Making Oklahoma's Tax Expenditures More Transparent and Accountable

by David Blatt

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Introduction

Oklahoma is facing its most severe fiscal crisis since the oil bust of the 1980's. State revenue for the current fiscal year is projected to come in at more than 25 percent below levels prior to the downturn and to remain virtually flat in fiscal 2011. Even with the expected use of nearly $2 billion of federal stimulus dollars and reserves from the Rainy Day Fund, state agencies are facing budget cuts of 5 to 15 percent this year and next. For many agencies, these levels of cuts are leading to reductions in services, programs, and staffing that are seriously impacting their ability to fulfill their core missions and that will, in many cases, end up imposing greater costs to the state over time.

Even if the economy enters a sustained recovery, the tight fiscal squeeze on public services is certain to persist for several years. Over the long-term, an aging population and an outdated tax structure means that Oklahoma, like other states, is expected to face a mounting structural deficit, where the annual growth of revenue is incapable of keeping pace with the annual growth in the cost of funding basic public services.

This troubling fiscal outlook could be of value if it provides an impetus for Oklahoma's policymakers to review with greater seriousness and urgency the ways the state raises revenue and delivers public services. One subject that is already attracting greater scrutiny in the context of dwindling tax revenue and deepening budget cuts is the state's extensive collection of tax exemptions, deductions, incentives, credits, and the like. These provisions, which are known collectively as tax expenditures, allow taxes not to be paid when they otherwise would. Revenue forsaken in the form of tax expenditures is unavailable to support increased investments in public services or to allow for decreases in tax rates.

Tax expenditures are an extremely prevalent and popular policy instrument in Oklahoma. The most recent Tax Expenditure Report prepared by the Oklahoma Tax Commission (OTC) identifies over 450 separate provisions of state law that provide for some reduction in the amount of state taxes that would have been collected but for the preferential tax treatment benefiting some favored activity or category of taxpayer.[1] The revenue impact of individual tax expenditures written in Oklahoma law ranges from zero or extremely minimal amounts for some, to tens or hundreds of millions of dollars annually for others. Collectively, tax expenditures result in billions of dollars of revenue forsaken each year. The total cost of tax expenditures — $5.6 billion in fiscal 2008 for provisions that could be estimated by the OTC — equals more than 75 percent of total state appropriations ($7.1 billion in fiscal 2008) and grew by over $1 billion since fiscal 2006.

Tax expenditures resemble direct budgetary expenditures in many respects. As one leading expert states, tax expenditures, "may, in effect, be viewed as spending programs channeled through the tax system."[2] Yet tax expenditures typically have the following features that distinguish them from direct spending programs:

- Tax expenditures are not subject to annual or recurring legislative authorization;
- They are fiscally open-ended. In most cases, any person or business meeting the eligibility

[1]Oklahoma Tax Commission (OTC), Tax Expenditure Report, 2007-2008, *available at* http://www.tax.ok.gov/reports/TER2007-2008.pdf.

[2]Jane Gravelle, Tax Expenditures, in The Encyclopedia of Taxation and Tax Policy, Washington, D.C.: The Urban Institute Press, 2005, p. 406, *available at* http://www.taxpolicycenter.org/taxtopics/encyclopedia/Tax-expenditures.cfm.

criteria can claim a credit, deduction, or exemption, without there being any cap on the total amount made available;

- When revenue falls short, direct expenditures are subject to automatic cuts, but there is generally no mechanism to scale back, suspend, or eliminate tax expenditures;
- Most tax expenditures are not subject to routine and ongoing legislative review as to their number, size, effectiveness, and impact.

Nonetheless, in recent years, tax expenditure policies in Oklahoma have received increasing scrutiny from policymakers and observers of both major political parties and from across the ideological spectrum. Several prominent instances of costly tax credits that produced little, if any, apparent economic benefit have focused attention on possible abuses and wrong-doing associated with tax credit programs. Legislators, the media, and political watchdogs have become more vocal in raising questions about the cost and benefits of particular tax preferences and the system as a whole. In response, the Oklahoma Legislature has adopted a number of measures that have made the overall system more transparent, effective, and accountable. The current legislative session has brought renewed efforts to review and curtail tax expenditures in both the Governor's Executive Budget and in introduced legislation (see box on next page).

This issue brief provides an in-depth review of Oklahoma's system of tax expenditures, with a focus on tax incentives that aim to promote state economic development. The brief has three sections:

The first section provides a general overview of tax expenditures, focusing on the main arguments made for and against their use as an instrument of policy.

The second section surveys Oklahoma's system of tax expenditures, identifying the types, number, and cost of state tax preferences.

The third, and most extensive, section explores the measures that have been adopted in recent years in Oklahoma to strengthen the transparency and accountability of tax incentives, while also recommending further measures to consider in the years ahead. We base our discussion and recommendations on a set of four principles in tax expenditure policy that Oklahoma should strive to implement. We contend that policies should:

- Provide full public disclosure of existing tax expenditures;
- Establish formal mechanisms for the review and evaluation of the effectiveness of existing tax credits and incentives;
- Provide for front-end evaluation of new tax credits and incentives;
- Limit fiscal exposure through financial caps and triggers.

