

Oversight Division

Committee On Legislative Research

PROGRAM EVALUATION

Review of the
DEPARTMENT OF ECONOMIC
DEVELOPMENT
POLICY FOR ECONOMIC GROWTH

Program Evaluation
DEPARTMENT OF ECONOMIC DEVELOPMENT
POLICY FOR ECONOMIC GROWTH

*Prepared for the Committee on Legislative Research
by the Oversight Division*

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**COMMITTEE ON LEGISLATIVE RESEARCH
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Members of the General Assembly:

The Joint Committee on Legislative Research adopted a resolution on June 20, 2011 directing the Oversight Division to perform a program evaluation of the Department of Economic Development, Policy for Economic Growth to determine and evaluate program performance in accordance with program objectives, responsibilities, and duties as set forth by statute or regulation.

The report includes Oversight's comments on internal controls, compliance with legal requirements, management practices, program performance, and related areas. We hope this information is helpful and can be used in a constructive manner for the betterment of the state program to which it relates. You may obtain a copy of the report on the Oversight Division's website at <http://www.moga.mo.gov/oversight/audits.htm>.

Respectfully,

A handwritten signature in cursive script that reads "Tom Flanigan".

Representative Tom Flanigan
Chairman

EXECUTIVE SUMMARY

The State of Missouri offers a wide range of tax credits as a part of its economic development program, and also offers tax credit incentives to participants in specific business and social activities. Applicants are generally required to make qualifying investments or conduct specific business or social activities in exchange for the credits.

Tax credits result in a direct reduction of a government entity's tax revenues. They are not an expenditure subject to normal budget and appropriation controls. Tax credits can provide direct financial assistance to a business or to an individual if the recipient of the tax credits has a tax liability. If the business or individual does not have a tax liability, the financial assistance may still be available by selling the tax credits but the financial assistance may be reduced due to broker fees or other transaction costs. However, some tax credits can not be sold or otherwise transferred and the benefit may be delayed or lost if the tax credits expire.

The Department of Economic Development (DED) and the Department of Revenue (DOR) are the primary Missouri state agencies involved in economic development tax credit programs, but additional state agencies are involved with other business or social tax credit programs.

Oversight reviewed the statutes, regulations, DED procedures, and other activities related to the economic development tax credit programs. We also reviewed a sample of recently active projects for which DED provided financial assistance. Our observations resulted in several comments and recommendations.

In our review of project files, we noted the files did not appear to be adequately organized and we could not determine if they were complete. We could not verify that DED staff had verified compliance with program requirements in some of the files. We recommend DED managers develop a standard format for project files, and ensure an annual file and compliance review is done by an appropriate manager. We also recommend DED managers develop a process to ensure more oversight over projects including more frequent project site visits.

We have significant concerns regarding compliance issues in three projects including the value of a contribution to a community development corporation, the shipment destination for computer equipment, and the wages paid to new employees on a project. We recommend DED managers reconsider the tax credits and other financial assistance provided to these projects and work with the Department of Revenue to recover any overpayments. Finally, we recommend consideration of a future program evaluation of the Missouri Development Finance Board, a component of the Department of Economic Development involved in large economic development project financing.

Chapter 1

Purpose/Objectives

The General Assembly has provided by law that the Committee on Legislative Research may have access to and obtain information concerning the needs, organization, functioning, efficiency and financial status of any department of state government or of any institution that is supported in whole or in part by revenues from the state of Missouri. The General Assembly has further provided by law for the organization of an Oversight Division of the Committee on Legislative Research and, upon adoption of a resolution by the General Assembly or by the Committee on Legislative Research, for the Oversight Division to make investigations into legislative and governmental institutions of this state to aid the General Assembly.

The Joint Committee on Legislative Research directed the Oversight Division to conduct a program evaluation of Missouri Tax Credit programs in 2009, and a report on that review was issued in January of 2010. Oversight was requested to update our review of these programs in 2010, to consider whether the technical and management requirements for these programs had been met, whether those requirements were adequate, and to review the potential for cost controls over these programs. On June 20, 2011 the Joint Committee on Legislative Research directed the Oversight Division to perform a program evaluation of the Department of Economic Development, Policy for Economic Growth, to determine and evaluate program performance in accordance with program objectives, responsibilities, and duties as set forth by statute or regulation.

