Oklahoma Incentive Evaluation Commission

Incentive Evaluation Update

November 17, 2022

PFM Group Consulting LLC.

1735 Market Street
43rd Floor
Philadelphia, PA 19103

(215) 567-6100

Today's Agenda

- Discussion of November 16, 2022 final evaluations, findings and recommendations.
- Next steps.

Introduction

- The following are the incentives under review in 2022:
  - Oklahoma Affordable Housing Tax Credit
  - Small Business Incubators Incentives
  - Applied Research Support Program
  - Health Research Support Program
  - Quick Action Closing Fund
  - Investment/New Jobs Tax Credit
  - New Products Development Exemption
  - Seed Capital Fund
  - Technology Business Financing Program
  - Technology Transfer Income Tax Exemption
- The Seed Capital Fund was evaluated in 2019; all the rest were evaluated in 2018

Oklahoma Affordable Housing Tax Credit

- **Recommendation: Retain,** with modifications**.**
- **Findings:**
  - Between 2015 and 2021, a total of $27.9 million in state credits was issued. These helped create more than 3,700 affordable housing units in Oklahoma.
  - Population restriction was eliminated in 2019, and eight newly eligible projects have been funded. These projects supported the development of 794 low-income units with $5.3 million in state tax credits.
  - There has been little change in availability of affordable housing in recent years:

Table 1: Number of Affordable and Available Rental Homes per 100 Renter Households

Household Type	2018	2022	% Increase/ (Decrease)
80% of AMI	106	106	0%
50% of AMI	73	74	1.4%
ELI Renter	49	46	-6.1%

  - Oklahoma faces a shortage of 71,160 rental homes affordable and available for extremely low-income renters. Between 2015 and 2021, the program has helped to fund 57 projects – equal to 0.1 percent of the need.

Oklahoma Affordable Housing Tax Credit (continued)

- **Findings (continued):**
  - When comparing the cost of the credits to the state and the additional state revenue generated and other benefits, the program is at least revenue neutral.
  - There have been changes to the program, which will take time to assess.
- **Recommendations**
  - As in 2018, the project team recommends making the credit refundable rather than transferable, to not dilute the resources that are dedicated to affordable housing. While this may create a ‘taxable event’ for federal income tax purposes, a transfer of the credit would also do so. Because the credit may be carried forward for two years, the taxpayer can elect to not make it a taxable event.

Small Business Incubators Incentives

- **Recommendation: Retain,** with modifications**.**
- **Findings:**
  - On average, incubators collectively have 149 tenants per year. Because the overall number of incubators has slightly declined while the number of tenants has remained essentially unchanged, the average number of tenants per incubator has increased by a compound annual growth rate (CAGR) of 2.4 percent.
  - 16 of the 36 incubators categorize themselves as mixed use, 16 focus on manufacturing/distribution, and 7 target technology-centered businesses.
  - There has been an increase in key indicators of incubator 'graduating' firms:

Table 1: Employment and Payroll of Incubator Graduates, 2015-2021

	2015	2016	2017	2018	2019	2020	2021
Employment	85	89	67	85	144	171	194
Establishments	8	9	10	10	15	17	18
Payroll ($ M)	$3.5	$3.7	$3.5	$4.3	$5.8	$7.1	$8.6
Avg. Wages	$40,615	$41,167	$52,684	$50,443	$40,451	$41,542	$44,222

Small Business Incubators Incentives (continued)

- **Findings (continued):**
  - Between 2018 and 2021, employment associated with tenants nearly doubled, growing from 827 to 1,660 over the four-year time period. In recent years, the Department has not collected consistent information regarding payroll. In 2018, it totaled $13.9 million – equal to $16,863 per employee.
  - While the program has not had a significant impact on Sate foregone revenue, there has been a recent increase, and there are no safeguards (such as program caps) to prevent a sudden increase (as, for example, from one firm with explosive growth).
- **Recommendations**
  - **Establish standards for tenant occupancy to qualify for the tax exemption. The** program statute does not require businesses to be tenants in an incubator for a designated amount of time or performance prior to becoming eligible for the exemption. A business could establish tenancy then immediately depart the incubator while becoming eligible for the exemption for 10 years.
  - **Increase data collection and require participation in the annual survey** as a condition of occupancy in State-certified incubators.