The report also sets out 12 specific recommendations that follow from these principles that aim to make tax expenditures more transparent, accountable, efficient and effective. (See p. 863 for a full list of principles and recommendations.)

I . Tax Expenditures Defined and Debated

According to the definition in federal statute, tax expenditures are "revenue losses attributable to provisions of [law] which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[3] Tax expenditures assume a variety of forms, including credits, deductions, exemptions, rebates, abatements, or deferrals. In general, tax expenditures affect the tax base — the range of income, sales, or property subject to taxation — rather than the tax rate. Collectively, while tax expenditures is the term of art, the term is used in this paper interchangeably with tax preferences or tax breaks.

While federal tax expenditures usually apply only to the income tax, at the state and local levels, preferential treatment is written into the laws for a wide range of taxes. Some tax advantages, such as the personal exemption that can be claimed against reported income or the homestead exemption for a primary residence, benefit a large group of taxpayers. Other provisions may benefit only a single industry or even, in practice, a single company.[4]

Tax expenditures are a widely utilized policy tool, with each legislative session seeing the introduction of dozens of bills calling for new or expanded tax breaks for individuals and businesses. Proponents of most specific tax break proposals tend to make the argument in their favor on one or both of the two following grounds:

- Tax preferences are instruments for accomplishing worthwhile public purposes. If policymakers agree, for example, that encouraging individuals to save for a college education is a worthy goal, then allowing a tax deduction or deferral for some or all of one's contributions to a 529 College Savings account may be the appropriate policy tool. Tax policy can also be used as a way to target assistance and benefits to groups deemed worthy of support, because of such factors as age, income level, disability,

[3]Quoted in Gravelle, note 4.

[4]See Jason Levitis, Nicholas Johnson, and Jeremy Koulish, Promoting State Budget Accountability Through Tax Expenditure Reporting, Center on Budget and Policy Priorities, April 2009, p. 5, *available at* https://www.cbpp.org/cms/index.cfm?fa=view&id=2772. The income tax credit for nonstop air service from Oklahoma to the Coast (68 O.S., s. 2357.28) was widely known to have been enacted specifically to assist Great Plains Airlines. The credit has been repealed.

military service, or occupation. Providing assistance through the tax code is often seen as a more effective and less expensive mechanism for providing support than operating a government spending program. Politically, gaining approval for a tax cut can be far easier than for new government spending.[5]

- *Encouraging Development.* Tax preferences are needed to encourage economic development. Oklahoma, like other states, has adopted a plethora of tax credits, exemptions, and incentive payments that support certain kinds of economic activity. The expressed goal in most or all instances is to promote capital investment and job creation by businesses that will benefit the state's economy. Tax preferences are generally justified as necessary and worthwhile when targeted to economically risky endeavors, emerging companies and sectors, export-oriented companies, and companies that will create high-paying jobs. In some cases, the explicit argument is that in a world of mobile capitol and competitive localities, businesses

[5]*Id*, p. 5.

Tax Breaks Under the Microscope

The combination of the state's historic budget shortfall and growing awareness of the problems associated with certain tax breaks have contributed to a surge in efforts to enact new limits on tax expenditures. The start of the 2010 Legislative Session has seen the following developments:

- **Fiscal 2011 Executive Budget**
  Gov. Brad Henry's fiscal 2011 Executive Budget includes a series of proposals to repeal or suspend tax breaks as part of his effort to bring next year's budget into balance. The Governor's descriptions, with estimated increase in fiscal 2011 revenue, are from the Executive Summary to the Governor's Budget:
  - — Repeal of the Rural Small Business Capital Credit ($37.4 million): "Governor Henry's budget proposes repealing the income tax credit for investment in certain large investment companies which invest in rural business that may or may not be economically viable." According to the online version of the 2008 Tax Expenditure Report, this credit cost $45 million in fiscal 2008, up from $3 million in fiscal 2006.
  - — Repeal of the Small Business Capital Credit ($11.1 million): "The Oklahoma Tax Code currently allows a credit equal to 20 percent of the cash invested in, or in conjunction with, a qualified small business capital company that invests in ventures that may or may not be economically viable." According to the online version of the 2008 Tax Expenditure Report, this credit cost $13 million in fiscal 2008, up from $1 million in fiscal 2006.
  - — Reform the Electric Car Credit ($9 million): "The Governor proposes revisions to the credit for conversion of motor vehicles to clean burning fuel or investments in qualified electric motor vehicles."
  - — One Year Moratorium on Select Tax Credits ($45 million): "The Governor proposes a one-year moratorium on income tax credits for tax year 2010." The list of affected credits has not been specified.
- **Legislative Efforts to Limit or Scrutinize Tax Expenditures**
  Along with the usual array of bills to add or expand tax preferences for various groups and activities, the 2010 session has seen the introduction of at least 20 bills that would provide for increased disclosure and review of tax expenditures or that would suspend, eliminate, or narrow existing specific provisions. The proposals include:
  - — Eliminating the tax credit for political contributions (SB 1266) and hydrogen fuel cell vehicles (SB 1267);
  - — Repealing the state's five-year Ad Valorem Manufacturing Exemption for qualifying manufacturers (SB 1797);
  - — Providing penalties for recipients of credits that leave the United States within a given period (HB 2617);
  - — Limiting the amount of state tax credits for purchases eligible for federal credits (HB 2641, HB 2820, HB 3037);
  - — Providing for additional disclosure of tax credit recipients (HB 2545, HB 2876, HB 3038);
  - — Providing for additional legislative review of tax credits (HB 3166, SB 1619, SB 2169);
  - — Suspending tax credits when revenue is not growing (HB 2044).