Oversight's review addressed, but was not limited to, the following:

- * Determining the Department of Economic Development's policy for long-term economic development.
- * Comparing the nature and scope of Missouri tax credit programs with other states' programs.
- * Considering whether other states have overarching policies regarding tax credits.
- * Comparing the amount of tax credits issued and redeemed by Missouri and other states.
- * Considering the economic impact of tax credit programs to the state.
- * Reviewing the criteria used by the Department of Economic Development in selecting projects for discretionary tax credits.
- * Documenting the stated purpose for each tax credit program.

Scope

The Oversight Division reviewed information regarding tax credit programs active from 2005 through 2011.

Methodology

The methodology used by the Oversight Division included reviewing Missouri statutes, rules and regulations, and legislation and fiscal notes pertaining to tax credit programs. In addition, we interviewed personnel from the Department of Economic Development, reviewed the information available regarding financial and management review of the Missouri tax credit programs, and collected public information from other state tax credit programs.

Background

The state of Missouri has a wide variety of economic development programs designed to leverage our competitive advantages and deliver strong economic growth for Missouri.

The Missouri Department of Economic Development (DED) is the primary state agency devoted to the state's programs for business and community development. Programs managed by DED include small business incubator programs, specialized business loan programs, the Certified Site Program, state programs for the issuance of industrial development, infrastructure, and other bonds, programs allowing sales tax exemptions and employee withholding tax retention programs for new, expanding, or relocating businesses, special tax increment financing programs for infrastructure development, targeted employment training programs, and state tax credit programs.

Staff and responsibility for most of the department's economic development programs have been assigned to the Division of Business and Community Services (BCS). BCS is also the administrative agency for seven of the eight active tax credit programs which were created by the General Assembly to encourage business development in the state. The Film Tax Credit Program is jointly administered by DED and the Missouri Film Commission; the Business Use Incentives for Large-Scale Development (BUILD) program is administered jointly by BCS and the Missouri Development Finance Board.

The business development tax credit programs are as follows.

- * BUILD tax credits authorized by Sections 100.700 to 100.850; RSMo.
- * Business Facility tax credits authorized by Sections 135.100 to 135.150; RSMo.
- * Development tax credits authorized by Sections 32.100 to 32.125; RSMo.
- * Enhanced Enterprise Zone tax credits authorized by Sections 135.950 to 135.973; RSMo.
- * Enterprise Zone tax credits authorized by Sections 135.200 to 135.270; RSMo.
- * Film tax credits authorized by Section 135.750; RSMo.
- * Quality Jobs tax credits authorized by Sections 620.1875 to 620.1890; RSMo.
- * Rebuilding communities tax credits authorized by Section 135.535; RSMo.

Tax credits amounting to approximately \$41 million per year were issued for these tax credit programs over the most recent five years, or approximately 7.4 percent of all Missouri tax credits issued over those years. Total assistance provided by DED to active projects over the most recent five years was approximately \$205 million.

Department of Economic Development

The Department of Economic Development (DED) is composed of divisions, boards, and commissions which execute statutory requirements, develop program regulations, and implement policy in the areas of community, economic and workforce development. The divisions, boards, and commissions work with businesses and communities to help firms create jobs, increase sales, find and train qualified workers, identify sites, and obtain financing support to locate or expand in Missouri, promote capital investment, and increase the self-sufficiency of communities in the state.

The Department of Economic Development, Division of Business and Community Services (BCS) offers programs and incentives for businesses and communities to create a pro-business climate and strong community partnerships where businesses can thrive.

The Missouri Development Finance Board (MDFB) is an instrumentality of the state which reports administratively to the Department of Economic Development. MDFB is authorized by state law to grant tax credits equal to 50% of any moneys contributed by any taxpayer to one of three MDFB funds; the “Industrial Development and Reserve Fund,” the “Infrastructure Development Fund,” or the “Export Finance Fund.” The funds generated can then be used for new or expanding businesses.

The Missouri Film Commission was created in 1983 to attract film, television, video and cable productions to Missouri, and to promote the growth of the film and video production industry within Missouri. The Missouri Film Commission and the Department of Economic Development jointly administer the Film Production Tax Credit which may be up to 35 percent of the amount expended by film production companies in Missouri, for production or production-related activities.

A more detailed description of these tax credit programs is provided on Appendix A and a listing of all Missouri tax credits is provided on Appendix B.

Chapter 2

Application, Vetting, and Review Processes

We discussed with Department of Economic Development (DED) managers the processes the department has implemented to ensure financial assistance provided through these programs is properly used to improve the economic status of Missouri citizens.

A. Project Application and Vetting

We noted DED officials are actively involved in recruiting businesses which could benefit from these programs. The prerequisites for participation in these programs are provided in the statutes which authorize the programs, and although DED has published regulations for these programs, DED has only limited discretion in selecting projects. The DED application and vetting process for new projects in these programs is concerned primarily with examining the documentation for the proposal.

