transferring it to the Arizona Office of Tourism, since both entities emphasize enhancing the State’s visibility. An Office of Tourism official explained that the two groups have explored merging in the past, and the official agreed that their missions fit together. In fact, this official notes that the main industry in rural Arizona is tourism. Moreover, Tourism is already involved in working with noncommercial film projects in Arizona. For example, Tourism helps organize tours of potential film locations for photographers or film producers. In addition, Tourism maintains a collection of photographs that are distributed to companies planning to film in Arizona.

Other major functions should be retained

Commerce’s remaining five functions should be retained, as these functions play a role in providing valuable services to Arizona businesses, workers, cities, and counties, or do not require state appropriations. The Legislature could retain some or all of these functions within Commerce; however, should the Legislature elect to eliminate or transfer the eight major functions discussed above, then the Legislature could sunset Commerce. If it elects to take this step, the Legislature should retain these five needed functions, transferring them to other state agencies, and consider eliminating nearly \$1.3 million in appropriations for agency administrative functions and the associated FTEs. These functions are as follows:

The Arizona Job Training Program

What it does—The program’s objective is to provide funding for job training assistance to Arizona businesses in the form of 2-year grants. To qualify, an Arizona business is required to match the employee training grant expenditures in an amount equal to 25 percent for new employees and 50 percent for existing employees. Training can be provided by an employer training program or by public or private higher education institutions. During fiscal year 2003, Commerce reports that it awarded 67 new grants, awarded over \$12 million, and anticipated training nearly 21,000 workers. Further, the program emphasizes the needs of rural and small businesses. Specifically, A.R.S. §41-1544 reserves 25 percent of the grants for rural businesses and 25 percent for businesses with fewer than 100 workers. The program uses the Arizona Job Training Fund for grants funded from a 0.1 percent employer-paid wage tax and a General Fund appropriation for operating costs estimated to be nearly \$200,000 in fiscal year 2003. As of June 30, 2003, the Fund had a balance of approximately \$26 million, although according to Commerce, most of this balance is committed to ongoing projects.

Why it is worth continuing, how it could be modified, and where it might be transferred—The Legislature should retain this function but eliminate General Fund support for it and make it self-funding, because it is a unique function funded primarily by business that is intended to improve workforce effectiveness. While the function currently receives operating support from the General Fund, there is no statutory requirement that the Legislature appropriate any money for it. The function could be self-funding, by using monies in the Job Training Fund for operating costs. Moreover, if Commerce is eliminated, this function could be transferred to DES, which operates the majority of the State’s other job-training programs. In fact, federal policies support transferring this function to DES. Specifically, the Workforce Investment Act of 1998 encourages states to combine separate workforce training programs such as those administered by DES and Commerce’s Job Training Program in order to better coordinate state workforce activities.

Staff Support for the Governor’s Workforce Development Council (Council)

What it does—The Workforce Policy Office reports that it provides staff and policy assistance for the Council, and the Director of Commerce or his designee serves as one of its members. The Council is mandated by the federal Workforce Investment Act of 1998 (WIA), which requires that every state adopt a board to

Arizona Job Training Program (Fiscal Year ‘03)

Staff:

2 FTE

Expenditures:

General Fund	\$ 158,200
Job Training Fund	9,485,400
Total	<u>\$ 9,643,600</u>

Fund Balance:

Job Training Fund	\$26,000,000
Total	<u>\$26,000,000</u>

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the years ended June 30, 2002, and June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

The Arizona Job Training Program should be made self-sufficient.

**Staff Support for the Governor's
Workforce Development Council**
(Fiscal Year '03)

Staff:

5 FTE

Expenditures:

Federal Fund	\$ 957,900
Interagency Agreement Fund	<u>257,500</u>
Total	<u>\$1,215,400</u>

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

Staffing for the Council should be retained and could be provided by DES or another agency if the Legislature eliminates Commerce.

Why it is worth continuing and where it might be transferred—The Legislature should consider retaining staff support for the Council because the federal government requires the Council. The Council allocates federal monies to support programs that improve the quality of the State's workforce. However, if the Department were eliminated, staff support for the Council could be provided by another agency, such as DES. Not only does DES receive the majority of the WIA funds for its programs, but it also records and reports performance measures

for the federal government. Further, there may be value in aligning workforce programs such as those funded by the Council with others that DES currently administers. Although some Council members do not support a transfer of the Council to DES because they indicate that DES has not always worked well with the Council, one official within DES indicated that it could provide staff support for the Council using the current \$315,000 it provides to Commerce for estimated staff expenditures.

Energy Office
(Fiscal Year '03)

Staff:

17 FTE¹

Expenditures:

Federal Fund	\$ 3,739,800
Oil Overcharge Fund	<u>\$ 8,624,600</u>
Total	<u>\$12,364,400</u>

Fund Balances:

Federal Fund	\$ 933,600
Oil Overcharge Fund	<u>\$ 6,042,500</u>
Total	<u>\$ 6,976,100</u>

¹ Does not include this function's share of the FTE representing the director who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the years ended June 30, 2002, and June 30, 2003, and organization charts as of January 2003. The Department provided the Federal Fund fund balance as of August 26, 2003. Numbers are rounded.

Energy Office

What it does—The Energy Office provides energy policy advice to the Governor and the Legislature, and implements 17 programs to encourage energy efficiency and renewable energy usage, including the federal Low-Income Weatherization Assistance Program, which provides grants to reduce energy costs for low-income households. Commerce reports that in 2002 this program helped 695 Arizona homes become more energy efficient. Commerce uses 17 full-time staff to carry out all of the Energy Office's duties.

Why it is worth continuing and where it might be transferred—The Legislature should consider retaining the Energy Office because it expects to receive approximately \$5 million in fiscal year 2003 from the federal government and uses no state monies. However, if the Legislature elects to eliminate Commerce, it could transfer the Energy Office to the Arizona Department of Housing. The Department of Housing separated from the Department of Commerce in October 2002 when Housing began operating as a cabinet-level department. Housing’s mission is to facilitate affordable housing in Arizona, and officials from this new department agree that the Energy Office’s role in reducing buildings’ energy consumption could fit well within their mission.

The Office should be retained and could be transferred to the Department of Housing.

Private Activity Bonds

What it does—By complying with Title 26 of the Internal Revenue Code, every state may allocate authority for issuing tax-exempt private activity bonds among bond issuers in an amount dependent upon its population. The Arizona maximum for 2002 was approximately \$400 million, established by using an allowance of \$75 per state resident. Statute allows the allocation to be made to bond issuers, who are generally county or municipal industrial development authorities, for specific purposes. For example, 35 percent can be allocated to mortgage revenue bonds, 10 percent to residential rental projects, 20 percent to student loan projects, 15 percent to manufacturing projects, and 10 percent to be used at the discretion of the Director of Commerce. According to Commerce officials, this discretion supports economic development projects. Since 1984, the Department of Commerce has been responsible for processing applications and distributing this bonding authority among local governments under a lottery process starting at the beginning of each calendar year and defined by A.R.S. §§35-901 through 35-913. This function is not supported by the General Fund but instead is funded by user fees from those applying for the bonding authority. For example, according to Commerce, in fiscal year 2002 application and confirmation fees amounted to over \$129,000.

Why it is worth continuing and where it might be transferred—The function should be retained since it allows bond issuers to issue tax-exempt bonds to make funds available to private users for projects within the State’s counties and cities. In addition, the function is not only self-funding but periodically contributes some revenue to the General Fund through forfeiture fees. For example, according to Commerce in fiscal year 2002, over \$119,000 was transferred to the General Fund. Should the Legislature eliminate the Department of Commerce, this function, with its one FTE, could be transferred to any agency familiar with bond projects. According to Commerce officials, the Commerce and Economic Development Commission, a commission that serves the State by investing in state-wide economic projects, could administer this function.

Private Activity Bonds Administration (Fiscal Year '03)

Staff:

1 FTE

Expenditures:

Bond Fund

\$241,900

Total

\$241,900

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, and organization charts as of January 2003. Numbers are rounded.

Private Activity Bonds should be retained and could be transferred to CEDC if the Legislature eliminates Commerce.

Arizona Military Airport Regional Compatibility Project

Arizona Military Airport Regional Compatibility Project (Fiscal Year '03)

Staff:

2.8 FTE¹

Expenditures:

General Fund	\$ 12,300
CEDC Fund	<u>177,900</u>
Total	<u>\$190,300</u>

¹ Does not include this function's share of the FTE representing the director who oversees this and other functions.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) Accounting Event Transaction File for the year ended June 30, 2003, organization charts as of January 2003, and data from the State's Human Resources Management System. Error is due to rounding.

The Project should be retained and could be transferred to another executive branch agency if the Legislature eliminates Commerce.

What it does—The project meets with local communities and base officials to develop comprehensive land-use plans around Arizona military airports. According to Commerce, the Legislature created the project through a one-time appropriation of approximately \$450,000, and dedicates an estimated \$12,300 each year in appropriations for administrative costs. Commerce used these monies for a consultant who helped draft a land-use plan for Luke Air Force Base and the surrounding area. The plan attempts to balance the needs of the community while limiting urban encroachment on the base. Commerce completed the plan for Luke Air Force Base in March 2003. While approximately \$450,000 from the General Fund was used to develop this plan, Commerce used a portion of the appropriation as matching funds to obtain an additional approximately \$450,000 grant from the United States Department of Defense's Office of Economic Adjustment. The federal grant will be used to develop plans for Luke Air Force Base's Auxiliary Field 1, Davis-Monthan Air Force Base in Tucson, the Barry M. Goldwater Range and its Gila Bend Auxiliary Airfield; review a current plan for the Marine Corps Air Station in Yuma; and develop a policy guidebook to benefit planning for all Arizona communities. Commerce anticipates it will complete these efforts in 2006.

Why it is worth continuing and where it might be transferred—The Legislature should retain this function because it is valuable to look at air base land use from a state-wide perspective. Developing a land-use plan for military air bases and their air access corridors is important at the state level, because local jurisdictions can adopt differing policies and procedures toward encroachment on military bases that must be combined. Activities at Luke Air Force Base, for example, involve eight cities and two government agencies. Further, 15 cities and 2 counties endorsed the state-wide project.

If Commerce were eliminated, this function should be transferred to another executive branch agency. According to a representative of the Department of Defense, the federal government would insist that the current project grant be managed by an executive agency under the Governor's authority. Without this, the grant could be suspended, and the Department of Defense would examine the possibility of issuing separate grants for each of the local jurisdictions.

Agency Administrative Functions

What it does and why it could be eliminated—Agency administration offers management guidance and agency-wide assistance to its divisions and functions. Administrative functions include the Director's Office, human resources, accounting and budget communications, and information technology. If the Legislature terminates Commerce, these functions would not be needed and therefore could be eliminated.

Commerce Administrative Functions

(Fiscal Year '03)

Staff:

24.2 FTE

Expenditures:

General Fund	\$1,297,900
Federal Fund	386,300
Oil Overcharge Fund	<u>101,400</u>
Total	<u>\$1,785,700</u>

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Transaction Extract File* for the year ended June 30, 2003, and organization charts as of January 2003. Error is due to rounding.

Recommendations

1. The Legislature should consider eliminating the following Department of Commerce functions, since, to some extent, they duplicate programs operated by other entities:
 - Small Business Services.
 - Apprenticeship Services.
 - Economic Information and Research.
 - Growing Smarter functions.
2. If the Apprenticeship Services function is eliminated, the Legislature should consider transferring the Pre-Apprenticeship Services to the Arizona Department of Transportation.
3. The Legislature should consider options for addressing the following functions:
 - **International Trade and Investment Office**—The Legislature could eliminate funding for this function, retain it, or, similar to a federal program, charge businesses for these services to help it recover a portion of its costs.
 - **Business Attraction and Office of Innovation**—Legislature could eliminate this function, or retain some or all functions within this function.
 - **Rural Development**—The Legislature could eliminate or retain this function.
 - **Arizona Film Commission**—The Legislature could eliminate this function, or transfer it to the Arizona Office of Tourism.
4. The Legislature should consider eliminating General Fund support for the Arizona Job Training Program.
5. While the Legislature could elect to retain the eight programs above, should it eliminate or transfer these functions, it could also elect to sunset Commerce. If Commerce were sunset, the following five functions should be retained and could be transferred to other state agencies:
 - Transfer the Arizona Job Training Program’s administration to the Department of Economic Security.
 - Transfer staff support for the Governor’s Workforce Development Council to the Department of Economic Security.
 - Transfer the Energy Office to the Arizona Department of Housing.
 - Transfer administration of tax-exempt private activity bonds to the Commerce and Economic Development Commission.
 - Transfer responsibility for the Arizona Military Airport Regional Compatibility Project and its federal Department of Defense grant to another executive branch agency.
6. If the Legislature elects to terminate Commerce, it should also eliminate Commerce’s administrative functions.