In addition, House Speaker Chris Benge has introduced a leadership shell bill, HB 3024, titled the "Tax Incentive Clarification Act" that could be used as a vehicle for changes to existing tax preferences.

will locate or move elsewhere in the absence of incentives. As long as other jurisdictions are offering incentives, failure to "play the game" is tantamount to unilateral economic development disarmament.

Yet if tax expenditures can serve a necessary and justifiable means to accomplish certain public policy goals, they also raise serious problems and concerns. Some of the concerns associated with tax expenditures include the following:

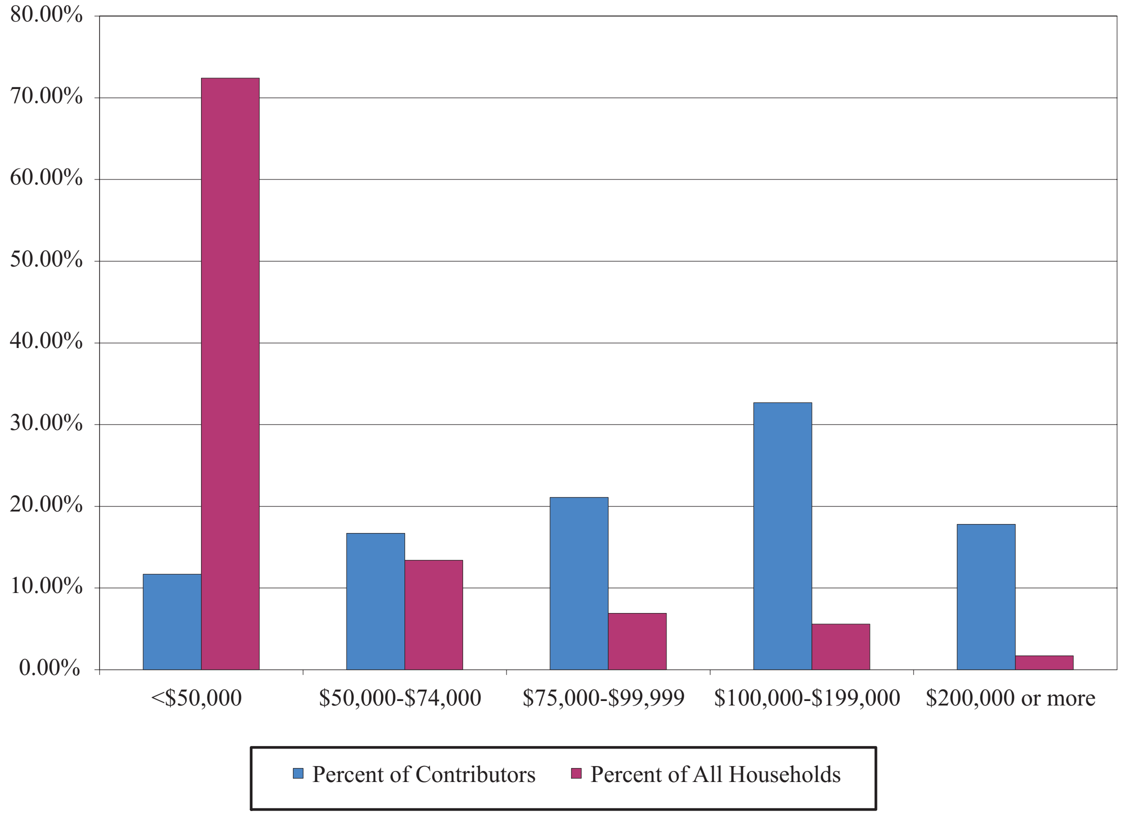
- *Hidden Expenditures.* Tax expenditures are largely invisible. Unlike direct spending programs, tax expenditures do not require annual appropriations or legislative review. In effect, they represent spending policies hidden in the tax code and administered by the Internal Revenue Service or Oklahoma Tax Commission. Traditionally, it has been difficult or impossible to obtain information about which companies and individuals claim tax breaks and in what amount because of taxpayer confidentiality. Even with greater disclosure in recent years, it remains hard to get consistent and reliable information about the cost and beneficiaries of tax breaks.
- *Efficiency.* While incentives are intended to get an individual or business to do something it would not otherwise do, it is often hard to establish whether a tax advantage makes a decisive difference in influencing behavior. Taxes, especially state and local taxes, are only one consideration among many that influence decisions by individuals and businesses. The national organization Good Jobs First, among the most vocal critics of state incentives policies, emphasizes that, "A mountain of evidence suggest that development subsidies are often abused by companies that would have done exactly what they did anyway."[6] In many instances, only a portion of the total cost of an incentive will produce an incremental increase in the behavior being promoted; the remainder is "wasted" as a pure subsidy or giveaway. This is also true of tax breaks intended to influence individual behavior: For example, at least some of those claiming a tax credit for first-time home buyers would have purchased a home irrespective of the tax break.
- *Accountability.* While tax incentive programs are generally created as a way to promote specific public goals, such as capital investment or the creation of high-paying jobs, there are frequently weak accountability provisions to ensure that goals are met. Many incentive programs impose few, if any, requirements that companies must meet to qualify for benefits, provide little ongoing monitoring or auditing, and rarely include oversight provisions or sanctions that can be imposed on companies that fail to uphold their commitments. As a result, some states have adopted "clawback" provisions as a component of incentive programs that require companies to refund all or part of their incentives if they fail to meet specified job or investment targets, or leave the state after receiving incentives.[7]
- *Neutrality.* Tax neutrality is the widely recognized principle that tax policies should "not interfere with the natural flow of capital toward its most productive use."[8] While this ideal may never be fully attainable, the practice of offering preferential tax treatment to certain individuals, businesses, and organizations rather than others tends to substitute political choices for market decisions in the allocation of resources. In many cases, there does not appear to be any clear or consistent reason why some economic sectors or activities are granted preferential tax treatment while others are not. Some distinctions can be justified on economic grounds (for example, not taxing business inputs), while others simply seem to reflect the clout of lobbyists, the economic interests of a powerful legislator, or the political muscle of a key voting bloc. These provisions can create competitive differences between similarly situated firms and individuals. For instance, two waste recycling firms operating in the same county may be subject to different tax treatment based on one having received tax incentives to relocate, while the other has not.
- *Equity.* While certain tax expenditures, such as the standard deduction or the earned income tax credit, provide preferential treatment for lower-income individuals, many of the largest tax expenditures, such as deductions for home-mortgage interest, pension contributions, and college savings, primarily benefit upper-middle class Americans. This is because many lower-income families do not have income tax liability against which to claim deductions, or do not have sufficient income to allocate to preferential forms of spending. A recent study by the Urban Institute-Brookings Institute Tax Policy Center found that households in the top fifth of income received twice as much benefit from federal tax expenditures as did households in the bottom fifth, who benefit primarily from the