Oklahoma Applied Research Support (OARS) Program

- **Recommendation: Retain,** with modifications**.**
- **Findings:**
  - Between 2009 and 2021, there have been $36.8 million in OARS grant awards (an average of $2.8 million per year). On a year-over-year basis, total grants awarded have declined, decreasing by a compound annual growth rate (CAGR) of -7.1 percent.
  - Recent OARs awards attracted $3.6 million in follow-on funds between 2016 and 2021.
  - Recent OARS recipients reported filing 26 patent applications and having 27 granted; the reported value of the patents is estimated to be $136.0 million.
  - In 2020 and 2021, prior OARS grant recipients formed 17 new companies, developed 115 new products or innovations, and filed 29 patents.
  - Between 2016 and 2021, $16.0 million in OARS grants resulted in an estimated total economic impact of $178.5 million but $5.9 million of net revenue to the State.
  - As a grant award program, adequate protections are in place to ensure the fiscal impact of the incentive does not increase substantially beyond the state's expectations in future years

Oklahoma OARS Program (continued)

- **Recommendations**
  - Further refine and improve data collection and reporting processes. While OCAST has begun collecting additional data points from its OARS grantees in recent years, it remains difficult to effectively evaluate the effectiveness of the program due to data collection and reporting process issues.
    - **OCAST should collect additional information from grant recipients as part of its data collection and reporting processes**, including jobs, payroll, economic activity, and success or failure rate.
    - **OCAST should conduct longitudinal case studies over a meaningful period of time for select companies.** This would track the advance and development of the effects and benefits of applied research funded by the program, showing the synergy between grants, follow-on funding and capital investment.
    - **For follow-on funding attained,** OCAST should obtain data on when funds are spent and the purpose for fund expenditures.

Oklahoma Health Research Support Program

- **Recommendation: Retain,** with modifications**.**
- **Findings:**
  - Between 2011 and 2021, $37.9 million Health Research grants were awarded, totaling $37.9 million (an average of $3.4 million per year). On a year-over-year basis, total grants awarded have declined, decreasing by a compound annual growth rate (CAGR) of -5.3 percent over that time period. In 2021, Health Research award payments totaled $2.5 million, representing a decrease of approximately $1.8 million from 2011.
  - The total number of federal National Institutes of Health (NIH) awards funded annually in Oklahoma remained relatively stable: between 1992 and 2017, total awards increased by a CAGR of 0.5 percent.
  - Recently, the state has seen a significant increase: between 2017 and 2021, growth was a CAGR of 10.6 percent. Total NIH funding in the State available under these awards has grown relatively steadily over time, increasing from $21.7 million in 1992 to $128.3 million in 2021, CAGR of 6.3 percent.
  - From 2016-2021, Health Research Program grant recipients attracted approximately $84.3 million in follow-on funds, representing a significant benefit of the program.

Health Research Support Program (continued)

- **Findings (continued):**
  - Recent Health Research Program grant recipients reported having 10 patent applications granted; the value of the patents is estimated to be $2.0 million.
  - Based on information collected by OCAST, in 2020 and 2021, prior Health Research Program grant recipients formed 6 new companies, developed 32 new products or innovations, and filed 8 patents.
  - Economic activity associated with program funding: In the aggregate, OCAST awarded approximately $18.5 million in Health Research Program grants between 2016 and 2021. OCAST reported a total financial impact of $183.4 million during the time period
  - When accounting for the direct, indirect and induced impacts of the Health Research funds awarded, the Health Research program generated approximately $5.9 million in state tax revenue between 2016 and 2021, well less than the $18.5 million in awards granted over the time period.
  - As a grant program with declining funding, adequate financial protections are in place.

Health Research Support Program (continued)

- **Recommendations:**
  - Further refine and improve data collection and reporting processes. While OCAST has begun collecting additional data points from its health research grantees in recent years, it remains difficult to effectively evaluate the effectiveness of the program due to data collection and reporting process issues.
    - **OCAST should collect additional information from grant recipients as part of its data collection and reporting processes**, including jobs, payroll, economic activity, success or failure rate, and industry sector formation.
    - **OCAST should conduct longitudinal case studies over a meaningful period of time for select grant recipients**. This would track the advance and development of the effects and benefits of health research funded by the program, showing the synergy between grants, follow-on funding and capital investment.
    - **For follow-on funding attained**, OCAST should obtain data on when funds are spent and the purpose for fund expenditures.