FINDING 2

Legislature should consider evaluating tax credit programs before they are renewed or altered

Since research suggests Commerce's tax credit programs are likely ineffective, the Legislature should consider requiring an analysis of the cost-effectiveness of Enterprise and Military Reuse Zones before they are renewed, and requiring similar cost-effectiveness evaluations before modifying other Commerce-administered credits, or adopting new ones. At the same time, the Legislature should modify the Department of Revenue's (Revenue) statutes to make it easier to determine how much the credits are costing the State in terms of foregone tax revenue. While these programs provide several different types of tax credits, businesses have used at least \$65 million in income tax credits alone for tax years 1994 through 2000, and hold an additional estimated \$60 million in credits that can be used on future returns. However, recent research of many other states' tax incentive programs concludes that tax incentives are of limited effectiveness in attracting businesses or creating jobs. In fact, research has shown that other factors, such as the availability of a skilled workforce and infrastructure, are far more important in influencing business location and job creation than tax incentives. In addition, tax incentive programs are costly for states to operate, and can lead to other unintended consequences.

Commerce administers five tax credit programs

Tax credits are one way that states have historically tried to induce economic growth. States have relied on a variety of methods to promote economic growth, including an overall low corporate income tax rate, direct subsidies, modifying the corporate income tax code, and providing specific, targeted incentive programs to promote certain types of behavior. This finding examines five targeted tax credit programs administered by Commerce. The Department of Commerce administers five statutorily created incentive programs designed to encourage business location, investment, and job creation (see Table 3, page 31 for a summary of these credits, and Appendix for a broader description of them). Through Commerce's programs, busi-

nesses are given an incentive to locate in Arizona; create new jobs; invest in new machinery, equipment and inventories; or re-use and re-tool their existing facilities. States have historically attempted to attain these goals by simply adjusting corporate tax rates or through targeting the tax credits to a firm, an industry, a geographic area, or a combination of the above.

Commerce shares responsibility with Revenue for administering the income tax portions of these five incentive programs, although as seen in Table 3 (see page 31), there are other tax incentives, such as property tax and sales tax benefits, also associated with these programs. To qualify for these programs, companies must demonstrate to Commerce that they meet specific statutory criteria. After Commerce's approval, the company completes a Revenue income tax credit form that is processed with the company's tax return. Because Commerce does not have access to companies' income tax returns, Commerce requires companies to notify them of the amount of credits claimed. According to Revenue, for tax years 1994 through 2000, companies have used these credits to claim at least \$65 million in income tax credits.⁸ Revenue also indicates that at the end of tax year 2000, businesses held an estimated \$23.4 million in unused credits from three of the Commerce-administered tax incentive programs, and an estimated \$36.2 million in unused credits from the Environmental Technology Assistance Program as of tax year 1998, the most recent year for which the balance is available for this program. These unused credits can be carried forward and used on future tax returns.

Research indicates that tax incentives induce only limited economic growth

As noted below, recent research does not support the overall use of tax incentives to enhance economic development. Literature suggests that, in general, modifying taxes to induce economic growth is not likely to be efficient or cost-effective. In particular, targeted tax incentives, such as those offered to firms located in a specified geographic area such as an enterprise zone, may attract capital investments, but have little impact on employment. Tax incentives play a small role in the costs considered by business when locating, relocating, or expanding. Numerous other factors, such as education and infrastructure costs, outweigh the role of taxes. Moreover, zones have not proven to be a cost-effective means of producing jobs, and tax incentives can also lead to unintended consequences.

Taxes have limited impact on economic development—Many researchers have assessed whether taxes have an effect on economic growth.⁹ In general, modifying taxes is considered to have a small impact on economic activity. Specifically, while one researcher estimates that reducing the tax rate from 2 percent to 1.8 percent (10 percent) would result in a 2.5 percent increase in business activi-

Table 3 Commerce-Administered Tax Incentive Programs

Program	Purpose	Incentive	Amount
Enterprise Zone	Encourage businesses to locate or expand in areas with high unemployment and poverty rates or in Arizona counties with low populations	Income Tax Credit	Offers up to \$3,000 for each net new job created
	Attract manufacturers that are independently owned by one or more women or minorities, or independently owned by an employer with fewer than 100 employees, to invest in locations with high unemployment and poverty rates	Property Reclassification	Reclassifies primary and real personal property taxes for up to 5 years
Defense Contractor Restructuring Assistance	Help defense contractors obtain Department of Defense contracts, diversify into commercial markets, and adopt new manufacturing techniques	Income Tax Credit	Offers a credit of up to 40 percent of real and personal property taxes paid based on the number of net new jobs created
		Income Tax Credit	Provides \$7,500 over a 5-year period for each net new job created
		Accelerated Write-off	Subtracts amortization from taxable income at a faster rate
Environmental Technology Assistance	Encourage the development of an environmental technology industry, recruit and expand environmental technology companies, and encourage the use of environmental technology products	Income Tax Credit	Allows employers to deduct 10 percent of qualified capital investment from their income tax. Credit can be carried forward 15 years
		Property Tax Assessment	Reduces property tax assessment ratio from 25 percent to 5 percent of full cash value for real and personal property for 20 years
		Sales and Use Tax Exemptions	Offers a 10-year sales tax exemption for machinery, equipment, materials and other tangible property used to construct a qualified facility; a 15-year sales tax exemption for energy sources such as electricity, fuel, or artificial gas directly used for environmental technology manufacturing, producing, or processing
Military Reuse Zone	Lessen the impact of military base closures and to create jobs and make capital investments in the aerospace and aviation industries	Property Reclassification	Reclassifies personal property in the reuse zone, representing up to 80 percent property tax savings for 5 years
		Sales Tax Exemption	Provides an up to 10-year sales tax exemption for many types of construction performed by eligible companies
		Income Tax Credit	Provides up to \$10,000 over a 5-year period for each new employee
Information Technology Training	Encourage employers to provide their employees with continuing technology skills training	Income Tax Credit	Provides up to \$1,500 income tax credit for offering technology skills training

Source: Arizona Revised Statutes and Department of Commerce documentation.

ty above what would have occurred without the reduction,¹⁰ other analysts suggest the effect is much less significant.¹¹ Another study, for example, estimates that if business taxes were increased by 17.8 percent, the average county in their study would lose less than one small firm and approximately 1.14 employees.¹² While researchers generally conclude that taxes have a statistically significant effect on economic activity, they also agree the effect is small.¹³

Researchers conclude that targeted tax incentives such as the type offered through enterprise zones have a similarly small effect on economic activity.¹⁴ Enterprise zones offer incentives when businesses locate to a certain geographic area and the credits are designed to create jobs and encourage investment in capital and machinery. Arizona also offers incentives targeted to specific industries, such as helping the defense industry and encouraging the development of an environmental technology industry. In terms of types of incentives offered, however, enterprise zones are little more than geographically targeted versions of standard state and local economic development programs.

The targeted tax incentive literature and specifically, enterprise zone literature, Commerce's largest tax credit program as measured by the number of tax credits used, shows that zones and the various tax incentives offered to firms located in the zones have almost no effect on economic growth. One study, for example, estimated that the average enterprise zone reduced the tax burden on new investment by 19 percent; however, the evidence from the enterprise zone literature does not support significant differences in growth rates in zones versus nonzones, despite such reductions in the tax burden.¹⁵ Regardless of how economic growth has been measured, such as firm births, firm relocations, firm expansions, income per capita, unemployment rates, or number of jobs created, no significant impact was found for these outcomes.¹⁶ Another study noted that enterprise zones may affect where companies locate and may shift the investment from machinery to inventories. However, if a goal is to improve employment of residents, as it is with three of the five programs administered by Commerce, the evidence suggests that residents are not measurably better off in terms of income per capita or employment.¹⁷ In fact, one recent study of 36 Ohio businesses compared the job growth of businesses accepting state tax incentives to those not accepting them. The study found that providing incentives actually resulted in 20 percent fewer jobs, or 10.5 jobs per firm, as compared with firms that did not accept incentives. The authors suggest that firms misrepresent their hiring plans to receive larger incentives from government.¹⁸

Other factors more important than taxes in economic development—

While taxes and targeted incentives play a small role in economic development, researchers point to other factors that are far more important in business investment decisions, most of which are beyond the control of state and local governments.¹⁹ For example, one researcher estimated that the labor market has 14 times more impact on a business than incentives such as tax and other economic development incentives.²⁰ Additional factors, such as education and infrastructure, are also key

public services for economic growth.²¹ According to two researchers, the value of a tax incentive is so modest in creating a new job that a \$2,000 tax credit will offset only \$0.48 of a \$12-an-hour wage, reducing the business' portion of the wage to \$11.52.²² This means that Arizona's \$3,000 income tax credit for creating a new job in an enterprise zone offsets only \$0.72 of a \$12-an-hour wage.²³ Finally, tax incentives are often only marginally helpful when businesses decide between locations once a specific region has been identified. In Arizona, tax incentives were ranked 14 out of 17 as a factor in business location decisions.²⁴

Costs of incentive programs could outweigh the benefits—Despite other factors being more important in business location decisions, states continue to use incentives to attract companies and promote job growth. Incentives are one of the factors affecting businesses that states can control, but they can represent significant costs for governments. For example, Tennessee attracted Saturn to Nashville in 1985 with an incentive package, which included tax incentives worth approximately \$80 million, for approximately 3,000 jobs. This made the cost per job estimated at \$26,000; shortly afterwards for a Toyota plant, Kentucky offered between \$125 and \$150 million for 3,000 jobs, putting the cost per job at \$50,000 that also included a training subsidy worth five times the Saturn subsidy. In 1994, Alabama offered Mercedes an incentive package of \$253 million for a plant that would employ 1,500 workers and required the state to purchase 2,500 cars.²⁵

Besides case studies of costs, researchers have also analyzed the cost-effectiveness of tax incentives and programs more systematically. One comprehensive study of 75 enterprise zones in 13 states determined that state and local government lost approximately \$59,000 per job.²⁶ In addition, a 2001 review of California's enterprise zones concluded that the state paid approximately \$4,800 per job, but these numbers are less reliable because the study did not control for whether the job was actually attributable to the enterprise zone or not.²⁷ Further, Ohio's evaluation of the costs of the enterprise zone programs determined that, to break even, three out of every five firms that move to Ohio's enterprise zones would have to be solely attributed to the zone program. The authors conclude that this is highly unlikely.²⁸ One analyst also found that certain Ohio zones were more cost-effective than others and recommended using performance-based criteria to reconfigure and decertify zones.²⁹ Other analysts have also made similar recommendations to more closely scrutinize tax incentive performance.³⁰

Incentives and programs have unintended consequences—Although researchers have not found a significant effect on job creation associated with tax incentives and programs such as enterprise zones, they have found that such incentive programs can have unanticipated consequences:

- **Inability to enforce "clawback" provisions**—States often attempt to protect their investments by including "clawback" provisions,³¹ or mechanisms where the government can recover the incentives should the company fail to meet its pro-

jections or leave before the full period of investment has expired. However, the development deals states offer firms are one-sided, because the company has more information about its intentions than the state.³² As a result, the company can renege on its commitments. In New York, NBC failed to meet its projected job creation goals but threatened to further reduce jobs if the city acted to recoup its losses. When states attempt to apply their clawback provisions, they are unlikely to meet with much success.³³

- **Incentives redirect valuable resources**—Government activities such as offering incentives to create jobs can take away from other state and local government programs, such as education, and as a result, can actually negatively affect income and the residents' welfare in an area.³⁴ Unfortunately, when growth is stimulated through incentives, the cost of that growth is borne mainly by the state and local government in the form of income, sales, and property tax incentives.³⁵ Ultimately, the residents of the state and in the city may pay higher taxes to support the same level of government services.³⁶
- **Growth is redistributed, not created, by incentives**—Incentives seem to work to redistribute existing capital and labor, but may not actually create it.³⁷ For example, when a business relocates from outside an enterprise zone to inside one, no new growth has been created, the capital has simply been shifted. Depending on the state's economic development policy, such shifts could be beneficial or not.³⁸ Similarly, decreased unemployment in enterprise zones may be incorrectly classified as growth, but may instead be due to migration patterns away from enterprise zones rather than increased employment within the zone.³⁹ Unless a state wants such migration, the changes in unemployment could be adverse.