[6]Good Jobs First, A Beginner's Guide to Economic Development, *available at* http://www.goodjobsfirst.org/accountable_development/beginners_guide.cfm.

[7]*Id.*

[8]The Free Dictionary; *available at* http://financial-dictionary.thefreedictionary.com/Tax-neutrality.

Figure 1.
Taxpayers Claiming Oklahoma 529 Tax Deductions by Income Level (Federal Adjusted Gross Income), 2005



refundable earned income tax credit.[9] In Oklahoma, data supplied by the Oklahoma Tax Commission revealed that some 72 percent of households claiming a tax deduction for contributions to the state's 529 college savings program in 2005 had annual income over $75,000, a group that represents just 14 percent of total Oklahoma households (Figure 1).[10]

- *Fiscal Impact.* The fiscal impact of tax expenditures is significant. Nationally, the Tax Policy Center study calculated the cost of tax expenditures claimed by individuals at $760.5 billion in 2007, more than the total budget for either national defense or non-defense discretionary spending.[11] As we will see, the total cost of tax expenditures for which the OTC was able to determine the cost exceeded $5.6 billion in 2008, which was not much less than that year's total appropriated state budget ($7.1 billion). This total is revenue that is unavailable to sustain public services in Oklahoma or to lower tax rates.

More significantly, perhaps, the cost of particular tax expenditures is generally unlimited. Typically, deductions and credits can be claimed in unlimited amounts so long as the credit's eligibility criteria are met. If an exemption or incentive proves popular, it can have a large and unanticipated impact on the budget. An example cited in a recent national report is of an Arizona tax credit for vehicles that can run on alternative fuels; the credit was expected to

[9]Leonard Burman, Eric Toder, and Christopher Geissler, How Big Are Total Income Tax Expenditures, and Who Benefits from Them? Tax Policy Center, December 2008; *available at* http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf.

[10]Data supplied by the Oklahoma Tax Commission for Tax Year 2005.

[11]*Supra* note 10.

cost $3 million to $10 million per year but ended up costing $680 million in its first year.[12] In Oklahoma, when businesses uncovered a way to exploit a loophole in the Venture Capital Tax Credit, the cost of the credit soared from $2 million to $66 million in one year.[13] More recently, it has come to light that the cost of the Oklahoma Rural Small Business Capital credit could reach $114 million in 2008 based on investments deemed to qualify for the credit.[14]

- *Local Impact.* Tax policies adopted by the state Legislature can have a large impact on the revenue available to local governments. With a few exceptions, the sales tax base for municipal and county governments is set by the state legislature, so that every new sales tax exemption adopted at the Capitol erodes the sales tax base of cities and counties across the state. On property taxes, while the Legislature cannot directly enact new exemptions, it can and does send proposals for statewide property tax exemptions to votes of the people. The local impact of decisions made at the state Capitol are particularly invisible, as the OTC does not report the cost of state-enacted tax expenditures on local government.