Quick Action Closing Fund

- **Recommendation: Retain,** with modifications**.**
- **Findings:**
  - The Fund's unreserved fund balance has more than tripled since 2018, up to $18.6 million from $4.3 million. Legislative appropriations drove this increase, rather than the statutory five percent of all new Quality Jobs Program rebate payments the Fund started receiving in FY 2019.
  - The Fund has made $36.9 million in awards, and two-thirds of the total award amount was made between FY 2021 and FY 2022. As more funding has been made available, more awards have been made.
  - A total of $24.5 million was awarded between FY 2021 and FY 2022, but only $7.3 million of those have been paid as these projects continue to work toward performance thresholds.
  - Fund award contracts are structured so payment is not issued until performance thresholds related to jobs, payroll and capital investment are met.

Quick Action Closing Fund (continued)

- **Findings (continued):**
  - Projects receiving awards were projected to create 6,752 new jobs at an average salary of $63,000. Projects that have received payments were projected to create 4,081 jobs, while another 2,681 projected jobs are associated with projects awarded in FY 2020 or later that are still working toward meeting performance thresholds.
  - An analysis of companies awarded funds found as of 2022, these companies have a total of 7,470 employees in the State with an average salary of $83,818.
  - The average projected capital investment per project is $151.4 million. Projects associated with awards that have been paid average $86.0 million while projects in progress (with award payments pending) average $308.2 million.
  - Assuming projections are achieved, for each $1.00 spent through the program award payments from FY 2018 through FY 2022, $2.55 of new state tax revenue is generated by the economic impacts of participating companies. Projected economic activity associated with companies receiving a total of $10.9 million in payments during this period would generate $1,602.6 million in economic impacts, creating $27.9 million in state tax revenue from employment, payroll, and investment activity.

Quick Action Closing Fund (continued)

- **Findings (continued):**
  - Nine of 12 companies that have completed QACF projects have also been awarded Quality Jobs Program contracts.
  - Effective cost controls are in place. All awards are required to be revenue neutral as determined by a detailed analysis by the Department of Commerce, and claw back provisions are included in award agreements to return funds to the State if performance thresholds aren’t met. The award agreements are structured so that awards are not paid until performance goals are met.
- **Recommendations**
  - **Require more robust reporting on awards.** Oklahoma publicly reports only the award amount, the company name, award date and a very brief description of how the award is to be used. Nearly all comparable programs have more detailed public reporting on projects that have received awards.
  - **Include an explanation of why each awarded project was considered “high-impact.”** Statute dictates the QACF may be used when the award would “likely be a determining factor in locating a high-impact business project or facility in Oklahoma.” However, no definition of “high-impact” is provided in statute.

Investment/New Jobs Tax Credit

- **Recommendation: Reconfigure.**
- **Findings:**
  - Use of the credit to offset tax liability has generally decreased over time, while the amount of unused carried forward credit has increased to $734.1 million as of TY2020.
  - The OTC is not statutorily required to and does not collect data for the purpose of analyzing program effectiveness, or to track program use in detail. OTC was able to provide more detailed information for one tax year upon special request. Without this information for each year of the program, evaluations will continue to be limited.
  - An analysis of a set of claims submitted for investments or jobs placed in service during Tax Year 2019 showed the following
    - Based on the economic activity associated with the claims, the credit generates $0.73 in new State tax revenue for each $1.00 of foregone State revenue.
    - Nearly all the credits claimed were for capital investment, which accounted for 99.7 percent of new credits claimed; less than one percent of credit claims were related to new jobs. This is in line with the previous evaluation of this credit that found 98.3 percent of new credit claims in Tax Year 2016 were for capital investment.

