

REPORT HIGHLIGHTS

PERFORMANCE AUDIT

Subject

The Legislature established the Department of Commerce in 1985 to promote and enhance the State's economic growth and development. Its duties include encouraging international trade, and assisting and attracting businesses.

Our Conclusion

Of Commerce's 13 major functions, 4 could be eliminated because they are available elsewhere or Commerce has a limited role. Another 4 functions could be eliminated or otherwise modified because they too are available or could be available elsewhere. If the Legislature eliminates these 8 functions, the remaining 5 functions, which should continue, could be moved to other agencies. Further, the Legislature should consider evaluating the effectiveness of the five tax incentives Commerce administers before they are renewed or extended.



2003

Eliminate, Transfer, or Modify Functions

Four Commerce functions can be eliminated

The Department has four operating divisions that provide development assistance to communities, help Arizona businesses market their products and services in other countries, help coordinate workforce programs and support apprenticeship programs, and provide economic information. Two separate agencies, the Commerce and Economic Development Commission (CEDC) and the Greater Arizona Development Authority (GADA), operate in the Department.

Commerce's operating divisions are responsible for 13 major functions. Four of these functions could be terminated because other agencies provide or could provide the same or similar services. Eliminating these functions would save both General Fund and CEDC Fund monies that the Legislature could redirect to other uses. These functions include:

The CEDC Fund consists of monies from two Arizona State Lottery games and registration fees on securities, and is used to support the State's economic development efforts as well as Commerce operations.

- **Small Business Services**—Commerce provides information over the Internet, by

phone, and in person to individuals interested in starting a small business. However, Commerce does not provide one-on-one counseling. The federal Small Business Administration already provides extensive small business services throughout Arizona, including one-on-one counseling, and over its Web site. In addition, the Corporation Commission, the State Procurement Office, the Department of Revenue, libraries, and counties have business information on the Internet. Commerce's Small Business Services has four staff and cost the General Fund \$12,400 and the CEDC Fund \$407,700 in FY 2003.

- **Apprenticeship and Pre-apprenticeship Services**—Commerce approves and registers apprenticeship programs for the U.S. Department of Labor (DOL), but it does not receive any federal monies to do so. DOL provides these services in 23 other states. The General Fund appropriation for Commerce to provide these services was \$146,500 in FY 2003.

Commerce provides a 6-week federally funded pre-apprenticeship training program for minorities and women in highway construction trades. The Arizona Department of Transportation, which receives the federal funds for this program and passes them through to Commerce, could administer this training program at no additional cost to the State.

- **Economic Information and Research**—Commerce acts as the State's central point for economic data, research, and analysis. However, more extensive information and analysis is available from other sources,

such as ASU's Arizona Economic Data Center, the Flinn Foundation, and the Department of Economic Security. This function cost the General Fund \$361,000 and the CEDC Fund \$89,500 in FY 2003.

- **Growing Smarter**—Commerce is required to receive all Arizona cities' and counties' development plans. These comprehensive, long-range plans address land use, open space, growth, and water resource issues. Commerce has only an advisory and support role regarding the plans, although it provides technical assistance for developing these plans. This function cost the General Fund \$9,700 and the CEDC Fund \$124,200 in FY 2003.

Four functions could be eliminated, but advantages exist for the State continuing to perform these functions

Another four functions could be eliminated. However, in contrast to the preceding four functions, we identified some advantages to continuing them, although possibly not in the same form and not in Commerce.

- **International Trade and Investment Office**—This Commerce function promotes Arizona products and services for export, and markets Arizona as a place for foreign business to expand. It operates four foreign offices. The U.S. Department of Commerce and private entities provide similar services, but usually for a fee. If this function continues, businesses receiving services should pay fees covering at least a portion of the costs of its services. This function cost the General Fund \$330,600 and the CEDC Fund \$842,000 in FY 2003.
- **Business Attraction and Office of Innovation**—Under these two programs, Commerce markets the State nationally and internationally to businesses in the fields of information technology, aerospace, bio-science, and environmental technology. Commerce refers interested businesses to metropolitan economic development agencies, and, if necessary, directly assists businesses considering sites. Similar services are also provided by approximately 300 local and state-wide economic development organizations. Further, research suggests

state-operated efforts have a limited impact on attracting businesses.