As much as tax preferences can be faulted on all these grounds, incentives and subsidies will still be defended as necessary tools for states competing against one another to attract or retain investment and jobs. But as Arthur J. Rolnick, the senior vice-president of the Federal Reserve Bank of Minneapolis has contended, this competition "interferes with interstate commerce and undermines the national economic union by misallocating resources and causing states to provide too few public goods."[15] Even if the subsidies war as a whole leaves no winners other than the companies that can wring concessions from state and local governments, states are unlikely to withdraw unilaterally. Accordingly, Rolnick is among those who have called on Congress to exercise its Commerce Clause power to put an end to the economic war among the states.[16] Conservatives and libertarian supporters of free-market principles have also consistently urged states to abandon the use of subsidies as a form of economic development.[17]

II. Oklahoma Tax Expenditures

The 2007-2008 Oklahoma Tax Expenditure Report, a biannual publication prepared, in accordance with state law, by the Oklahoma Tax Commission, lists some 455 separate "exclusions, deductions, credits, exemptions, deferrals or other preferential tax treatment allowed by law."[18] While the greatest number of tax preferences have been carved out of the income tax and the sales and use tax, tax breaks have been granted to 24 different tax types, from motor fuels taxes and alcoholic beverage taxes to charity games taxes. The report only includes tax expenditures applied to state taxes that are spelled out in statute, so it does not include an itemized list of services that are exempt from the sales and use tax. Beginning with the 2008 report, the OTC no longer reports on ad valorem tax preferences on the grounds that those impact local revenue only. It also does not attempt to calculate the impact of state sales tax exemptions on local government revenue, or the impact of federal tax provisions on state revenue.

The OTC Tax Expenditure Report determines the state revenue impact of tax expenditures, or "the amount of state revenue that would have been collected but for the existence of each exclusion, deduction, credit, exemption, deferral, or other preferential tax treatment allowed by law for the previous fiscal year."[19] Where possible, the OTC bases its estimates on actual tax returns, but also, in some instances, uses projections from a sample of returns or from secondary data sources, such as government agencies and industry sources. In total, the OTC provides an estimated revenue impact for 134 tax expenditures, or just over one out of every four of the total tax expenditures in statute. There are several reasons why a tax expenditure may lack a revenue estimate:

- The revenue impact is estimated to be zero or minimal (less than $25,000) because few people, if any, qualify for or take advantage of the tax preference;
- The revenue impact is unavailable as there is no known reliable data source on which to develop an estimate; or
- The OTC has determined that it is precluded from reporting a revenue impact due to the risk of divulging confidential tax information.

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[12] Levitis, Johnson and Koulish, op. cit., p. 8.

[13] Incentive Review Committee (IRC), 2007 Report of the Incentive Review Committee, March 2008, pp. 5-6

[14] Summary of Small Business Capital Company and Rural Small Business Capital Company Information reports for Calendar Year 2008 Activity, presented to Incentive Review Committee, Aug. 27, 2009

[15] Arthur J. Rolnick, "Congress Should End the Economic War Among the States," testimony to the Domestic Policy Subcommittee, Oct. 17, 2007, *available at* http://www.minneapolisfed.org/publications_papers/studies/econwar/ro lnick_testimony_2007.cfm.

[16] *Id.*

[17] For a good statement on the subject, see Lawrence Reed, Time to End the Economic War Between the States, Mackinaw Center, April 4, 1996; *available at* http://www.mackinac.org/article.aspx?ID=718.

[18] *Supra* note 3.

[19] *Id.,* p. 3.

Of the 134 tax expenditures for which the OTC was able to develop an estimate in its 2008 report, the total fiscal 2008 fiscal impact was an estimated $5.6 billion. Table 1 (next page) provides a list of the 40 items with an estimated fiscal 2008 impact greater than $10 million. These expenditures had a combined estimated impact of $5.5 billion, or some 98 percent of the total estimated.

The list of the most expensive tax expenditures reveals them to be of several types:

- *Sales to businesses and government:*The two costliest tax expenditures, by far, involve exemptions to the sales and use tax involving sales to manufacturers and sales for resale. Together, these two exemptions totaled $3.1 billion in 2008. These exemptions stem from the policy principle that products should be taxed only at the time of their final purchase by consumers, and not at multiple steps along the chain of production. It is unclear, however, why the exemption for sales for resale should have increased by a startling $720 million, or 93 percent, between 2006 and 2008. Sales to used motor vehicle dealers and to commercial airlines or railroads are other examples of exempting business inputs. The state also exempts sales to state, local, federal, and tribal governments.
- *Universal exemptions:* Most or all taxpayers are allowed to exempt a certain portion of their income from taxation through the personal exemption and standardized or itemized deductions, and of their property through the homestead exemption.
- *Preferences for worthy populations and activities:* The tax code bestows a variety of tax preferences to population groups, economic entities, and activities seen as worthy of support and assistance. The tax liability for seniors, persons with disabilities, veterans, and low-income households is all reduced by totally or partially exempting these groups from various taxes. The purchase of various categories of goods is exempted from sales and use taxes. In some cases, exemptions are for goods that may be seen as necessities (e.g. drugs and medical devices; utilities for residential sales; water, sewage and refuse services), but in other cases, it is non-essential goods that benefit from going untaxed (e.g. advertising sales, agricultural sales, livestock purchased out of state, newspapers and periodicals, horses, and tickets to professional sporting events). While none make the list of costliest tax expenditures, the Legislature has also granted sales tax exemptions for sales to and by a wide range of charitable organizations, including churches, veterans groups, biomedical research foundations, and fire departments.
- *Incentives for specified economic activities:* The state also offers tax credits and deductions as incentives to businesses and individuals to encourage certain kinds of economic behavior. While there are several dozen economic tax incentives in statute, only a few have a calculated fiscal impact exceeding $10 million, including: the Investment/New Job credit; incentive rebates for oil and gas production; the ad valorem manufacturing exemption; the small business and rural small business capital credits; and the oil and gas depletion allowance. In addition, the Quality Jobs Program provided $63.7 million in payments to businesses in 2008; however, it is excluded from the Tax Expenditure Report on the grounds that it is an incentive payment, not a tax credit.