Changes needed to better evaluate Arizona credits

The Legislature should consider taking steps necessary to evaluate Commerce's tax credit programs, including revising Revenue's confidentiality statutes to better determine the cost of credits, and evaluating current and new tax incentives. A number of states have taken steps to evaluate their tax incentives. However, Arizona is prevented from reviewing income tax incentives such as those administered by Commerce because of current restrictions in Revenue's statutes. Therefore, the Legislature should consider revising these confidentiality statutes, requiring the regular review of two of Commerce's current credits as they become eligible for renewal, and analyzing the other tax incentive programs before they are expanded or extended, as well as new tax incentive programs before they are adopted.

Other states evaluating incentives—Other states have been taking steps to determine the costs and benefits associated with tax incentives. For example, at the

request of the state's governor, two West Virginia organizations reviewed the state's 22 tax incentives for their effectiveness, and recommended that half of them be eliminated. Further, the review recommended that the remaining incentives, along with any new tax incentives, should have statutory criteria for evaluating their success, including a provision that they be reviewed against this criteria every 3 years.⁴⁰ Ohio contracted with Cleveland State University to evaluate its enterprise zone performance and made recommendations to eliminate or restructure its zone program.⁴¹ California's governor recently recommended all tax incentives be periodically reviewed for their effectiveness.⁴² In addition, New Jersey's governor proposed that over \$23 million allocated for its Business Employment Incentive Program be discontinued in fiscal year 2004.⁴³ Further, Florida's Senate Committee on Fiscal Resources recommended criteria for evaluating business incentives, including raising the question of a post review, a sunset provision, or working toward a cost benefit analysis of incentives.⁴⁴ While Florida's Office of Program Policy Analysis and Government Accountability (OPPAGA), an agency which examines agencies and programs to improve services and recommend the best use of public resources, attempted to review that state's enterprise zone program, its assessment was limited by lack of data and the program's failure to provide an approved method for evaluating the program.⁴⁵ Some researchers have made similar recommendations, such as requiring a cost-benefit analysis prior to implementing an incentive; requiring economic development legislation and programs to be placed on a sunset cycle; and requiring state legislatures to examine costs and benefits as compared with other state responsibilities.⁴⁶

Current statutes limit tax incentive reviews in Arizona—Before Arizona can take any of these steps for Commerce-administered tax incentive programs, Revenue's confidentiality statutes would need to be changed to allow a more accurate estimate of the costs of income tax incentives. Currently, Revenue's statutes do not allow any income tax return data to be released if it would allow the identification of a particular taxpayer. Specifically, Revenue interprets A.R.S. §42-2001 to identify confidential information to include a taxpayer's identity and the amount of income tax credits claimed. Since some credits have few companies claiming them, Revenue believes that, in these cases, releasing any of the information would violate its confidentiality statutes. For example, Revenue would not release income tax credit information for the Defense Contractor Restructuring Assistance Program for 1994, 1995, and 1998, because so few companies claimed this credit during these years. As a result, while Revenue reported that companies used over \$8.7 million in these income tax credits from 1994 through 2000, this amount is understated without the data for these 3 years.

This statute has limited attempts in Arizona to evaluate the effectiveness of income tax credits. In 2002, a legislative study committee attempted to establish a standard for measuring the success or failure of Arizona's tax credits, but was unable to do so because of Revenue's confidentiality statutes.

In contrast to Arizona, some other states have taken action to allow for more disclosure of income tax credits' impact on their states. For example, according to a 2002 report, Minnesota and Maine have enacted laws that allow for full disclosure of business incentives, such as income tax credits.⁴⁷ Connecticut and North Carolina also require publication of company-specific income tax information. Since statutes require disclosure, companies claiming income tax credits in these states should know that this information will be made public.

Current and proposed credits should be reviewed for cost effectiveness—If the Legislature loosens Revenue confidentiality statutes to allow more complete reporting, it should then consider requiring a cost-effectiveness analysis of Enterprise Zones and Military Reuse Zones before they are renewed, before Commerce-administered tax incentive programs are extended or expanded, and before new tax incentive programs are adopted. Specifically, the Legislature should consider taking steps for the following programs:

- **Enterprise Zone and Military Reuse Zone programs**—Because these zones must be periodically renewed, the Legislature should consider requiring a cost-effectiveness analysis of these zones before they are renewed, terminating those that are not effective. Specifically, each Enterprise Zone is established for 5 years, but Commerce may renew these zones for terms up to 5 years. The Governor approves Military Reuse Zones for 5 years, and may extend each zone for another 5 years. Thereafter, the Governor and Legislature may renew the zones for additional 5-year terms. Therefore, before Commerce approves the renewal of each Enterprise Zone, and before each Military Reuse Zone is extended, the Legislature should require an analysis of each zone's cost-effectiveness, and consider eliminating those that are not cost-effective.
- **Other Commerce-administered tax incentive programs**—While other Commerce-administered programs have a statutory termination date, the Legislature should consider requiring similar cost-effectiveness analyses before renewing or revising these programs. Specifically, both the Defense Restructuring Assistance and Environmental Technology Assistance incentive programs are closed to new companies, but companies already in these programs can continue to claim tax credits for many years (see Appendix, pages a-i through a-iii for more details). Finally, companies can claim tax credits from the Information Technology Assistance program until 2006. However, past legislation has altered how long companies can claim credits. Specifically, Laws 2000, Ch. 390, §§24 and 25 extend the amount of time companies can claim earned credits from 5 years after the credit was earned to December 31, 2011. Therefore, the Legislature should consider requiring a cost-effectiveness review before it considers renewing or revising any of Commerce's tax incentive programs.

- **New tax incentive programs**—Finally, the Legislature should consider requiring an analysis of any new tax incentive program’s cost-effectiveness. For example, one report recommended that state officials establish a strategic plan for economic development, and then analyze each incentive proposal in terms of the anticipated benefits, the cost to government, and the rate of return on investment.⁴⁸

Recommendations

1. The Legislature should consider modifying the Department of Revenue’s statutes to allow more complete reporting of the income tax credit program’s fiscal impact on the State.
2. The Legislature should consider mandating in statute that a cost-effectiveness analysis be conducted before:
 - a. Commerce renews each Enterprise Zone;
 - b. The Governor and/or Legislature renew each Military Reuse Zone; and
 - c. The Legislature renews or revises any Commerce-administered tax incentive program.
3. The Legislature should consider mandating in statute that any Enterprise Zones and Military Reuse Zones that are found to not be cost-effective are terminated.
4. The Legislature should consider requiring a cost-benefit analysis of any new tax incentive programs prior to adopting them.

OTHER PERTINENT INFORMATION

During this audit, other pertinent information was obtained about the issues related to combining the organizational structures of the Arizona Department of Commerce and the Arizona Office of Tourism (AOT). During the Sunset review, auditors noted that both agencies conduct economic development activities, although Commerce emphasizes business, while AOT seeks to attract tourism.

Commerce and Tourism functions are in separate agencies in Arizona

In Arizona, economic development and tourism functions are divided between the Department of Commerce and the Office of Tourism. Commerce and Tourism are separate agencies, with separate budgets, and directors appointed by the Governor. However, this structure has not always been in place. Originally, both of the agencies' responsibilities were performed by one agency. Specifically, both functions were part of the Governor's Office of Economic Planning and Development. In 1975, the Governor created a separate Office of Tourism, which the Legislature formally adopted in 1978. In 1985, the Legislature created a Department of Commerce, removing it from the Governor's Office.

The Arizona Department of Commerce's mission is to create vibrant communities and a globally competitive Arizona economy through leadership and collaborative partnerships. For example, the agency provides technical assistance to rural cities that are interested in obtaining grants to revitalize their downtown areas. In addition, Commerce works with urban and rural communities to encourage businesses to locate in Arizona cities. To meet this mission, Commerce used 94.3 FTE positions for fiscal year 2003 and an approved budget of an estimated \$27.5 million. According to Commerce officials, approximately \$650,000 of this amount is dedicated to economic development marketing.

The Office of Tourism is charged with promoting tourism and encouraging tourism development throughout the State. For example, AOT maintains and distributes a variety of literature pertaining to Arizona cities and tourist attractions. In addition, it

has a Web site that lists many events and locations that potential tourists may consider visiting in Arizona. To carry out these functions, for fiscal year 2003 AOT was authorized 25 FTEs, and a budget of almost \$11 million.

Other states organize commerce and tourism differently

Although Arizona and some other states have two separate agencies to promote tourism and economic development, most other states have organized these functions within the same agency. In contrast, still other states have adopted an altogether different structure for tourism and economic development agencies, including separating the functions among various state agencies or having them performed by private sector companies.

Most states' economic development and tourism functions are combined—Most states have organized their economic development and tourism functions into one agency. According to a review of 50 states,⁴⁹ 35 states have adopted this structure. For example, Washington's Department of Community, Trade, and Economic Development performs functions such as business and community development, and promotes state-wide economic vitality. Although initially separate units within the same department, in October 2001, Washington combined business and tourism development within the department, primarily to try to save costs and combine each unit's marketing efforts. In addition, Utah's Department of Community and Economic Development is an agency that supports business development, arts and museum services, and tourism functions.

Other states have separate economic development and tourism agencies—In contrast to the majority of the states that organize tourism and economic development functions within the same agency, 12 other states have organized these functions into two separate agencies, similar to Arizona. For example, New Mexico's Economic Development Department performs the state's economic development activities, such as facilitating international trade between companies in New Mexico and abroad and assisting communities with coordinating their own economic development programs. A separate agency, the Department of Tourism, performs New Mexico's tourism activities. Prior to 1990, tourism and economic development functions were moved within one agency. However, according to a New Mexico Department of Tourism official, the Department of Tourism was made its own cabinet-level agency to stress the importance of tourism in the state and to obtain more marketing funds.

While Florida has separate economic development and tourism functions, it elects to provide them through public-private partnerships. In 1996, Florida included both economic development and tourism functions in its Commerce Department. However, according to one Florida tourism official, the tourism industry decided that public

support for tourism could be enhanced by developing a better mechanism for private support. Therefore, the state terminated its Commerce Department and placed its tourism function with Visit Florida, a public-private partnership designed to promote Florida tourism. According to one Visit Florida official, Visit Florida is required to match every dollar of public funding with a dollar from private sources. Likewise, Florida placed its economic development in the hands of Enterprise Florida, an organization headed by a board of directors composed of top business, economic development, and government leaders, and receives financial support from both the state and private donations. The board is chaired by the state's governor.

A few states employ different models—Some other states have structured their tourism and economic development agencies differently than the models presented above. Three states have organized their tourism functions within state agencies other than economic development. For example, in Arkansas, the tourism function is housed within its state Department of Parks and Tourism, which is responsible for operating the state parks system and promoting tourism. Louisiana's tourism efforts are organized within its Department of Culture, Recreation, and Tourism, which includes functions such as state parks and historic preservation programs. Both states also have a separate agency responsible for commerce and economic development functions.

Various perspectives regarding potential cost savings and structure

Economic development and tourism stakeholders within Arizona, as well as representatives from four other states, were contacted during the audit and had various perspectives regarding the relative advantages and disadvantages of various organizations for tourism and economic development functions. Two themes emerged from these discussions—the potential cost savings resulting from combining economic development and tourism promotion functions, and the prominence of tourism within a combined agency.

These representatives and stakeholders expressed various viewpoints on the potential cost savings from combining these functions. Officials in other states indicated that most benefits of combining economic development and tourism functions arise from combined marketing functions. According to representatives from Utah and Washington, some cost savings arise from shared marketing efforts. For example, Utah's Department of Community and Economic Development combined the efforts of its economic development and tourism staff to develop marketing tools, such as co-producing a promotional DVD that covers a variety of subjects, from high-tech business opportunities to tourism and Utah's lifestyle, and sharing costs for a promotional brochure that covers the state's tourism and economic development opportunities. One official indicated that, previously, there had been overlap in these func-

tions. Further, according to one official in Washington's Business and Tourism Development unit, Washington was able to tap into the skills and professionalism of its business development and tourism areas to assist with its Web site design and marketing efforts. It has helped them improve their business relocation marketing material by using information developed by their Tourism staff. In contrast, according to one representative of the Arizona tourism industry, pooling marketing resources from Commerce and Tourism would be detrimental, since the two agencies have different missions and target audiences.