Investment/New Jobs Tax Credit (continued)

- **Findings (continued):**
  - New credit claims made in Tax Year 2019 were associated with $1,300 million in capital investment. Of this investment, 86 percent was in an Enterprise Zone in Oklahoma.
  - Oklahoma's tax benefit ranks 9th of 11 among comparable state programs. Because Oklahoma's one percent credit is claimed over a five-year period, the present value of the capital investment tax credit is four percent of total investment cost, despite its nominal total benefit of five percent.
  - In general, it is unlikely that the credit is significantly influencing business decisions:
    - From TY 2008 through 2019, excluding years a cap was in effect, an average of 21.1 percent of the total reported value of credits claimed was used to reduce tax liability.
    - The State's corporate and top individual income tax rate declined from 6.0 to 4.0 percent, and 5.0 to 4.75 percent, respectively, starting in Tax Year 2022 and is likely to increase the amount of carried forward credit.

Investment/New Jobs Tax Credit (continued)

- **Findings (continued):**
  - The credit's impact on location decisions is likely negligible.
    - On a present value basis, the investment tax credit reduces investment costs by 4.0 percent, assuming credits claimed in each year of the five-year period are fully used to offset tax liability.
    - The economic research literature has examined how business taxes affect business activity, suggesting that a 1 percent cost reduction (measured as a percent of business value-added) increases the likelihood of making a desired location or expansion decision by 10 percentage points. Using this approach, it is estimated that the 4.0 percent reduction in costs over the five-year period equates to 0.24 percent of the estimated value-added generated by a given capital investment.
    - Thus, the cost reduction generated by the credit is equivalent to a 2.4 percentage point increase in a favorable location decision. If these estimates are adjusted to reflect the reality that claimants are not using all credits claimed each year to offset tax liability, the impact on location decisions decreases.
    - A similar increase of 2.3 percentage points was estimated for the new jobs tax credit.

Investment/New Jobs Tax Credit (continued)

- **Findings (continued):**
  - The Investment-New Jobs tax credit does not require an application or advanced notice to receive benefits. The credit is claimed on tax returns, so firms may claim the credit regardless of whether it played a role in the investment decision.
  - While the capital investment tax credit has been able to keep up with inflation and cost growth because it is a percentage of total investment, the new jobs tax credit as a fixed dollar amount has fallen behind. From 2001 to 2021, the value of the $500 tax credit per new job has declined from 1.5 percent to 0.8 percent of Oklahoma's average annual pay in manufacturing.
  - Key program requirements expressed as dollar amounts in statute have not been updated since the credit was created in 1980. The minimum salary required to qualify for the new jobs tax credit is extremely low, at $7,000. This equates to 11.2 percent of average annual pay for manufacturing in Oklahoma in 2021. The minimum required investment amount of $50,000 has also not been changed since 1980. Adjusted for inflation, this is equivalent to about $170,000 in 2022.

Investment/New Jobs Tax Credit (continued)

- **Recommendations:**
  - **Limit the carryforward period to seven years.** The carryforward period for capital investment credits is indefinite, contributing to the continued growth in the State's unused tax credit liability. This is in line with the Commission's recommendation following the last evaluation of this credit.
  - **Require claims to be filed with the Tax Commission each year of the carry forward period**, regardless of whether the credit is used to offset tax liability. Regular annual claims can require claimants to attest that the capital investment is still in use and, in aggregate, these annual claims would provide the State a clearer picture of how much credit is still available to be used.
  - **Require an application and approval before allowing claims.** The application would be submitted within 60 days of the capital investment being placed in service and would need to be approved before the taxpayer could claim the credit on a tax return. Applying in a timely manner would increase the likelihood that firms would have to plan to plan on taking the credit when making a qualifying investment.
  -

Investment/New Jobs Tax Credit (continued)

- **Recommendations (continued):**
  - **Eliminate the new jobs credit, in favor of incenting manufacturing job creation through the Quality Jobs Program.** The Investment-New Jobs Tax Credit needs significant updates to its job creation requirements. As noted in key findings, the minimum annual pay required of $7,000 is equal to 11.2 percent of the manufacturing's average annual pay in Oklahoma. There is also no requirement related to benefits provided to new jobs. Only one new job is required to receive a new job tax credit.