III. Oklahoma Tax Expenditure Policy: Current Practices and Best Practices

The merits of granting tax preferences can be debated as a matter of principle; however, the reality is that tax preferences are embedded in so many sections of the tax code and involve such a wide array of programs, populations, and purposes that there is no basis to imagine they will ever entirely go away. What is more useful is to identify what distinguishes good policy from bad in the area of tax expenditures and to promote policies that improve a state's performance in this domain. The remainder of this paper sets out four principles that should govern tax expenditure policy, identifies what Oklahoma is currently doing well and poorly in each area, and offers a dozen recommendations for steps the state should adopt to ensure that the system of tax expenditures promotes worthwhile policy objectives.

Principle #1: Provide maximum public transparency into tax expenditures.

We have already noted that tax preferences share many common features with direct budgetary expenditures by government agencies. However, whereas direct expenditures are typically subject to annual appropriations or budgetary authority, tax expenditures are typically hidden in the tax code and are rarely reviewed. Information about who benefits from preferential tax treatment and in what amount may not be collected or made available to the public, the media, or legislators.

However, Oklahoma has implemented two significant reforms to improve the general transparency of tax expenditures.

- *Tax Expenditure Report.* In 1995, the Legislature passed legislation which tasked the Oklahoma Tax Commission with preparing a biannual tax expenditure report to identify and estimate the fiscal impact of each instance of

Table 1.
Tax Expenditures With a Fiscal 2008 Estimated Cost Impact >$10 million

Tax Type	Description	Amount Fiscal 2008	***	Amount Fiscal 2006
Sales & Use Tax Exemptions	Sales to manufacturers	$1,623,110,000		$1,532,912,000
Sales & Use Tax Exemptions	Sales for resale	$1,493,000,000		$773,781,000
Income Tax Deduction	Itemized & standard deductions	$685,506,000		$562,862,000
Income Tax Exemption	Personal exemption	$137,911,000		$150,273,000
Corporate Tax Credits	Income tax credit for investment or increased employment	$118,738,138	***	$40,244,733
Sales & Use Tax Exemptions	Subdivisions or agencies of state government	$104,750,000		$98,929,000
Sales & Use Tax Exemptions	Utilities for residential use	$99,592,000		$94,058,000
Cigarette Tax Stamp	Indian tribal compact sales	$96,648,000		$119,261,050
Sales & Use Tax Exemptions	State of Oklahoma	$85,105,000		$80,376,000
Income Tax Exemption	Social security benefits	$77,496,000		$71,904,000
Motor Vehicle Excise Tax Property Tax Exemptions	Used motor vehicle dealers Homestead exemption (1)	$70,725,758 not provided		$56,522,440 $65,997,987
Sales & Use Tax Exemptions	Agricultural sales	$63,905,000		$33,264,000
Motor Vehicle Excise Tax	Prorate vehicle excise tax — trucks and truck-tractors	$63,516,288		$55,497,150
Sales & Use Tax Exemptions	Drugs and medical devices	$60,967,000		$14,021,000
Gross Production and Petroleum Excise Taxes	Incentive rebates	$57,000,000		$106,000,000
Income Tax Exemption	Government retirement benefits	$50,215,000		$43,592,000
Sales & Use Tax Exemptions	Livestock purchased outside of state	$48,049,000		$45,379,000
Sales & Use Tax Exemptions	Advertising sales	$46,794,000		$44,194,000
Sales & Use Tax Exemptions	Commercial airlines or railroads	$45,706,000		$43,166,000
Corporate Tax Credit	Investment in rural venture capital companies and rural small business ventures	$45,068,020	***	$2,794,369
Property Tax Exemptions	Manufacturing facilities (2)	$44,825,246		$46,930,867
Estate Tax	Parents', children's or descendants' bequests	$38,381,000		$35,441,785
Income Tax Credit	Low-income sales tax relief	$37,813,000		$37,813,000
Income Tax Credit	Nonrefundable tax credit for taxes paid to another state by resident individuals on personal services compensation	$33,321,000		$28,225,000
Personal Income Tax	Oklahoma Earned Income Tax Credit	$30,243,000		$26,661,000
Corporate Tax Credits	Venture capital	$26,615,717	***	$1,664,000
Gross Production and Petroleum Excise Taxes	Small Business and Rural Small Business Capital Companies	$21,532,800		
Sales & Use Tax Exemptions	Federal food stamp program	$20,731,000		$11,775,000
Income Tax Credit	Net operating loss	$19,876,000		$ -
Sales & Use Tax Exemptions	Tuition and educational fees paid to private schools	$19,600,000		$18,511,000
Income Tax Exemption	Private retirement benefits	$17,657,000		$10,558,000
Tobacco Products Tax	Indian tribal compact sales	$16,485,000		$20,141,000
Motor Vehicle Excise Tax	Marital & parental transfers	$15,263,954		$13,482,370
Motor Vehicle Excise Tax	New resident	$13,867,224		$12,168,005
Sales & Use Tax Exemptions	Newspapers and periodicals sales	$13,772,000		$13,007,000
Income Tax Credit	Investment in qualified small business capital companies	$13,324,778	***	$1,004,632
Sales & Use Tax Exemptions	Water, sewage & refuses services	$12,771,000		$12,061,000
Property Tax Exemptions	Personal property tax exemption (1)	not provided		$12,336,735
Sales & Use Tax Exemptions	Disabled veterans	$12,178,000		$1,642,000
Income Tax Credit	Deduction as allowance for depletion based on cost of oil and gas deposit	$11,637,000		n/a
Motor Vehicle Excise Tax	Vehicles taxed under Ad Valorem Tax Code	$10,667,156		
	ALL OTHER EXPENDITURES (<$10M fiscal 2008)	$102,496,676		$223,550,428
	TOTAL OF ALL ESTIMATED EXPENDITURES	$5,606,861,385		$4,562,001,551