In addition to potential savings through combined marketing, officials also raised the possibility of small savings from staff reductions. However, Utah and Washington officials noted that when they combined the functions, the only staff savings was one director-level position. Moreover, two stakeholders from Arizona economic development and tourism organizations indicated that cost savings from combining the agencies would be minimal.

Some individuals that auditors interviewed expressed concerns over the prominence of the tourism function in a combined agency. For example, a representative from New Mexico's Department of Tourism noted that being a separate state agency helps it obtain more funding from the Legislature. In addition, while Utah's Division of Travel Development is part of an economic development agency, its tourism function has its own budget. As a result, one Utah official noted that it is important to make sure if the two functions are combined that tourism has equal prominence within the new agency. Three Arizona tourism and economic development stakeholders contacted during the audit expressed concerns that by combining the state tourism agency with the Department of Commerce, tourism might suffer a loss of stature. For example, one person from Arizona's tourism industry stated that one state agency trying to meet the needs of both tourism and economic development would lose focus and start to target one or the other, to the detriment of both.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2954, the Legislature should consider the following 12 factors in determining whether the Arizona Department of Commerce (Commerce) should be continued or terminated:

1. The objective and purpose in establishing the agency.

The Legislature established Commerce in 1985 with responsibilities for promoting and enhancing the State's economic growth and development. Its duties include encouraging international trade and investment, collecting economic and business-related information and distributing it to the public, supporting the expansion of existing businesses, and attracting targeted business to Arizona. In addition, it assists communities with economic planning and facilitates the State's workforce development system by supporting the Governor's Council for Workforce Development.

2. The effectiveness with which the agency has met its objective and purpose and the efficiency with which it has operated.

Commerce needs to improve its performance measures to better measure its effectiveness. A review of Commerce's performance measures found that, although it has established over 200 performance measures in its Fiscal Year 2003-05 Strategic Plan, many of these report its activities, but fail to report results. For example, programs such as International Trade and Investment and Small Business Services measure the number of visitors accessing Commerce's Web site pages as a performance measure. The pages being measured include directories, guides, and the Online Business Plan Counselor. However, although this measures an activity, the programs fail to measure the results achieved by accessing these pages. Instead, Commerce should develop a limited number of performance measures that address its service priorities and that more adequately report results, such as the number of businesses assisted online. Finally, the agency should use the performance measurement data to accurately assess the effectiveness and efficiency of economic development programs.

Additionally, Commerce could do a better job of measuring the effectiveness of tax credits if Revenue's confidentiality statutes were modified. Commerce currently administers five tax credit programs as one type of economic assistance, and nationally, literature generally shows that the effectiveness of these programs is limited (see Finding 2, pages 29 through 37). However, Commerce does not have access to complete information on all credits claimed, due to restrictions on what information can be published by the Department of Revenue for confidentiality reasons (see Finding 2, pages 29 through 37). If the Legislature made statutory changes allowing it and the public access to the amount of income tax credits claimed on company returns and required assessment of these programs' cost-efficiency, Commerce should develop better measurements of the tax credit's effectiveness. For example, the Oregon Secretary of State issued an audit report recommending that the state adopt measurements such as return on investment program efficiency, and the amount of program expenditures per estimated tax dollar generated. Moreover, Arizona statutes include standards for evaluating economic development programs, although three Commerce-administered income tax credit programs are currently excluded. A.R.S. §41-1505.07 requires the Commerce and Economic Development Commission (CEDC) to establish business incentives and assistance procedures for evaluating business retention, expansion, and location projects. Although this statute applies only to the CEDC, these procedures could be used as a basis for measuring the performance of economic incentive programs, including income tax credits.

3. The extent to which the agency has operated within the public interest.

Although some Commerce functions serve the public interest, others may not be necessary, and other groups could serve the public by administering some of the functions currently administered by Commerce (see Finding 1, pages 7 through 28). Specifically, some Commerce functions are available to businesses from other sources, while some functions that must be retained could be transferred to other state agencies.

4. The extent to which the rules adopted by the agency are consistent with legislative mandate.

According to the Governor's Regulatory Review Council (GRRC), Commerce has adopted some, but not all, of the rules required by statute. GRRC approved rules for the Technology Training Assistance and Arizona Job Training functions. However, according to GRRC, these are the only two Commerce programs that

currently have rules. GRRRC specifically noted 13 statutes that required rules, but for which no rules had been filed, including:

- A.R.S. §41-1505.02, which established the Main Street Program. GRRRC noted that this appears to be a grant program without any rules to determine applications for the funds, who is eligible, or the amount of funds to be awarded to each rural community.
- A.R.S. §41-1524, which established the requirement that the Enterprise Zone Commission submit an application to Commerce to designate a county as an Enterprise Zone. There are no rules to prescribe the application form for this tax credit.

However, according to Commerce, it plans to adopt additional rules in 2003 concerning the Commerce and Economic Development Commission, Enterprise Zones, the Rural Economic Development Initiative (REDI) Program, and the Arizona Main Street Program. Additionally, Commerce plans to amend its existing rules to incorporate 2002 statutory changes to its programs. Commerce estimates that the rules will be in place by December 2003.

5. The extent to which the agency has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.

According to Commerce, it notifies the public of proposed rules in accordance with A.R.S §41-1001 et seq. Also according to Commerce, it sought public input for the rules it adopted in 2001 from economic development partners, the Arizona Job Training Council, interested industry consultants, community colleges, and the public.

In addition to allowing public input into its rule-making process, Commerce indicated that it communicates information to its stakeholders in a variety of ways:

- Publishing news releases concerning agency activities that are faxed or e-mailed to media across the State and posted on Commerce's Web site, and distributing daily electronic news clippings to a list of subscribers.
- Sending bi-monthly electronic newsletters to members of the Legislature during the regular session.
- Convening technical advisory committees, leadership councils, and stakeholder groups from the community that provide input to Commerce for a variety of community and business-development initiatives.

6. The extent to which the agency has been able to investigate and resolve complaints that are within its jurisdiction.

This factor is not applicable, since Commerce does not have investigative or regulatory authority.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.

In general, this factor is not applicable because Commerce is not a regulatory agency with enforcement or oversight responsibilities. However, one provision in its enabling statutes, A.R.S. §41-1509(B)(4), states, "Each contract shall provide that the attorney general may commence actions that are necessary to enforce contracts and achieve repayments of loans made pursuant to this section."⁵⁰

8. The extent to which the agency has addressed deficiencies in their enabling statutes which prevent them from fulfilling their statutory mandate.

Commerce has addressed deficiencies in its enabling statutes during recent legislative sessions. The following outlines examples of Commerce-initiated legislation that was passed during the 2002 session:

- Laws 2002, Chapter 260 provides for the Clean Air Fund to be transferred to the Department of Environmental Quality.
- Laws 2002, Chapter 237 for Enterprise Zones, clarifies A.R.S. §20-224.03 and establishes additional limits on the credits and requires taxpayers to report qualified credits to Commerce in a more timely manner.
- Laws 2002, Chapter 264, authorizes the Governor's Council on Workforce Policy to assume the duties of the Arizona Job Training Council. Beyond additional reporting requirements, the law also makes two important programmatic changes: (1) the Council is required to develop guidelines to determine a minimum annual-wage rate that reflects current economic conditions to be established by each county to qualify for tax credits, and (2) unused portions of the rural and small business set-asides are to be made available to any qualified applicant after June 15 of each fiscal year.

9. **The extent to which changes are necessary in the laws of the agency to adequately comply with the factors in the Sunset laws.**

Four of Commerce's functions can be eliminated because they could be provided by other agencies, or because Commerce's role is limited. Specifically, the Legislature should consider eliminating the following programs (see Table 1, page 4):

- Small Business Services (A.R.S. §41-1504).
- Apprenticeship and Pre-Apprenticeship Services (A.R.S. §41-1504).
- Economic Information and Research (A.R.S. §41-1504(A)).
- Commerce's Growing Smarter-related Functions (A.R.S. §§9-461.06 and 11-806).

The Legislature should consider a range of options for four additional Commerce functions. Some of these functions duplicate services that the federal government or other state, local, nonprofit, or private entities provide. However, for each of these functions, auditors identified some advantages to the State for their continuation:

- International Trade and Investment Office (A.R.S. §§41-1504 through 41-1504.02).
- Business Attraction and Development and Office of Innovation, Technology, and Entrepreneurship (A.R.S. §§1552 through 41-1552.02, and 41-1514.01 through 41-1514.02).
- Rural Development (A.R.S. §§41-1505.02 through 41-1505.03).
- Arizona Film Commission (not established in statute).

Further, if the Legislature elects to sunset Commerce, it should consider five functions that should be retained but will need to have their statutes altered and transferred to other organizations. In addition, the Legislature should consider eliminating Commerce's administrative functions if the agency is terminated. Specifically, the Arizona Job Training Program and the Governor's Workforce Development Council could be transferred to the Department of Economic Security, the Energy Office could be transferred to the Arizona Department of Housing, Commerce's Private Activity Bond responsibilities could be transferred to the Commerce and Economic Development Commission, and Commerce's Arizona Military Airport Regional Compatibility Project could be transferred to another executive branch agency.

In addition, the Legislature should consider revising the Arizona Department of Revenue's confidentiality statutes, A.R.S. §42-2001 et seq, to allow a more complete reporting of the cost of income tax incentive programs to the State. Further, since research suggests tax incentive programs have limited effect on economic development, the Legislature should consider requiring a cost-effectiveness analysis of the Enterprise and Military Reuse Zones before these zones are renewed, terminating those that are not proven effective, and evaluating any Commerce-administered tax incentive programs before the Legislature considers extending or expanding it (see Finding 2, pages 29 through 37). Finally, the Legislature should consider similar evaluations before adopting new tax incentive programs.

10. The extent to which the termination of the agency would significantly harm the public health, safety, or welfare.

Based on audit work presented in Finding 1 (see pages 7 through 28), the termination of Commerce would not significantly harm public health or safety.

However, according to Commerce officials, the termination of Commerce would, over time, negatively and increasingly impact the public's economic welfare. Although Commerce acknowledges that, absent a state department, site selection consultants would still consider locating companies in Arizona, it also states that the lack of a state coordinating entity would make inquiries substantially more complicated, signal a lack of state-level commitment to business attraction, and could increase the likelihood of losing business prospects to competing states. The lack of a single, easily identifiable contact point for out-of-state organizations to gather information about relocating businesses to Arizona or increasing the amount of business they do with the State would be more significant in rural areas, where the economic development infrastructure is relatively limited. As such, the Legislature could consider retaining Commerce's function as a central point of contact, but not necessarily within Commerce.

11. The extent to which the level of regulation exercised by the agency is appropriate and whether less or more stringent levels of regulation would be appropriate.

Since Commerce is not a regulatory agency, this factor is not applicable.

12. The extent to which the agency has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

Commerce uses the services of private sector contractors and consultants for a variety of services and functions. For fiscal year 2002, Commerce outsourced almost \$950,000 worth of services to private contractors. Commerce competitively procures and establishes contracts with outside contractors for large-scale projects. Examples include contracts for the implementation of certain energy programs, and consultants in conjunction with the Arizona Main Street Program. Most recently, Commerce has worked with an outside contractor in the data gathering and completion of the Statewide Economic Study. Commerce also competitively procured a private contractor to survey land-use planning around Arizona's military bases. Further, Commerce uses the services of private sector companies through state-wide procurement contracts. Examples include temporary services, information technology and computer programming, and professional services such as marketing, advertising and promotion, facilitation, and external legal services.

Finally, according to Commerce, its foreign trade offices, located in Mexico, England, Taiwan, and Japan, are either partially or fully outsourced. The foreign trade office's appropriation totaled approximately \$1 million in CEDC monies for fiscal year 2003.