We are concerned these programs may be used to replace or supplement the normal capital requirements for the formation or operation of a businesses. This practice could lead to the state providing financial assistance to projects which could succeed without state assistance, or to projects which are not likely to succeed and to provide long-term jobs. We noted one of the projects we selected for detailed review resulted in jobs which lasted only the two years when state financial assistance was provided. The facility was closed at the end of its eligibility for assistance.

DED managers told us they try to prevent the excessive use of tax credits, and limit the amount of tax credits for each project to the lowest amount which will make the project feasible. They also told us they do not believe they have the ability to reject weak proposals or to shut down failing projects.

We also understand state financial assistance is sometimes provided as a direct response to financial incentive proposals from other states and DED managers are placed in the position of developing a “competitive” proposal for the employer.

We have discussed our compliance concerns with specific projects in another comment.

B. Project Review

DED officials have developed processes to verify critical information about job creation and retention projects. We noted the larger and newer projects are funded through the Enhanced Enterprise Zone or Missouri Quality Jobs programs, and DED procedures for these programs include verification of employee numbers, payroll costs, and payroll taxes retained for each project through arrangements with the Department of Labor and Industrial Relations and the Department of Revenue. We noted these verifications were performed for most projects but we also noted some exceptions which are discussed in our file review comments.

Although DED managers told us they do not accumulate records of projects which fail or are cancelled, we noted one of the projects we selected for detailed file review was cancelled when the employer could not achieve the required number of new hires. We were also made aware of additional projects which had failed before tax credits were issued. DED was able to cancel the tax credits and other benefits authorized for those failed projects so the benefits could be applied to other projects.

DED managers told us they plan to visit each project site at least once during its lifetime; however, as we have noted in our file review comments, documentation of such visits could not be located in all project files. We believe a more formal process could result in earlier detection of problems with these projects.

Providing DED with the authority to use discretion in choosing projects for assistance would require legislative action, and we do not offer a recommendation regarding potential legislative action. However, we believe increased attention, including additional site visits, to active projects could provide more assurance that state support is being used properly.

We recommend DED managers develop a process to ensure project site visits are made near the beginning of a project, and at least annually during the life of a project.

Project Files

Oversight reviewed a sample of files maintained by DED for projects which were active during the past five years. Because of the length of time a project remains eligible for tax credits under these programs, some of the projects we selected for detailed review originated prior to the most recent five years.

- * We noted the files were extremely large for some programs. DED managers told us they retain all the documents related to a project for the duration of the project, but this practice actually adds to the difficulties we will discuss in our other comments.
- * We were unable to detect a consistent methodology, or even a common structure, for the project files we reviewed. We noted project files for some programs included a file checklist. The file checklist provided some assurance DED staff had reviewed and filed critical documents for projects, but the contents of those files were not further organized and a checklist was not available for most of the files we reviewed.
- * DED managers told us project documentation was filed in chronological order and we found this to be generally true. However, due to the size of some files, large amounts of insignificant information had to be searched in order to find critical project documents such as application and approval forms for the project, and approval for the issuance and transfer of tax credits.
- * Projects involving the Missouri Development Finance Board (MDFB) were located at the MDFB office and away from DED offices.

We were unable to locate some information in the DED files which we consider critical to documenting that businesses met the legal and regulatory requirements for these programs. Because of the condition of the files, we are not certain whether those documents were missing or just misplaced. We discussed the more significant of these situations with DED managers, with the following results.

- * In two Enhanced Enterprise Zone (EEZ) projects, there was no documentation of the employers' payment of employee health insurance premiums. DED managers told us they considered the corporate officers' signatures on the application for tax credits to be adequate. We believe DED should review and verify that the amounts actually paid by the employers satisfy program requirements.

- * In one Enterprise Zone project we could not locate any information regarding 2007 activity. In another Enterprise Zone project we could not locate any documentation of the DED verification of new hires. DED managers told us some documents may have been misplaced. We have noted the DED process for these programs would require the documents to be available at the time tax credits were issued; however, we believe the ability to retrieve such documents when needed is an essential management requirement.
- * In two Business Use Incentives for Large Scale Development (BUILD) projects, there was no documentation of DED verification for new hires reported.

Oversight believes the missing documents were most likely due to the condition of the files; however, it is also possible some project compliance verifications were not performed by DED managers. Program files should be constructed in a systematic, logical order to provide DED managers with the ability to reliably retrieve documents supporting their compliance verification including new hire data, payment of required health insurance premium, required new investment for projects, and other significant compliance attributes for these economic development programs.