Source: Oklahoma Tax Commission, Tax Expenditure Report 2007-08 (Online Version) and 2005-2006.
***Items marked with asterisk represent significant discrepancies between online report and print report.
(1) OTC did not provide estimates on ad valorem exemptions in 2008 as these affect local tax revenue.
(2) 2007-2008 data from OTC Ad Valorem Division on Exempt Manufacturing Reimbursements

preferential tax treatment written into law.[20] The OTC has released seven tax expenditure reports; the most recent appeared in October 2008 and included fiscal estimates for fiscal 2008 (An updated version of the report, with new numbers for several income tax credits was posted online in late 2009.) The report is valuable for compiling a comprehensive inventory of tax expenditures, organized by tax type, and for reporting the cost of some, but not all, provisions (see previous section).

- *Taxpayer Transparency Act.* SB 1, the Taxpayer Transparency Act, which became law in 2007, provided for a public Web site to compile information on not only the expenditures of state funds but also incentive payments and tax credits. The Web site now provides a section that allows users to search tax credit information. The searchable database generates list of the names of individuals and businesses claiming over three dozen income tax credits in Tax Years 2007 and 2008 along with the amount of credits claimed. Information about the purpose of the credit and eligibility criteria is also provided.

Both the Tax Expenditure Report and the Openbooks.ok.gov Web site provide important information that helps shed light on the overall scope of tax expenditures in Oklahoma, as well as particular instances. However, both mechanisms have been implemented in ways that, thus far, fall short of the goal of providing maximum transparency into the use and cost of tax expenditures.

The Tax Expenditure Report suffers from a number of features that limit its usefulness:

- The report is unable to provide cost estimates for almost two-thirds of the listed provisions. In fact, Oklahoma's report is singled out in a recent national review of tax expenditure reports as one that is notably "weakened by repeated cost estimate omissions."[21] In instances where cost estimates are unavailable, no explanation is provided for why none could be provided.
- Information is often unreliable. The online and print versions of the 2008 Tax Expenditure Report have major discrepancies in the fiscal impact of various income tax credits, and differ further from the amount of credits identified on Openbooks.ok.gov.
- For each tax expenditure provision, the report provides a description and a cost estimate for the most recent year, where available. However, additional information is absent, including:
  — the year the provision was enacted;
  — the purpose or rationale of the provision;
  — statutory changes to the provision over time;
  — the number of recipients benefiting from the provision;
  — prior year cost impacts; or
  — future year cost projections.

These types of details, which are provided by the tax expenditure reports in many states, would make the report far more informative and useful.

- The report does not provide information on the fiscal impact of services that are not considered part of the sales tax base or the impact on local governments of sales tax and property tax exemptions that are parts of state law. While the scope of the report is in keeping with the statutory requirements, this additional information would provide a fuller and more accurate picture of tax preferences.

Recommendation 1A: Expand Oklahoma's Tax Expenditure Report to provide more detailed and comprehensive information.

- For each tax expenditure, the report should identify, along with existing information, the year it was enacted; the purpose of the provision, if available; statutory changes since enactment; its historical cost impacts and future cost projections; the number of beneficiaries; and an evaluation of its effectiveness, if available.
- Information that is unavailable should be accompanied by an explanation for its unavailability.
- The report should be expanded to include information on sales tax exemptions for services and the local fiscal impact of state exemptions.

The recently launched Openbooks.ok.gov Web site provides a valuable trove of detailed information on the recipients of tax income tax credits and may be just the first stage of a work in progress. However, at this time, the limits to the Web site include the following:

- The Web site provides information on recipients of income tax credits, but does not encompass incentive payment programs, even though these programs are spelled out in the statute.
- The site provides information only on income tax credits. Other major tax expenditures, such as rebates from the gross production tax for oil and gas for various kinds of drilling and credits claimed against the insurance premium tax, are not provided. In the case of the Coal Credit, $11.3 million was claimed against the Insurance Tax credit in 2007 compared to just $963,000 against the income tax.
- While the site allows a user to generate a list of recipients of each credit and the amount claimed, it does not provide aggregate data on the number of recipients or total amounts

[20] 68 O.S., s. 205.
[21] Levison, Johnson, and Koulish, op. cit., pp. 18-19.

claimed for each credit. To compile aggregate data, the user must pull up multiple pages (up to 56 pages in the case of the New Jobs/ Investment Credit), each with 25 entries.