APPENDIX

Summary of five income tax credits administered by the Department of Commerce

Enterprise Zone

What it is—A.R.S. §41-1525 establishes that the owner of a business located in an enterprise zone is eligible for an income tax credit. A local commission nominates an area of the State, and if it meets state requirements, Commerce designates it as an Enterprise Zone. This income tax credit is designed to encourage companies to locate or expand in these locations. The companies can claim an income tax credit for a maximum of 200 net new qualified positions created each year. Companies may claim the credit for each of these employees for a maximum of 3 years. Moreover, Commerce supported the law change that requires companies claiming the credit to report to Commerce annually the number of qualified positions, the amount of capital investments made in the zone, and income tax credits qualified for.

What was claimed—In fiscal year 2002, Commerce reported that 183 companies claimed Enterprise Zone credits. Revenue also reported that from tax years 1994 through 2000, companies used over \$35 million in income tax credits, and at the end of 2000, companies held an estimated \$8.3 million in credits that could be used on future tax returns.

When it expires—The program began in 1989 and is currently open to companies relocating to these zones before July 1, 2006.

Defense Contractor Restructuring Assistance

What it is—A.R.S. §41-1508 provides for a defense contractor restructuring assistance program. The program, which began in 1993, allows defense contractors that have at least \$5 million in sales and employ at least 200 full-time staff dedicated to Department of Defense contracts to claim the credit accord-

ing to the statute. The credit was intended to help these contractors obtain Department of Defense contracts, diversify into commercial markets, and adopt new manufacturing techniques. Commerce certifies companies' eligibility for the credit for only 5 consecutive years. Companies are required to annually report to Commerce information such as the amount of the credit claimed on their tax returns.

What was claimed—According to Commerce, three companies claimed defense restructuring income tax credits for tax year 2000, the last year for which data is available. Revenue reports that they filed for nearly \$8.8 million in available income tax credits used from tax years 1996 through 2000, and at the end of 2000, companies retained an estimated additional \$15 million in tax credits that can be claimed on future returns. However, data for 1994, 1995, and 1998 is not available from Revenue to verify Commerce's data due to confidentiality restrictions cited by Revenue.

When it expires—This program has been closed to new applicants since June 30, 2001; currently, certified contractors can claim credits through 2011.

Environmental Technology Assistance

What it is—A.R.S. §41-1514.02 provides for an environmental technology assistance (ETA) program to recruit and expand environmental technology companies, encourage the use of environmental technology products, and encourage the development of an environmental technology industry. To become eligible, companies must develop a memorandum of understanding (MOU) with Commerce that describes program requirements, and submit an annual report of the number of people employed, capital investments made, and the tax benefits claimed from Revenue.

What was claimed—According to Commerce, five companies claimed this income tax credit in 2001. According to Revenue, in 1998, the latest year for which data is available, companies used over \$21 million in environmental technology assistance income tax credits from tax year 1994 through 1998 and retained an additional estimated \$36.2 million in credits that could be used on future returns.

When it expires—The program was created in 1993 and has been closed to new applicants since June 30, 1996. Currently, certified companies could undertake new projects in the future that would qualify them for tax credits. The credits may be carried forward for a maximum of 15 years.

Military Reuse Zone

What it is—A.R.S. §41-1532 establishes the military reuse zone income tax credit program to lessen the impact of military base closures and create jobs and capital investments in the aerospace and aviation industries. The statute was established in 1992, and two military bases have been designated as Military Reuse Zones: Williams Gateway Airport zone in 1996, and Goodyear Airport zone in 2002. To qualify, companies must enter an MOU with Commerce and annually provide information such as employment goals and performance in achieving those goals.

What was claimed—According to Commerce, in tax year 2001, only one company claimed this credit. According to Revenue, from 1996 through 2000, companies reported using over \$38,000 in income tax credits and retaining an estimated \$130,000 in credits that could be used on future returns.

When it expires—Military Reuse Zone designation is valid for 5 years, but the Governor may renew it once. Companies may claim this credit for a maximum of 5 years.

Information Technology Training

What it is—A.R.S. §41-1518.01 provides for a technology training assistance program that encourages employers to provide their employees with continuing technology skills training.

What was claimed—According to Commerce, 18 companies claimed information technology training income tax credits for tax year 2001. The total amount of information technology training income tax credits was not available from Revenue.

When it expires—The program began in 2000; tax credits are available until January 1, 2006.

NOTES

- 1 An additional function, tax credit administration, is discussed in Finding 2 (pages 29 through 37).
- 2 See Table 2 (pages 8 and 9) for a summary of the findings and recommendations of Finding 1 (see page 28) and their potential impact on Commerce and the General Fund.
- 3 Blakely, Edward J. *Planning Local Economic Development: Theory and Practice*. Thousand Oaks, Calif.: Sage Publications, 1994.
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- 15 Fisher, Peter S. and Alan H. Peters. Tax and Spending Incentives and Enterprise Zones.

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- 49 The review was conducted using information obtained from the Arizona Department of Commerce's auditors' own review of these states and a 2000-2001 survey of U.S. tourism offices conducted by the Travel Industry Association of America.
- 50 This statute relates to loans made from oil overcharge monies. An oil overcharge fund was established, and monies received by the State as a result of oil overcharge settlements are deposited in the fund. At least 15 percent of all monies received are to be allocated for loans, grants, and other purposes that benefit the low-income population. The Commerce director may grant loans from the principal balance of the oil overcharge fund to assist political subdivisions and nonprofit organizations of Arizona in funding energy projects.

AGENCY RESPONSE

Ms. Debbie Davenport
Auditor General
Office of the Auditor General
2910 N. 44th St., #410
Phoenix, Arizona 85018

Dear Ms. Davenport:

I respectfully submit this response to the Auditor General's performance audit and sunset review of the Arizona Department of Commerce.

I am pleased that the audit staff found no evidence of malfeasance, incompetence or mismanagement in the agency. I also appreciate the acknowledgment that Commerce has done much to address deficiencies in its enabling statutes, helping to improve program administration and service to constituents. The report points out that this Department needs to hone its numerous performance measures, and that the legislature should consider improving the reporting and evaluation processes associated with economic development incentive programs. I agree with those conclusions.

However, this review failed to measure the actual *performance* of the Department. This document contains little information regarding legislative intent, program performance, accomplishments and constituent value/satisfaction. In fact, this report, as evidenced by the conversation in our meeting of April 2, 2003, focused from the outset on significantly reducing agency size or *eliminating* Commerce entirely. Department officials made repeated efforts to shift the review premise from "what can be eliminated" to whether this agency is fulfilling its legislative mandates—to no avail. Furthermore, the report suffers by the fact that auditors chose to rely on sometimes outdated, conflicting or non-comparable literature instead of contact with constituents to assess the value of the Department activity.

Since my appointment as Director in January 2003, I have focused the agency to strengthen its ability to deliver value added integrated economic development assistance—particularly to rural areas--and to improve support to constituents statewide. From generating, gathering and analyzing data for use in decision-making at all levels of government, through foundational work at the community level in preparation for business expansion and attraction to the establishment of industry-driven workforce development, the Arizona Department of Commerce is solidly positioned to produce and implement the mandated 10-year state-wide, economic development plan. *The findings make implementation of a 10-year statewide economic plan or any focused economic development effort impossible.* This is foolhardy at a time when our economic base industries continue to erode.

We are disappointed that the audit team focused on eliminating or downsizing the agency rather than looking for opportunities to improve efficiency and constituent value.

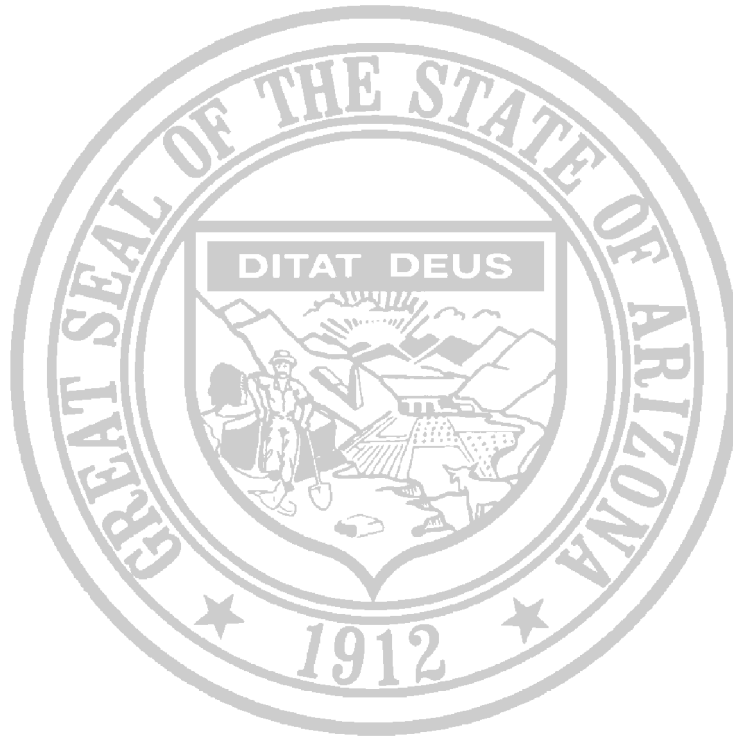
Respectfully,

Gilbert Jimenez
Director

**ARIZONA DEPARTMENT OF COMMERCE
RESPONSE TO THE AUDITOR GENERAL**

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ARIZONA DEPARTMENT OF COMMERCE RESPONSE TO THE AUDITOR GENERAL

The Arizona Department of Commerce respectfully submits that this performance report fails to recognize the fundamental purpose of the Department or the application of its multiple programs to develop useful economic information and promote economic, community and workforce development in Arizona.

Economic development is a team sport in which Arizona faces significant challenges: fierce competition from other states and countries; vast disparities in opportunities and resources between urban and rural communities; and a dearth of quality economic, community and workforce development information for decision makers at all levels. Consequently, local and regional economic development organizations depend on the Department to provide statewide leadership, coordination and both technical and financial resources. Recognizing this need, every state in the Nation has an organization similar to the Department.

Investment by the state and effective collaboration with local entities results in:

- Increasing per capita income. (Arizona per capita income is at 85% of the national average.)
- Increasing industry diversity. (Arizona ranks 40th among states in economic diversity and last among states considered competitors for the attraction and development of technology industries.)
- Increasing the tax base, which increases government resources to fund critical public services.

For maximum effectiveness in statewide economic development, the Department organizes its programs and efforts into four core areas:

PLANNING, RESEARCH & POLICY

Data + Analysis = Information

- Supplying state and local decision-makers with good information to support good decisions, the Department compiles, analyzes and reviews economic data from more than 125 federal, state, local and private sources.
- The Department's broad stakeholder base enables cost sharing among government, university and civic groups, as well as businesses. For the 2002 Statewide Economic Study, the Department leveraged more than \$100,000 of in-kind services to the state.
- The Department spearheads many of the state's most targeted and comprehensive research projects including:
 - ✓ Arizona's Economic Future
 - ✓ Positioning Arizona and Its Research Universities
 - ✓ Arizona's Economic Infrastructure
 - ✓ Arizona's Special Economic Sectors
 - ✓ Preliminary Examination of Arizona's Governmental Revenue Structure
 - ✓ Impact of Arizona's State Parks
 - ✓ Number of Small Businesses in Arizona
 - ✓ Community Economic Analysis (forthcoming)
 - ✓ Impact of Technology Sectors in Arizona's Economy (forthcoming)
 - ✓ Impact of Enterprise Zones (forthcoming)
 - ✓ High Technology Activities in Arizona (forthcoming)

COMMUNITY DEVELOPMENT

Smart Growth is the Foundation for Economic and Community Prosperity

- Rural areas face high employment, little economic diversity and inadequate infrastructure. The Department provides technical and financial resources to these communities with such efforts as the Rural Economic Development Initiative, Arizona Film Commission, the Main Street program and Growing Smarter planning assistance.

- Military Airports Regional Compatibility Project. The Department coordinates the effort to resolve land use issues and preserve Arizona's military bases, impacting 83,000 jobs and generating \$5.7 billion annually. The Department secured a \$440,000 federal grant that effectively doubles the budget to continue to work at other bases.
- Through the Greater Arizona Development Authority, the Department has leveraged a \$1.1 million investment into \$45 million in low-interest loans. Recent issues include:
 - ✓ Coolidge issued \$3.795 million in revenue bonds for a police/fire building project – and saved \$197,396
 - ✓ Guadalupe issued \$3.445 million in revenue bonds for capital projects and debt refinancing – and saved \$193,680
 - ✓ Clarkdale issued \$400K in revenue bonds for public office space renovations – and saved \$37,655
- The Department works with communities, schools and small businesses to promote energy conservation. In FY03, the Department pulled down \$5 million in grants at no cost to the GF.