We recommend DED develop a standard format for all project types including, at least, a file maintenance checklist and documentation of an annual compliance review by an appropriate DED manager. Critical compliance verification documents should be reliably located in a prominent location in each project file.

Tax Credit Claims

Oversight observed several unusual claims in the project files we reviewed.

- A. In one project, a manufacturer reported a contribution to a community development corporation of two patents valued at \$6 million and received \$3 million in Business Development Tax Credits. The contribution and tax credits were included as part of an incentive package developed by DED managers and the manufacturer. The package also called for the manufacturer to invest \$70 million in the plant, and to retain 1,450 jobs at the plant.

Section 32.110; RSMo provides for the Department of Economic Development to issue Business Development Tax Credits to organizations which engage in certain community development and economic development activities, and it allows the Department of Economic Development to provide tax credits to businesses which make "contributions to a neighborhood organization" as defined in the statutes for the program. A "neighborhood organization" is further defined as "any organization performing community services or economic development activities". DED has published regulations which allow for tax credits to be issued for in-kind donations of property and services in lieu of cash donations, based on the estimated value of those donations.

DED managers told us the Business Development Tax Credits were provided in exchange for the contribution to the community development corporation in this case because there was no other tax credit program available which fit the unique circumstances of that project. The manufacturer kept the plant open and retained the jobs at risk for the duration of the agreement with DED and the city.

We reviewed copies of the relevant documents including the patent transfer agreement, the patent files, and an appraisal done at the manufacturer's request to establish the value of the patents. We noted there were two patents involved; both were specifically related to the production of vehicles which were manufactured at the plant. The appraisal was extensively documented, provided extensive references to the technical specifications of the patents, and included the appraisers' estimate of the value of the two patents. We noted the estimate of value was based primarily on engineering estimates of manufacturing cost savings associated with the patents.

DED managers told us they believe the donation meets the statutory requirements and justifies the tax credits issued to the manufacturer based on the appraisers' estimate of value. We were able to verify that ownership of the patents was transferred to the community development organization, but we do not believe this transaction meets the statutory requirements for the program.

- * The transfer agreement gave ownership of the two patents to the community development corporation, but it provided for the manufacturer to have exclusive use of the patents in exchange for royalties of \$1 per year per patent. We believe those provisions substantially impair the value of the donated property on which the tax credits were based. In addition, the arrangement did not provide any significant funding for the community development corporation.

- * The community development corporation which received the patents does not appear to meet statutory requirements since it has not performed any community services or economic development activity. We contacted city officials, and they told us the community development corporation was created to receive donations for a tax incentive program and has not had any significant revenues or expenditures.

City officials did not have any further information regarding the operations or the financial activities of the community development corporation. Information about the corporation was not included in the city's financial statements, nor has the corporation issued separate financial statements.

- B. In another project, a financial services company received \$2 million in Development Tax Credits in exchange for the placement of some \$4 million in computer equipment in the State of Missouri; however, the supporting invoices for approximately \$3 million of the computer equipment indicated a "ship to" address in Virginia.

DED managers have not been able to determine if qualifying equipment was actually delivered to Missouri.

- C. In a third project, an agribusiness company received more than \$1.3 million in tax credits for the first four years of its participation in the Business Use Incentives for Large-Scale Development (BUILD) program. The project file indicated the company would make a significant investment in the project and employ a large number of persons, but wages paid to the company's employees would be lower than the county average.

Section 100.770; RSMo states the "amount the average wage paid ... exceeds the average wage paid within the county" is to be considered in "determining the credit that should be awarded" as well as the costs of the project to the state and the affected political subdivisions.

DED managers told us the statutory language for the BUILD program indicated several factors were to be considered in determining the credit to be awarded, and they did not consider the statutes to establish a set of baseline requirements. In addition, DED managers told us there was strong local support for the project since it created a significant number of jobs in an area of the state with high unemployment.

We believe the clear intent of the statute was to provide tax credits for projects which would create jobs with better wages than the county average.

We recommend DED managers review these transactions again, and make appropriate adjustments to the tax credits awarded to the businesses which made these claims. If the tax credits are determined to be improper, the department should work with the Department of Revenue, and make every reasonable effort to recover any overpayments.