However, Commerce and businesses that we contacted cite the importance of having a central contact point for the State to provide impartial information and answer questions about the State's business climate. Therefore, these functions could be retained, but could be limited to providing a state-wide point of contact for business that could then be referred to local organizations or other sources. These programs cost the General Fund \$539,500 and the CEDC Fund \$541,300 in FY 2003.

- **Rural Development**—Commerce provides technical and financial assistance to rural communities for downtown revitalization, economic development, and business retention and expansion. In FY 2004, Commerce was authorized to issue \$175,000 in grants, which the rural communities value. However, other groups provide similar services through grants and fund-raising for rural communities. This function cost the General Fund \$295,400 and the CEDC Fund \$177,700 in FY 2003, including grants.
- **Arizona Film Commission**—This Commerce function provides free support services to film and television production companies who approach it about working in Arizona. These same services are available from 22 local film offices for free and from private sources for a fee. The Office of Tourism already assists some film companies, so another option would be to merge the Arizona Film Commission into the Office of Tourism. The Commission received \$299,000 from the General Fund in FY 2003.



Other major functions should be retained

The Legislature should retain the five remaining functions because they do not duplicate other programs, or they do not

require state appropriations. If the Legislature decides to sunset Commerce, these programs could readily be transferred to other agencies:

- **Arizona Job Training Program**—Through this program, Commerce provides 2-year grants for job training assistance for Arizona businesses. During FY 2003, Commerce reports it awarded 67 new grants, awarded over \$12 million, and planned to train nearly 21,000 workers. The Legislature should consider eliminating the over-\$150,000 General Fund appropriation for this program, because the 0.1 percent wage tax provides sufficient monies for it to operate. If Commerce were eliminated, this program could be transferred to the Department of Economic Security (DES), because DES operates other job-training programs.
- **Staff Support for the Workforce Development Council**—Pursuant to federal law, the State established the Council to develop plans for distributing approximately \$48 million in federal job training funds. While DES receives most of this money for its job training programs and reports its performance to the federal government, Commerce receives federal funds to provide staff for the Council. Because the Council's duties primarily involve DES-operated programs, if Commerce were eliminated, the Legislature could transfer staffing duties to DES.
- **Energy Office**—This Commerce program provides energy advice to the Governor and Legislature, encourages energy efficiency and renewable energy through 17 programs, and provides grants to reduce energy costs for low-income households. No state monies are spent on this program. If Commerce were eliminated, the Legislature

could transfer the Energy Office to the Arizona Department of Housing, whose mission is in-line with such activities.

- **Private Activity Bond Administration**—Under this program, Commerce distributes authority to local governments to issue tax-exempt private activity bonds. If the Legislature eliminated Commerce, it could transfer this function to the CEDC, which is familiar with bond projects.



- **Arizona Military Airport Regional Compatibility Project**—Through this project, Commerce meets with local communities and base officials to develop comprehensive land-use plans around five military airports, which it expects to complete in 2006. This project was created through a one-time appropriation and receives a small appropriation each year for administrative costs. Commerce also obtained an approximately \$450,000 grant from the federal government to develop the land-use plans. If Commerce is eliminated, this function could be transferred to another executive branch agency.
- **Agency Administrative Functions**—If the Legislature eliminates Commerce, it should also eliminate over \$1 million in agency administrative functions.

Recommendations

- The Legislature should consider eliminating four Commerce functions.
- For four other Commerce functions, the Legislature should consider eliminating them or making other modifications.
- If the Legislature decides to sunset the Department of Commerce, it should consider transferring five other functions to other state agencies and eliminating Commerce's administrative functions.