GLOBAL BUSINESS DEVELOPMENT

Companies Seek a Central Point of Contact

- More than 80% of companies looking to locate and expand facilities make initial contact with the Department for information such as business climate, workforce and various regions of the state.
- The Department provides more than 30% of metropolitan locate leads and nearly 100% of rural leads.
- The Department leads efforts to grow the economic base, convening cities, universities and private resources to land the International Genomics Consortium and launch the Translational Genomics Research Institute – initiatives that benefit all regions of Arizona.
- Over the next three years, 70,000 new direct and induced jobs from companies assisted by the Department between 1999 and 2002 will result in nearly \$400 million in additional state tax revenue, per noted economist Elliott D. Pollack.
- In FY03, the Department helped 54 companies locate or expand, 14 in rural, 40 in metropolitan areas, together resulting in 14,126 NEW jobs.
- In the past two years, the Department provided export promotion assistance to over 600 small and medium-sized companies. Actual and projected export sales attributed to this assistance conservatively total over \$1.45 Billion.

WORKFORCE DEVELOPMENT

Skilled Workers Are Business' Most Important Resource.

- Today's economy is driven by accelerated product development requiring continued training and increased productivity. Business' top issue is the need for skilled, flexible employees.
- In 2003, the Department leveraged \$12 million in job training tax funds into more than \$25 million of training. Over the next three years, more than 20,000 employees statewide will be trained with these funds.
- The Department combines on-the-job training and related classroom instruction through the state's Registered Apprenticeship program, providing employees the experience needed to succeed in a skilled occupation.
- The Department is improving the coordination of more than \$200 million in federal and state workforce development dollars through Arizona Workforce Connection – a streamlined system aimed at cutting red tape and providing valuable training services to Arizona companies.
- During the Rodeo/Chediski fire, the Department pulled down \$2.3 million in federal funds to retrain workers dislocated by the disaster.

RECOMMENDATION AND RESPONSE SUMMARY--FINDING 1

Recommendation #1: The Legislature should consider eliminating the following Department of Commerce functions, since, to some extent, they duplicate programs operated by other entities:

- Small Business Services
- Apprenticeship Services
- Economic Information and Research, and
- Growing Smarter Functions

Department Response #1: The finding of the Auditor General is not agreed to and the recommendation will not be implemented. (*See Attachment 1-4*)

Small Business Services: The assertion that this function is duplicative of other small business entities and state agencies such as SBDCs is false. Additionally, the report does not adequately address the Department's work with Minority and Women-Owned businesses and misunderstands the Department's small business advocacy role.

Apprenticeship Services: The assertion that this function is duplicative of services that could be provided by the Department of Labor (DOL) fails to reflect the fact that the recommendation would result in lower service levels, reduced accountability, and the inability for the State to ensure the efforts alignment with the needs of Arizona businesses. Also, after January 1, 2004, any federal assistance would be managed remotely from an office in Nevada, providing only minimal service.

Economic Information and Research: This function is fundamental and absolutely critical to the effective operation of all agency programs. The assertion that this function is duplicative of programs operated by other entities is false and misunderstands the development of economic information/policy in several ways. In addition, without additional funding, no other entity has the capacity or desire to fulfill this role.

Growing Smarter Functions: This function is the State's only central point of expertise regarding technical components of the Growing Smarter Act. Eliminating it would severely impede statewide efforts to promote planned community growth, particularly in rural areas. Also, this activity is inextricably linked with the Department's work regarding military base preservation.

Recommendation #2: If the Apprenticeship Services function is eliminated, the Legislature should consider transferring the Pre-Apprenticeship services to the Arizona Department of Transportation.

Department Response #2: The finding of the Auditor General is not agreed to and the recommendation will not be implemented. Fragmenting this function from the Department's Apprenticeship Services function and the business-led workforce system will impede the state's ability to develop statewide training strategies for in-demand skills.

Recommendation #3: The Legislature should consider options for addressing the following functions:

- International Trade and Investment Office – The Legislature could eliminate funding for this function, retain it, or, similar to a federal program, charge business for these services to help recover a portion of the costs.
- Business Attraction and Office of Innovation – The Legislature could eliminate this function, or retain some or all functions within this function.
- Rural Development – The Legislature could eliminate or retain this function.
- Arizona Film Commission – The Legislature could eliminate this function, or transfer it to the Arizona Office of Tourism.

Department Response #3: The Department submits that these functions should be retained and the following elements of the recommendation will be considered for implementation. (*See Attachment 5-8*)

International Trade and Investment Office: Unlike federal operations, the Department provides assistance focused on connecting Arizona companies with trade opportunities, by providing export counseling, generating trade leads and organizing trade events. Going forward, the Department will develop a fee structure, currently authorized by A.R.S. 41-1504.01, to charge businesses for export promotion services, helping to recover a portion of associated costs.

Business Attraction and Office of Innovation: Because it is the only statewide economic development entity, local and regional organizations depend on the Department to generate new business prospects, coordinate various location projects, and assist with local business retention and expansion efforts. Minimizing State assistance will substantially hamstring local economic development initiatives, particularly in rural areas. Moving forward, to more specifically measure the relative value of assistance, the Department will score locates based on the level of service provided and more accurately survey client companies.

Rural Development: This function provides critical state level assistance, helping small and rural communities organize and create the necessary public infrastructure to broaden their economic foundation, attract new businesses, expand the tax base and improve per capita income. This work is foundational, in that it provides local communities with technical expertise and modest grant monies to organize and implement locally driven economic development efforts. The Auditor General’s review found “the communities that Rural Development assists view the function as valuable.”

Arizona Film Commission: Attracting a film production company to Arizona injects money into the local economy, particularly important in rural areas. Local film offices depend on the Arizona Film Commission. No other organization serves as the central point of contact for production executives who are comparing production opportunities among competing states. When these executives contact the Department they are not thinking of a particular community, they are thinking of a particular “look.” The Department helps them match that “look” with a location in Arizona, presenting various locations and connecting them with local communities. Every state has a film commission because the film community desires a state-level, knowledgeable point of contact to meet their unique and complex needs. Transferring the function saves no funding and only disconnects the Commission from other economic development efforts.

Recommendation #4: The Legislature should consider eliminating General Fund support for the Arizona Job Training Program. The Auditor General recommends funding administration of the program from the fund, which is created by a dedicated tax and yields an estimated \$14 million annually.

Department Response #4: The finding of the Auditor General is agreed to and the Department will seek legislative approval to implement the recommendation.

Recommendation #5: While the Legislature could elect to retain the eight programs above, should it eliminate or transfer these functions it could also elect to sunset Commerce. If Commerce were sunset, the following five functions should be retained and could be transferred to other state agencies:

- Transfer the Arizona Job Training Program’s administration to the Department of Economic Security
- Transfer staff support for the Governor’s Workforce Development Council to the Department of Economic Security
- Transfer the Energy Office to the Arizona Department of Housing
- Transfer administration of tax-exempt private activity bonds to the Commerce and Economic Development Commission

- Transfer responsibility for the Arizona Military Airports Regional Compatibility Project and its federal Department of Defense Grant to another executive branch agency.

Department Response #5: The finding of the Auditor General that these programs be retained is agreed; however, the recommendation to transfer the programs is not agreed to and will not be implemented.

The report confirms that these functions should be retained because they provide valuable services to Arizona businesses, workers, cities, or counties, and do not require state appropriations.

Arizona Job Training Program: The Job Training Program is funded by a dedicated payroll tax and serves as one of only two state-level business attraction and retention tools. Only the Department has the stakeholder base and expertise to strategically administer this program. Transfer of a business-focused program to a welfare agency diminishes the efficacy of the program.

Governor's Workforce Development Council: The Department of Labor has consistently asserted that each state's workforce development strategies be focused on the workforce system's primary client – the business community. The Department is the State's link to the business community and, as such, is in the best position to administer this function within the greater context of statewide economic development strategies.

Energy Office: The report's assertion ignores the critical policy role of this function. As the recent gas situation demonstrated, reliable infrastructure is an absolute necessity for business retention and job creation. The Department informs growth and planning decision-making statewide and has the State's unique expertise regarding energy policy issues and trends that directly impact business' ability to locate and remain in the state.

Tax-exempt Private Activity Bonds: This function is outside the mission and competency of the Commerce and Economic Development Commission. Current status enables alignment with other key Department resources and statewide economic development strategies.

Arizona Military Airports Regional Compatibility Project and Department of Defense Grant: The Department is the only State agency with the planning expertise to ensure effective monitoring and implementation of the project, and to promote integration of this effort with Growing Smarter implementation.

Recommendation #6: If the Legislature elects to terminate Commerce, it should also eliminate Commerce's administrative functions.

Department Response #6: The finding of the Auditor General is not agreed to but the recommendation would be implemented if the Legislature chooses to eliminate the Department.

If the Department is eliminated, Arizona would become the only state in the nation without an effective statewide economic development agency, relegating the state to third-tier business environment status, generating much negative publicity and costing much more in future dollars to rebuild.

Additionally, Arizona would be unable to address two of its most pressing economic challenges – low per capita income and a lack of industrial diversity (40th among states). Arizona's per capita income is 85% of the U.S. average and dropping. Improving opportunity for Arizona's citizens requires attracting and growing new, high paying jobs in diverse industries.

Rural communities, which look to the Agency more than the metropolitan areas for infrastructure development and business relocation opportunities, will be especially impacted.

RECOMMENDATION AND RESPONSE SUMMARY--FINDING 2

Recommendation #1: The Legislature should consider modifying the Department of Revenue's statutes to allow more complete reporting of the income tax credit program's fiscal impact on the State.

Department Response #1: The finding of the Auditor General is agreed to and the Department will advise the Legislature as it considers the recommendation.

At a minimum, the Department should be permitted to compare its data with DOR's to check accuracy. Currently, the Department receives some confidential information from the taxpayer but has no way to validate this information independently.

Recommendation #2: The Legislature should consider mandating in statute that a cost effectiveness analysis be conducted before:

- Commerce reviews each Enterprise Zone
- The Governor and/or Legislature renew each Military Reuse Zone; and
- The Legislature renews or revises any Commerce-administered tax incentive program.

Department Response #2: The finding of the Auditor General is agreed to and the Department will advise the Legislature as it considers the recommendation.

Unlike many other states, no resources are allocated to the Department to conduct cost/benefit evaluations of economic development incentives. Local zone administrating entities may not have resources for this purpose. The Department recommends that the legislature allocate sufficient resources for program evaluation.

In general, the Department agrees that the program is difficult to measure but does not agree with the Auditor General's impression that the costs exceed the benefits, and that incentives do not significantly impact job creation or business location and expansion decisions. First, the literature review was not specific to Arizona - Arizona's program is somewhat unique. Second, a June 2003 study entitled: "Cost-Benefit Analysis of California's Enterprise Zone Program" refutes some of the major sources of the Auditor's report. The study casts serious doubt on the methodology used by earlier researchers and suggests that if properly and conservatively evaluated, the California program clearly generates more revenues than it costs the state. ([See attached Auditor General Reply](#))

More importantly, the impression that the EZ program does not create jobs is erroneous. For example, if it is claimed that jobs are not created, there is no incentive provided by law. Moreover, if a company fires an employee that was among the new hires promised, the incentive can no longer be taken. Also, if a company closes or leaves the zone location, the credits stop and the company is prohibited from using carry forward credits.

Recommendation #3: The Legislature should consider mandating in statute that any Enterprise Zones and Military Reuse Zones that are found not to be cost-effective are terminated.

Department Response #3: The finding of the Auditor General is agreed to and the Department will advise the Legislature as it considers the recommendation.

It is important to note that eliminating a designation may create issues regarding vested rights. Firms make business decisions based on the understanding that the enterprise or military zone benefits will be available to them. A claim might be made against the State if a current operational zone is terminated.

As a result, the Department recommends that evaluation and potential termination occur only at the program level and when the program is subject to a normal five-year sunset review.