Economic Growth, Financial Incentives, and Job Creation

- A. We discussed the state of Missouri's overall economic development policy with DED managers and learned an overall policy was first developed and adopted in May of 2011, with assistance from a research organization and financing from a private charitable organization. We understand the department is working towards implementing this overall plan in the near future.
- B. Oversight has prepared a brief summary of some of the significant events affecting the economy of the United States over recent years. That summary, provided only for informational purposes, is presented in Appendix D.
- C. Oversight has also summarized certain economic and unemployment statistics for the United States, for Missouri, and for the states which adjoin Missouri, from December 31, 2006 to June 30, 2011. These statistics are shown in Schedule 2, and we have the following observations on the data.
 - * United States Gross Domestic Product was essentially stagnant during 2008 and 2009; although the level of economic activity fell in 2008, growth resumed in 2009. State economic and employment data appear to be consistent with the federal data.
 - * Employment numbers for the United States and all the states reviewed - except for Oklahoma and Nebraska - were lower as of June 30, 2011 than they had been at December 31, 2006.
 - * The State of Illinois lost the greatest number of jobs among the states reviewed. Tennessee had the second largest number of jobs lost and the highest percentage of jobs lost. Missouri had the second highest percentage of job losses and third largest number of jobs lost.

- D. Finally, Oversight has summarized the cost of these eight economic development tax credit program programs over the years from 2007 through 2010. As shown in Schedule 3, there was an average of \$39 million in tax credits issued and an average of \$35.7 million in tax credits redeemed. We noted the pattern of tax credits issued and redeemed does not appear to correspond with changes in the number of jobs or the unemployment rate.

We have previously commented on the proliferation of Missouri tax credit programs, and we have noted other states do not appear to have the number of programs nor the amounts spent on tax credit programs as compared to Missouri. However, we do not have detailed information regarding tax credits issued or redeemed by other states.

- E. Tax credits may not necessarily be a primary driver in job creation.

Although the Department of Economic Development has a number of additional programs to assist businesses and communities with their growth and planing processes, tax credit programs appear to be the primary financial incentive available to the department.

Tax credits are provided in an effort to reduce the cost of starting or operating a business, but the cost of doing business in Missouri is already low compared to other states. One recent publication indicated the State of Missouri had the third lowest business cost of any state in 2011. According to the Tax Foundation, Missouri has the fifth lowest corporate income tax rate in the U.S., the ninth lowest unemployment insurance tax rate in the U.S., and a better overall tax climate for business than all of its surrounding states. According to the United States Department of Energy, Missouri had the eighth lowest average commercial electricity costs in 2010 and the tenth lowest average industrial electricity costs in 2010. Missouri was ranked third overall for business energy costs by the Small Business and Entrepreneurship Council in 2010. Oversight is concerned that providing additional state incentives to reduce the cost of doing business in a low-cost location may not be productive.

DED managers also told us about some other significant factors which can have an impact on where a business chooses to locate its operations. DED managers told us of the recent reorganization of a large telecommunications company in Kansas. The reorganization made a large amount of office and commercial space available in the Kansas City area at very low cost. We understand comparable space on the Missouri side of the metropolitan area is significantly more costly for employers.

- F. Finally, as we have noted in a previous review of tax credit programs, the state cost of redeeming tax credits frequently exceeds the benefit provided to the entity which received them.

Tax credit programs are intended to benefit new or expanding businesses which may not be immediately profitable; however, in some cases, tax credits can only be redeemed by entities which have a tax liability. There was a total of \$49.6 million in tax credits issued during the year ended June 30, 2010 for these eight programs. Out of that total, \$30.5 million was refundable to the recipients; \$15 million was not refundable but could be carried over or sold, transferred, exchanged, assigned, or otherwise conveyed, and \$4.1 million could only be carried over by the recipients.

The refundable tax credits could be fully used to provide funding for a new or expanding business which was not profitable. Those nonrefundable tax credits which could be sold, transferred, exchanged, or otherwise conveyed to another entity could be conveyed to provide cash for operations, but there would likely be brokers and other so-called middlemen involved in such a transaction and the amount of economic development funding available from the transaction could be considerably less than the amount of tax credits redeemed by the eventual holder. Those tax credits which could only be used by the recipients could not be used until and unless the business achieved profitable operations.

These comments are presented for informational purposes and Oversight does not have any recommendations related to them.

Missouri Development Finance Board

A portion of our review was focused on the BUILD Missouri (Business Use Incentives for Large-Scale Development) Program. As we noted above, this program is administered jointly by the Division of Business and Community Services and the Missouri Development Finance Board (MDFB). The BUILD Program is a key part of MDFB activities. Our specific observations on the two BUILD projects we selected for review were included in our file review comments in this report.