Tax Credits Have Only Limited Effectiveness— Periodic Review Needed

While states have historically tried to induce economic growth through tax credits, research suggests that modifying taxes to induce economic growth is not likely to be efficient or cost-effective. Commerce administers five tax credit programs that the Legislature intended as an incentive for businesses to locate to Arizona, make capital investments, re-use or re-tool their existing facilities, and create jobs.

Although complete data is not available for release due to the Department of Revenue's confidentiality statutes, since 1994 through 2000, businesses used at least \$65 million in income tax credits and at the end of 2000, held an estimated \$60 million more for future use.

Generally, many researchers consider modifying taxes to have only a small impact on economic activity. For example:

- One researcher estimates that a 10 percent tax cut increases business activity only 2.5 percent.
- Another study concluded that increasing taxes 17.8 percent would result in the average county in their study losing only one small firm and 1.14 employees.

While taxes in general have a small effect on economic activity, research suggests targeted tax incentives have an equally small impact. Studies suggest that enterprise zones, Commerce's largest tax credit program, have no significant impact on:

- Creating, expanding, or relocating firms.
- Per capita income.
- Unemployment or job creation.

A study of 36 Ohio businesses compared the job growth of those accepting tax incentives and those not accepting them. Those accepting incentives had 20 percent (10.5) fewer jobs per firm than those not accepting incentives. The study further concluded that firms accepting incentives inflate their hiring plans to gain greater incentives.

Other factors, such as education and infrastructure, are more important to firms. One researcher estimated that the labor market has 14 times more impact than incentives.

A \$2,000 tax incentive will pay only 48 cents of a \$12/hour job wage, according to one report.

Providing incentives can also have a significant impact on state revenues. Tennessee attracted Saturn to Nashville in 1985 with a tax incentive package worth about \$80 million for about 3,000 jobs. The average cost is about \$26,000 per job. This example was repeated at even greater cost per job in Kentucky (Toyota plant) and Alabama (Mercedes plant).

Changes needed to assess impact of Arizona's tax credits—One impediment to evaluating the effectiveness of the Commerce-administered tax credit programs is that the exact amount of the income tax credits claimed is unknown. The credits are claimed on tax returns. By statute, the Department of Revenue is prohibited from providing even basic income tax credit information if it would reveal the identity of the taxpayers. Because so few companies claim some credits, the Department cannot release

the information without potentially identifying the taxpayers.

Other states' laws allow more disclosure of tax credit information. Two states, Minnesota and Maine, require full disclosure of business incentives such as tax credits, even if it identifies the taxpayer. At least two other states, Connecticut

and North Carolina, require publication of company-specific income tax credits. If Arizona's statutes are changed to allow the necessary reporting of tax credit information, the Legislature should require cost-effectiveness analyses before renewing existing tax incentive programs or adopting new ones. Other states, such as West Virginia and Ohio, have conducted reviews and recommended eliminating or restructuring many of their credits.

Recommendations

The Legislature should consider:

- Modifying Department of Revenue statutes to allow complete reporting of tax credits.
- Requiring cost-effectiveness analyses of existing tax incentive programs and terminating those that are not cost-effective.
- Requiring a cost-effectiveness analysis of any new tax incentive programs before adoption.

Other Pertinent Information

Thirty-five states organize their economic development and tourism functions in the same agency. Other states have separated these functions, and at least one state has formed these functions into public-private partnerships funded with both state and private monies. Economic development and tourism experts in Arizona and other states discussed two issues concerning combining these functions:

- While some officials in other states indicated that combining these two functions could result in cost savings, most notably through shared marketing efforts, they felt cost savings in terms of staff reductions would be small.
- Some representatives in Arizona expressed concern over the possible loss of prominence the tourism function could face if combined into a larger economic development agency.

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Lisa Eddy