Recommendation #4: The Legislature should consider requiring a cost-benefit analysis of any new tax incentive programs prior to adopting them.

The Legislature should consider requiring a cost-benefit analysis of any new tax incentive programs prior to adopting them. The finding of the Auditor General is agreed to and the audit recommendation will be implemented should the Legislature incorporate this administrative discretion upon adopting new tax incentive programs.

Although it is true that an incentive or tax policy may not be as important as other factors in making location or expansion decisions, states do become finalists only when these more important factors are satisfied, such as adequate infrastructure and a well-trained workforce. Incentives often tip the scale in favor of one state over the next.

Finally, it is very misleading to suggest that Arizona has a liberal incentive policy or has made a habit of providing incentives similar to the examples the Auditor General used in referencing Tennessee, Kentucky, or Alabama when attracting firms to the state. In fact, Arizona has been very conservative with its incentive programs and it is not accurate to compare activities in those states with Arizona. .

ATTACHMENT

1) Small Business Services is the only statewide, one-stop resource for business. This service helps cut government red tape and reduces barriers to small business development by efficiently directing potential and existing entrepreneurs to available public/private resources and regulatory entities – without the run around.

The Legislature created the Department's small business function to address the following issues:

- Small businesses face significant challenges navigating federal, state and local regulations, acquiring licenses and permits, and accessing public/private resources. In State government alone, over 57 offices impact business to some degree.
- Minority and women-owned businesses often face a unique set of challenges and historically have been under-represented in obtaining state procurement opportunities.
- Small business needs a conduit for entrepreneurs to connect with the Governor, Legislature and State agencies in order to address government barriers to business creation, essentially an ombudsperson.

By creating a centrally located information resource, the State improved service to Arizonans, providing a statewide connection of the multiple federal and local public/private small business organizations, cutting red tape and removing barriers to small business development. By utilizing on-line technology and targeted community outreach, the Department has been able to trim staff from 10.5FTE to 3.5FTE, while maintaining quality service. The Department's services are accessed through the Arizona Business Connection an average of 9,000 times a month. Staff participates in minority and women-owned business outreach an average of 6 times per month and conducts quarterly procurement opportunity informational functions targeted to minority and women-owned service providers.

Federal and local small business organizations rely on the Department's function. The Auditor argues that the network of Small Business Development Centers (SBDC's) could provide the same services. The Department works closely with these centers to ensure no duplication takes place. In fact, the SBDC's connect customers with the Department to address questions regarding basic licensing and regulatory issues.

- According to the State Director of the Arizona SBDC Network, "the SBDC does not provide the important informational and coordinative services that the Department of Commerce provides to small businesses and small business services provider organizations."¹

The Department collaborates with the State Procurement Office and reaches out to the minority community to improve access to procurement opportunities. The Auditor argues that the "... SBA operates two women's business centers located in Phoenix and Tucson that provide information to women business owners such as how to apply for federal contracts ...". The fact is that the Department's function has statewide responsibility and is most appropriately suited to facilitating improved minority access to state contracts. This function connects with various entities, local, regional and federal, to improve overall opportunities for minority businesses.

Finally, the Auditor General misunderstands the Department's small business advocacy role. Certainly, membership driven business organizations advocate on behalf of dues paying members, and they serve their clients well. The Department's function is one of equal access to state government for all Arizona small business owners.

¹ Mike York, State Director of Arizona SBDC network, wrote in a letter to Director Jimenez.

- Currently, this function is evaluating opportunities to streamline the state business permitting process, something no membership organization can effectively undertake; developing a stakeholder advisory council; identifying methods to better measure minority access to procurement opportunities; and helping to improve small business outreach among all Department programs.

2) Apprenticeship and Pre-Apprenticeship Services Program helps businesses address their top priority – access to a qualified workforce.

The Department assists Arizona employers with designing and implementing apprenticeship training programs, helping develop a supply of skilled labor. The Auditor contends that the federal government is obligated to provide these services if the state does not do so. However, the report fails to reflect the fact that the recommendation would result in lower service levels, reduced accountability, and the inability for the State to ensure the effort's strategic alignment with the needs of Arizona business. The Department has implemented 125 apprenticeship programs in Arizona.

- The federal Department of Labor (DOL) would be obligated to provide only minimal staffing.² The Auditor notes that 23 States rely solely on Federal support for this function, however, the report reveals no discussion of service or stakeholder satisfaction levels in those states. Recently, the Department was notified that DOL will eliminate its Arizona based FTE regardless of this recommendation beginning January 1, 2004. Any future Federal assistance will be provided out of DOL's Nevada-based office. Service levels would inevitably decrease to mere updates of new federal guidelines and new apprenticeable occupations. Presence in Arizona would be limited to possible participation at quarterly meetings to address questions or concerns about federal issues.
- Commerce maximizes program efficiency and customer service to Arizona businesses by working with various local, state, or federal programs/initiatives. Most importantly, it aligns apprenticeship training opportunities with the workforce needs of businesses statewide. The federal government would not support apprenticeship operations sufficiently to pursue these objectives.

3) The Economic Information and Research function analyzes data, develops information, and conducts research that is fundamental and critical to all agency programs. The function also provides quality information to state and local decision-makers regarding economic, community, and workforce development.

The Auditor states that “The information Commerce maintains is already available from other sources, and some of these sources have additional economic information and research and analysis that is unavailable from Commerce.” This criticism discounts the legislative mandate and demonstrates a fundamental misunderstanding of the development of economic information/policy. First, it isn't just about the availability/access to data, information and research. The primary function of EIR is to integrate multiple, disaggregated data sources, reports and other information, analyze the results and implications from an economic, community and workforce perspective, and conduct appropriate peer/public review. Only at the end of this process do these separate elements become useful for legislators, state and local officials and others in making well-informed public policy decisions. One data set or a single report does not a good decision make.

The Auditor states “...Commerce's role is generally not to perform its own research, but rather to coordinate research conducted by other entities, such as business, government, university, and civic groups.” EIR performs research in the most efficient and effective way – EIR identifies the research need, defines the scope of work, contracts with appropriate consultants/economists, approves and oversees research methodology, and approves the final results as credible and reliable. Throughout the research process, EIR involves a wide variety of agency constituents. EIR created the Economic Research Advisory Committee, a volunteer group that brings together the collective knowledge and wisdom of more than 15 seasoned economists on important economic

²Ronald M. Johnson, Region 6 Director, DOL Employment and Training Administration, in a letter, January 6, 2003.

issues. With all three universities and several state agencies involved, the collaborative effort creates synergy and less duplication of research, saves the state money, and ensures objective and accurate results.

- Department led research projects include: Arizona Economic Base Study, Arizona's Economic Future, Positioning Arizona and its Research Universities, Arizona's Economic Infrastructure, Arizona's Special Economic Sectors, Economic Impact of Arizona's State Parks, Number of Small Businesses in Arizona. Forthcoming reports include: Community Economic Analysis, Impact of Technology Sectors in Arizona, High Technology Activities in Arizona. Department information has been used and referenced in numerous policy-making areas, most recently the Governor's Essential Services Task Force and the Governor's Council on Workforce Policy.

Also, EIR centralizes data and information and ensures its consistency across the Department's varied program responsibilities, ranging from local infrastructure development to business assistance. Data and information on the topics of economic, community, and workforce development are generated by more than 125 individual local, state, national and international sources. EIR ensures Department programs have accurate information.

As the legislatively mandated central clearinghouse for economic, community and workforce development research, EIR serves the public interest by assisting companies. If companies looking to relocate have to visit multiple agency, university and local government web sites to judge the suitability of Arizona, the state will lose out to competing states every time. The Department's EIR clearinghouse database, community profiles, research/studies, and other economic information tools provide the only centralized capacity to facilitate favorable consideration of Arizona communities. Local communities, particularly those in rural areas of the state, rely on EIR's centralized data for their own economic development efforts. No other statewide public or private source has the incentive to provide this perspective and service without additional funding.

4) The Growing Smarter function is Arizona's only central point of expertise regarding technical components of the Growing Smarter Act, local planning, and military base preservation. This function is critical to statewide efforts – particularly in rural areas – to promote sensible, planned development.

The Department believes implementation of the Auditors recommendation will have the following impacts:

- Diminish state leadership to promote sensible, planned growth statewide. Growth issues are consistently among the top agenda items of state, local and civic leaders. As the only state entity with expertise in planning, zoning, and Growing Smarter statutes, the Department is absolutely critical to state leadership in this area. No other state agency is monitoring compliance and implementation of the Growing Smarter statutes. For this reason, the Growing Smarter Oversight Council, the panel charged with monitoring the implementation of the Act, relies heavily on Department staffing and expertise.
- Adversely impact the ability of local communities to implement quality growth plans and to comply with the mandates of Growing Smarter. Growing Smarter is an unfunded mandate. 79% of Arizona's rural communities have neither in-house planning expertise nor the capital funds to hire consultants. To provide help, State statute mandates the Department provide technical and financial assistance to communities and counties.³ These constituents consistently report that this assistance is valuable to local efforts. Over 40 communities and counties have been awarded grant assistance since 1998. Nearly 45% of Arizona's jurisdictions are still the process of updating general plans in compliance with the Growing Smarter legislation.

³ Have received Department assistance: Apache Junction, Avondale, Benson, Buckeye, Camp Verde, Carefree, Casa Grande, Cave Creek, Chandler, Clarkdale, Clifton, Colorado City, Coolidge, Cottonwood, Douglas, Eager, El Mirage, Eloy, Fountain Hills, Florence, Gilbert, Glendale, Globe, Holbrook, Huachuca City, Kearny, Quartzsite, Lake Havasu City, Litchfield Park, Oro Valley, Paradise Valley, Payson, Peoria, Phoenix, Pinetop-Lakeside, Prescott Valley, Quartzsite, Queen Creek, Sahuarita, San Luis, Scottsdale, Sedona, Snowflake, Somerton, St. Johns, Superior, Tempe, Williams, Winslow, Youngtown, and Cochise, Coconino, Gila Graham, Greenlee, La Paz, Pima, Pinal, Santa Cruz Counties.

- Growing Smarter functions are inextricably linked with the Department’s work to protect Arizona’s military bases (Military Airports Regional Compatibility Project). Growing Smarter statutes include military planning and zoning mandates related to land use compatibility around active military airports. The mandate for communities and counties to provide plan reviews and amendments to the Department maintains the link between state efforts to preserve Arizona’s military assets and the integration of state guidance into local growth governing documents.

5) International Trade and Investment Office, utilizing its foreign trade offices in Europe, Mexico, Japan and Taiwan, provides tailored assistance focused on connecting Arizona companies with trade opportunities – export promotion counseling, trade leads, Arizona-specific trade events, etc.

When Arizona’s businesses export goods and services, they import dollars to the local economy, creating substantial economic impact here in Arizona. Jobs connected with international exporting pay an average of 5-20% higher wages⁴. However, accessing these markets is difficult for small and medium-sized companies. In FY03, the Department conducted 817 technical assistance sessions with 356 companies and business organizations, and organized 5 targeted trade missions. 95% of survey respondents rated the service as important to the businesses’ ability to explore international markets⁵.

- An ASU College of Business study concluded: “Efforts to organize trade shows and trade missions, to develop leads for trade and investment, and to generally promote the Arizona economy are for the benefit of Arizona firms and workers. **Since the benefits are specific to the state, the activities should be carried out at the state level.**”
- The Department’s staff and foreign offices provide customized services that generate opportunities specifically targeted for Arizona companies, thus providing the companies with a competitive edge and more timely information and opportunities. The federal Export Assistance Centers and the foreign-located representatives of the US Commercial Service do not provide such specialized services. According to director of the Arizona Export Assistance Centers for the US Department of Commerce, “Eliminating [state department] assistance to us and our small business sector would result in lost exports, lost jobs, and lost revenue for the state of Arizona. Funding the Arizona Department of Commerce is an investment in our state’s future.”⁶
- Though federal centers work with Arizona companies, when a company requires information or services that are to be sourced/performed outside of the U.S., federal resources overseas handle the inquiries. These foreign-based offices do not work solely for Arizona companies – they work for companies in all 50 states. As a consequence, Arizona companies are lumped into mass, non-customized efforts. For this reason, most states maintain international export organizations to serve local companies. A survey of states’ international business development programs found that of 42 states responding, 37 maintain foreign offices. The average is 6.5 (Pennsylvania has 19; South Dakota has 1).⁷ State contacts indicate that a key reason they maintain foreign offices is to provide local companies with targeted leads and services.