New Products Development Exemption

- **Recommendation: Repeal.**
- **Findings:**
  - Royalty Income Tax Exemptions have declined, from $452,462 in TY 2015 to $181,719 in TY 2020.
  - The OTC does not calculate the total amount of income excluded by manufacturers as part of this program. While firms need to be approved through the OCAST registration process, the corresponding OTC data is only available in the aggregate.
  - Based on data from 2015 to 2020, the New Products Development Income Tax Exemption may have a negative return on investment. Estimated tax expenditures were approximately $1.6 million with an estimated tax revenue increase of approximately $0.5 million, for a total loss of $1.1 million. However, data limitations for the depreciable property exemption means this is likely understating the impact.
  - Two firms represent 93 percent of registration applications from July 2017 to July 2022, with one firm 91 percent of the total. This follows a similar pattern identified in the 2018 incentive evaluation of this program.

New Products Development Exemption (continued)

- **Findings (continued):**
  - Of the companies registered with OCAST for the royalty tax exemption, 3 of the 30 companies have also received the Investment/New Jobs Tax Credit. The company with the highest number of registration applications on file has also received nearly $1.4 million in Investment/New Jobs Tax Credits over TYs 2014 through 2016.
  - Relative to comparable state programs, Oklahoma's New Products Development Income Tax Exemption is broad-based. Two of the three comparable programs in other states target incentives for inventors in certain industries or to small businesses. Oklahoma does not restrict its program by industry or company size.

New Products Development Exemption (continued)

- **Recommendations:**
  - **Improve data processing in order to collect and report the total cost of corporate tax exemptions.** In order to improve future evaluations of this program and any other program associated with corporate tax exemptions, the OTC should improve its data processing to allow for the disaggregation of the total cost of each corporate tax exemption.
  - **Modify program requirements to require companies to provide key data on a yearly basis to be eligible for the tax exemption.** Currently, those wishing to take the tax exemption must register with OCAST, but there is no requirement that the inventor or manufacturer provide additional information that would be useful in determining the effectiveness or efficacy of the program. The inventor or manufacturer should be required to provide information on annual revenues, annual payroll, and FTEs, both the total number and the number located in Oklahoma to be eligible for the tax exemption.

Seed Capital Fund

- **Recommendation: Retain,** with modifications
- **Findings:**
  - From 2008 to Q3 2022, OSCF has closed 83 investments totaling $31 million in 44 companies. Companies receiving funding have made repayments totaling more than $9 million to the fund.
  - From 2008 to Q2 2022, total capital investment in Oklahoma by companies receiving OSCF funding has reached $272 million. The capital investment amount is approximately 8.8 times the initial investments made over that same period.
  - Since establishing the first fund Series in 2007, the OSCF has leveraged more than $700 million of private capital in total. This represents an approximate 23:1 leverage ratio.
  - From 2008 to 2021, for economic impact that can be measured, the OSCF has an internal ROI that is negative. However, this does not include impacts from additional capital invested in Oklahoma as a result of these early, strategic investments in seed stage companies. The fund is also revolving, so that repayments and investment returns are able to be recycled in the future.

Seed Capital Fund (continued)

- **Findings (continued):**
  - The most common OSCF investment recipients are companies operating in the biopharmaceutical or computer software industries. These industries account for 68 percent of the total number of investments and 70 percent of the total dollar amount of investments made.
  - According to data from the National Venture Capital Association, Oklahoma ranks 46th among all states in number of companies receiving investment, venture capital deals, and total dollars invested. After making up ground compared to nearby states in the last evaluation, Oklahoma has continued to grow, but not as quickly as states such as Kansas and Arkansas.
  - Data collection and reporting improvements are needed. Data reported by i2e is collected via an annual survey of all participating firms. The response rate of firms varies from year to year, so there can be no time-series trend drawn from the data. There is also no information collected that identifies the sector where each job is created or at what stage in the investment's lifecycle it was created.

Seed Capital Fund (continued)

- **Recommendations:**
  - Current focus in software and biotech firms could be shifted over time to align with other statewide programs and incentives.
  - **Given the maturation of the venture capital industry in Oklahoma, it could be valuable to reexamine OSCF's role and mission in the market**. Implementation of the new pre-seed capital program in FY23 solves a major challenge for firms accessing the TBFP. Additional research – in the form of surveys, in-depth interviews, and/or focus groups – should be conducted to identify remaining gaps for entrepreneurs that can be supported through the OSCF and its associated programs.
  - **Improve data collection and reporting.** Annual data collection and reporting should be modified to collect data that better ties business performance to the initial investment made by the fund. This would improve future evaluations and more accurately describe the benefits of the program. The annual survey should collect growth in employment, wages, revenue and measures of profitability.