6) The Business Attraction function markets the state to attract new businesses and provides state assistance to existing businesses seeking to expand.

A Department-commissioned report concludes that Arizona ranks 40th among states in industry diversity, last among competing states in development or attraction of technology based industries, and has per capita income

⁴ Howard Lewis III and J. David Richardson, “Why Global Commitment Really Matters.”

⁵ Annual survey conducted by the Department of customers that have received extensive support from International Trade and Investment Office.

⁶ Frank Woods, Director, Arizona Export Assistance Centers, in a letter to the Department, May, 2003.

⁷ Source: The State International Development Organizations and Council of State Governments, December 2002.

at 85% of the national average.⁸ Also, recent budget shortfalls demonstrate the importance of expanding the tax base via business development. Though these facts are a function of many factors, targeted economic development efforts can attract businesses from diverse industry sectors that pay salaries above per capita and make substantial capital investment. The Department's work to this end provides critical assistance to local and regional economic development efforts statewide.

The Department generates the majority of business prospects for local and regional business attraction. Companies seek a central point of contact when considering locating in a given state. A national survey concluded that 80% of site selectors first contact the state economic development entity, seeking information such as business climate, workforce data and opportunities throughout the state.⁹ A separate survey reports that a top priority of site selection consultants is a single contact at the state level that can handle or expedite their requirements for location.¹⁰ Confirming this, the Auditor accurately states "... economic development officials contacted during the audit reported that businesses prefer to work with a neutral, state-wide contact that can provide impartial information about potential sites and answer questions about a state's business climate."

While there are many local economic development entities, the Department of Commerce is the only statewide organization. Local groups look to the Department for varying degrees of assistance. Rural areas depend almost exclusively on Department-generated qualified business prospects (metropolitan Phoenix about 50% and Tucson about 75%). The Department tailors its outreach to the needs of its stakeholder communities or organizations. All constituents depend on the Department for state-level coordination of some projects and assistance regarding state programs, resources and regulations. Rural areas rely on Commerce for a full range of assistance, including providing detailed information regarding state incentives, operating and tax environment, site selection services, industry expertise, workforce development resources, supply chain contacts, available and appropriate land and real estate, and governmental resources provided by the Department's local, state and federal partners. Recently in a survey of companies served by the Department, all respondents ranked this function's services as important to the decision to locate.

- In FY03, the Department provided location or expansion assistance to 54 companies (21 outside of Maricopa County). Expected 3-year job creation over 14,000 new jobs, with an average salary over \$40,420 (above Arizona per capita), and making capital investment of over \$568.6 million. The Department coordinated 187 prospect visits (159 non-Arizona companies; 28 Arizona companies seeking to expand)
- The Department played the lead role in establishing the Translational Genomics Research Institute (Tgen) and landing the International Genomics Consortium.
- Over the next three years, 70,000 new direct and induced jobs created by companies assisted by the Department between 1999 and 2002 will result in nearly \$400 million in state tax revenue.¹¹ The Auditor correctly points out that many factors played a role in company decisions to create these jobs. Department assistance benefits companies to varying degrees. The fact remains, however, that all companies in the study sought state assistance. The Department only lists companies where assistance provided meets a value-added threshold. Moving forward, to more specifically measure the relative value of assistance, the Department plans to score locates based on the level of service provided and to more accurately survey client companies.
- The Department launched an online supply chain development portal. AzBusinessLINC.com increases buyer awareness of products and services available throughout the state and identifies sales opportunities for Arizona companies encouraging transactions in and out of state. Successes to date from the test pilot in Southern Arizona: a \$50 million contract of the Department of Defense in Sierra

⁸ Economy.com "Arizona's Economic Future"

⁹ The Marketing Center, "Factors in Site Selection", February 1999.

¹⁰ O'Neil and Associates, 1999.

¹¹ Elliot D. Pollack & Co. Economic Impact Study

Vista; \$1.2 million in international contracts; nearly \$400,000 IT service contract award by a public sector entity in Tucson and several hundred thousand dollars of expected sales by a wire cabling company in Nogales.

- Targeted marketing efforts concentrate on face-to-face meetings as well as participation in trade shows including ComDef and Bio 2004 where existing industries such as Aerospace/Defense and achievements such as the attraction of TGen can be leveraged to attract new locates. A regional initiative marketing clusters of Arizona communities where a critical mass of industry, workforce, and infrastructure exist has also been launched to leverage local resources.

Finally, the Department must address a point by the Auditor that may mislead the legislature: “Research suggests that state-operated economic development efforts have a limited impact. Specifically, one report noted that locally based economic development and employment generation is more likely to be successful if initiated at the community and local level rather than elsewhere.” The cited text is *Planning Local Economic Development: Theory and Practice*. According to the co-author of the third edition of this text, Dr. Ted K. Bradshaw, “[The Department of Commerce] approach seems more in line with what we advocate in which states support local development initiatives and doing things more effectively done by the state than individual communities. In the quote [above], it appears that the auditors misinterpreted the findings.”

[\(See attached Auditor General Reply\)](#)

7) Rural Development functions provide technical and financial assistance important to local initiatives in resource constrained rural communities.

Arizona’s rural communities face significant economic challenges – high unemployment, low paying jobs and poor industry diversity – and they lack the local resources with which to address these issues. The Department’s Rural Development function provides critical state level assistance, helping small and rural communities organize and create the necessary public infrastructure to broaden their economic foundation, attract new businesses, expand the tax base and improve per capita income. This foundational work provides local communities the technical expertise and modest grant monies to organize and implement locally driven economic development efforts. The Auditor General’s review found “... the communities that Rural Development assists view the function as valuable.”

The two key programs in this effort are the Rural Economic Development Initiative (REDI) and Main Street program. REDI provides technical and financial assistance to more than 30 accredited rural communities. This assistance is typically the only help available and is critical to the ability of many rural communities to pursue economic development strategies. In FY02/03, the Department leveraged approximately \$140,000 in state resources into more than \$748,500 in local economic development projects (examples include rural business development marketing campaigns, site selection materials, labor force studies, etc.).¹² Lack of adequate telecommunications infrastructure is a premier barrier to rural business attraction efforts. The Department is supporting multiple community telecommunications assessments to map existing assets and identify gaps to be addressed by local decision makers.

The Main Street Program organizes and assists rural efforts to revitalize downtown business districts, critical to the economic sustainability of many small communities. This revitalization prevents economic leakage by providing local residents access to retail establishments, helping capture tourist spending that imports new dollars into the community and supports local government services. Since 1986, Arizona Main Street efforts have facilitated 8,186 new jobs, 1,529 new business, 3,774 building projects and \$1.4 billion in local reinvestment. To be sure, the Department does not claim the full magnitude of the impact; however, the results are a testimony to the organized state, federal and local collaboration led by the Department.

¹² REDI participating communities include Benson, Casa Grande, Coolidge, Cottonwood, Eagar, Eloy, Flagstaff, Globe, Hayden, Kingman, Lake Havasu City, Miami, Nogales/Santa Cruz County, Payson, Pima, Pinetop/Lakeside, Prescott, Prescott Valley, Safford, St. Johns, San Luis, Show Low, Sierra Vista, Snowflake, Somerton, Springerville, Taylor, Thatcher, Wellton, Winkelman, Yavapai-Apache Nation, Yuma.

The Department disagrees with the Auditor General’s suggestion that the Rural Development function could be eliminated. The Auditor argues that a) “Funding and technical support is available to rural communities from other sources,” principally the State Historic Preservation Office (SHPO); and b) “... private fund-raising efforts have created funding for some rural development projects, although these efforts would need to increase if Commerce Main Street program were eliminated.” First, SHPO focuses on preservation planning, but provides no assistance regarding commercial district development or business retention, the critical element in many economic development strategies. Second, the Department encourages private sector contribution by requiring matching funds to public financial assistance. And third, the recommendation does not address the fact that no other entity is positioned to provide assistance delivered by the Department’s REDI program, leaving many communities with little or no opportunity to develop and implement business attraction and expansion strategies. Absent the Department’s Rural Development function, resource-limited rural communities will face increased barriers to economic development.

8) The Arizona Film Commission attracts film production companies to Arizona, particularly rural areas, injecting substantial economic resources to the local economy.

Attracting a film production company to Arizona injects money into the local economy, particularly important in rural areas. Local film offices depend on the Arizona Film Commission. No other organization serves as the central point of contact for production executives who are comparing production opportunities among competing states. When these executives contact the Department they are not thinking of a particular community, they are thinking of a particular “look.” The Department helps them match that “look” with a location in Arizona, presenting various locations and connecting them with local communities.

- Local communities depend heavily on the Department’s statewide coordination.
- Production companies rely on the Department to assist with permits dealing with state land, state highways, and federal property.
- Every state has a film commission because the film community desires a state-level, knowledgeable point of contact to meet their unique and complex needs.

According to the president of the Arizona Production Association, a volunteer organization and member association, “The AFC [Arizona Film Commission] is one of the key points of contact for businesses considering bringing in millions of dollars for production.” In addition, he states, “We need clean, high-tech, reusable industries and having the AFC promote Arizona Production as part of the Commerce Department is a great example of that kind of forward thinking.”¹³

The report’s statement that the Arizona Office of Tourism (AOT) helps organize tours of potential film locations is incorrect. This function is primarily managed by the Department – the role of AOT is limited to travel media tours. The recommendation to move this function to AOT does not take into account the need for expertise and experience to facilitate film production, connect with state, local, federal and tribal liaisons, secure production permits and conduct statewide locations scouts—services currently delivered by the Department. Also, transferring the function saves no funding and only disconnects the Commission from other economic development efforts.

¹³ Donald Woodard, President, Arizona Production Association, in a letter.

AUDITOR GENERAL REPLY TO AGENCY RESPONSE

The following auditor comments are provided to address certain statements made by the Arizona Department of Commerce:

- In response to the Arizona Department of Commerce's comments related to Finding 2, Recommendation 2 (see page 6 of their response), the Auditor General has determined that a central assumption of a June 2003 study Commerce cites (*Cost Benefit Analysis of California's Enterprise Zone Program*) results in an overstatement of the revenue generated by enterprise zones. Auditors spoke with the study's author, who concurred that the assumption he used warrants further investigation.
- The Auditor General disagrees with the Arizona Department of Commerce's statement (see page 13 of their response) that the Auditor General misinterpreted the passage from *Planning Local Economic Development: Theory and Practice*. In the audit report, the quote is used to support the limited impact of the state in attracting businesses. Auditors contacted both Professors Edward J. Blakely and Ted Bradshaw, who coauthored the third edition of this book. Both authors agree that state efforts in business attraction, specifically "smokestack chasing," are less effective than the overall business climate and other types of efforts, such as providing information and technical assistance, or guaranteed loans. Therefore, the Auditor General concludes that our statement does not misinterpret the intent of either author.

Performance Audit Division reports issued within the last 12 months

02-03	Department of Economic Security—Kinship Foster Care and Kinship Care Pilot Program	02-12	HB2003 Children’s Behavioral Health Services Monies
02-04	State Parks Board—Heritage Fund	02-13	Department of Health Services—Office of Long Term Care
02-05	Arizona Health Care Cost Containment System—Member Services Division	03-L1	Competitive Electric Metering, Meter Reading, and Billing and Collections
02-06	Arizona Health Care Cost Containment System—Rate Setting Processes	03-01	Government Information Technology Agency—State-wide Technology Contracting Issues
02-07	Arizona Health Care Cost Containment System—Medical Services Contracting	03-02	Registrar of Contractors
02-08	Arizona Health Care Cost Containment System—Quality of Care	03-03	Water Infrastructure Finance Authority
02-09	Arizona Health Care Cost Containment System—Sunset Factors	03-04	State Board of Funeral Directors and Embalmers
02-10	Department of Economic Security—Division of Children, Youth and Families, Child Protective Services	03-05	Department of Economic Security—Child Protective Services—Foster Care Placement Stability and Foster Parent Communication
02-11	Department of Health Services—Health Start Program	03-06	Arizona Board of Appraisal
		03-07	Arizona State Board for Charter Schools

Future Performance Audit Division reports

Arizona Tourism and Sports Authority

Department of Economic Security—Child Protective Services—Caseloads and Training