Technology Business Financing Program

- **Recommendation: Retain,** with modifications
- **Findings:**
  - The data is not sufficient to determine the economic impact of the program. i2E, the program administrator, conducts annual surveys of the number of jobs, average salary, and annual revenue of program participants. Fluctuations in responses means the data can only offer a snapshot of a sampling of participating companies.
  - Of the $12.9 million in funding advanced, $6.3 million has been repaid. With no new appropriations planned for the TBFP, current projections estimate the program will run out of funds between 2036 and 2058.
  - TBFP portfolio companies have a four-year survival rate of 66.2 percent. The average four-year survival rate for Oklahoma establishments in general has been 54.5 percent since the inception of the program. This suggests the program may be providing some advantage to participants.
  - The most common OSCF investment recipients are companies operating in the biopharmaceutical or computer software industries. These industries account for 68 percent of the total number and 70 percent of the dollar amount of investments made.

Technology Business Financing Program (continued)

- **Recommendation:**
  - **Require program participants to respond to annual surveys.** There is currently no requirement that companies receiving funding through the TBFP respond to i2E's annual survey. Requiring companies to respond to the survey, at least for a certain period of time after receiving funding, would allow for an analysis of employment and payroll growth from year to year.

Technology Transfer Income Tax Exemption

- **Recommendation: Reconfigure**
- **Findings:**
  - The OTC is unable to provide data on the use of the exemption. Corporate tax exemptions are claimed through Form 512, as part of the calculation of Oklahoma taxable income for corporate income tax returns. The OTC collects this information through a "Miscellaneous Other" exemptions form box – the Technology Transfer program represents one of five possible exemptions that can be listed in that space.
  - Despite many other states having similar goals, Oklahoma is the only example of this particular strategy to incentivize the relevant activities. In Arkansas, the state offers grant funding to reduce technology transfer costs for businesses. Other states supplement federal programs, including the Small Business Technology Transfer (SBTT) program, by offering technical training, funding to complete the SBTT application process, or matching grants for federal funds received.

Technology Transfer Income Tax Exemption (continued)

- **Recommendations:**
  - **Enhance data collection through changes to current corporate tax forms.** OTC staff expressed the opinion that the current tax forms are viewed as burdensome for taxpayers, and the OTC seeks to streamline and reduce the required data rather than increasing it. Their general perspective is that increased complexity leads to greater taxpayer reporting errors. While this is an understandable perspective, there is also a public policy need for data and information associated with tax expenditures. Given that digital tax preparation software is widely used, and many of the impacted taxpayers are probably retaining tax preparation professionals, the OTC should consider targeted, high-value additions to these forms to improve data quality.
  - **Shift administration of the program to a contract-based agreement with the Department of Commerce.** The authorizing statute could require that those wishing to take the exemption must be approved by the Department of Commerce. The Department of Commerce could then make data reporting an annual requirement for program approval.

Technology Transfer Income Tax Exemption (continued)

- **Recommendations (continued):**
  - **Consider reconfiguring the program to incorporate best practices from benchmark programs.** This might include converting the income tax exemption to a grant, as has been successful in the Arkansas example. Specifically, the program could be altered to reduce costs for entities generating technology that can be transferred, as opposed to the corporations that acquire the technology.

    Funding can also be diverted to support services such as technical assistance for small businesses that are applying for STTR awards, or to connecting small businesses and entities such as colleges and universities that frequently develop these desirable technologies to generate additional opportunities to commercialize these products and services.

Next Steps

- PFM has drafted some additional language that may be included in the Commission's report to the Governor and Legislature – of course, it may be modified as the Commission sees fit.
- PFM will assist in modifying the schedule for evaluations, which the Commission will have to adopt at its December 8th meeting.
- The Commission will also have to determine whether it wishes to extend the PFM contract for 2023.
- The contract cannot be extended past 2023, so the Commission and OMES will have to issued a new RFP for incentive evaluation services in 2023.

Questions and Discussion