Recommendation 1B: Expand the Openbooks.ok.gov Web site to cover a fuller range of tax expenditures and provide more aggregated information.

- The Openbooks.ok.gov Web site should incorporate information on incentive programs (currently available only from the OTC's Web site),[22] and on recipients of gross production tax rebates and incentives and insurance premium tax credits.
- The site should provided aggregated information on the number of recipients and total amount claimed for each credit and incentive payment by year.
- The site should allow users to download the database into a spreadsheet.

At the same time, the Openbooks.ok.gov Web site likely oversteps the appropriate bounds of public disclosure in some respects. The Web site currently provides information on all individuals who claim income tax credits, regardless of the amount or the nature of the credit. Thus the Web site lists, for example, the names of some 3,200 individuals who have claimed the volunteer firefighter credit, usually in the amount of $200 or $400, and of 1,246 individuals who made a biomedical donation and claimed credits for as little as $1. The disclosure of this kind of information from individual tax returns for credits that are not associated with economic development goals might be unnecessarily invasive of reasonable expectations of taxpayer privacy and might discourage taxpayers from claiming benefits for which they are eligible.

Recommendation #1C: Consider exempting certain tax credits and/or information on individual taxpayers claiming credits below threshold amounts from the Openbook.gov Web site

A final limitation is that while the Tax Expenditure Report and Openbooks.gov Web site could be complementary, the two form of reporting are currently not well integrated. Aside from a link to the PDF version of the Tax Expenditure Report on the OpenBooks.gov Web site, there is no simple way for a user to gather all the information from the two reports on any particular tax expenditure. Similarly, information on Quality Jobs incentives payments is reported on the OTC Web site but not at Openbooks.ok.gov. The OTC Web site currently lacks a link to Openbooks.ok.gov. Perhaps most alarmingly, there are systematic and often substantial differences in the cost of tax credits between the two data sources.

Recommendation 1D: Integrate the information currently provided separately in the Tax Expenditure Report and Openbook.gov

All the information on particular tax expenditures should be available in a single searchable database.

Principle #2: Existing tax expenditures should be formally reviewed and evaluated as to their effectiveness in achieving their purposes

Tax expenditures can become especially problematic if they are enacted into law and made permanent without a formal, ongoing review of how they are operating and an evaluation of whether they are succeeding in fulfilling a worthwhile public purpose. While accountability is important for various forms of tax expenditures, it is especially crucial for tax incentive programs that are intended to promote economic development by spurring investment and creating jobs.

There are several mechanisms that a state can adopt to promote accountability in the area of tax incentives and other forms of preferential tax treatment. These include: adopting sunset provisions for tax expenditure provisions; establishing committees or boards with responsibility for reviewing and evaluating tax incentives; developing clear and formal guidelines for evaluating tax incentives; and providing for ongoing monitoring, with possible sanctions, to ensure compliance with laws and obligations.

The Oklahoma Legislature has, in recent years, made considerable progress toward increasing the level of review and evaluation of tax expenditures. Its efforts have included:

- Providing for the statutory sunsetting of some tax incentives. Many of the state's income tax credits have been enacted for a set period of time, usually three to eight years, after which they expire unless reauthorized by the Legislature. A 2008 summary prepared by the OTC showed that of 52 income tax credit and tax exemption programs, 17 had sunset provisions.[23] Six of the seven allowable rebates against the gross production tax for specified kinds of drilling are also subject to sunsetting;

[22] http://www.tax.ok.gov/reports1.html. It is not clear whether the OTC's report includes all incentive payment programs or just the main Quality Jobs Program.

[23] Oklahoma Tax Commission, Oklahoma Incentives. Attachment A to 2008 Incentive Review Committee Report, Apr. 17, 2009.

Defining Principles of Sound Tax Incentive Systems

In 2005, the Oklahoma Incentive Review Committee adopted eight principles of sound tax incentives systems that they have used in each of their reports as a standard by which to review and evaluate particular incentive programs. The principles are:

- **Principle 1. The benefits and costs of the incentive system should be equivalent.** Too often, we consider only the benefits, not the costs. Too often, we view the effect of incentives in a partial equilibrium sense, not general. For example, a highly successful incentive program might raise the cost of doing business for firms not receiving the incentive, necessitating a reduction in employment. States with balanced budget requirements must recognize that less revenue from one source creates greater burdens on existing firms and citizens. Similarly, when estimating the benefits and costs of an incentive program, the time value of money should be considered. That is, if the benefits of an incentive all occur many years in the future, the current benefit is significantly lessened and this impact must be accounted for in estimates of both costs and benefits.
- **Principle 2. An individual incentive program should fit well within the broad strategic framework of state economic objectives.** Individual programs should fulfill at least one key role in a broad portfolio of policy initiatives that focuses on business attraction, business retention, new business start-up, high technology, land use, and training to improve productivity. That broad strategic framework needs to well-encompass local economic development perspectives, initiatives, and professionals.
- **Principle 3. The objectives of the program should be clearly identified.** Incentive programs have as their purposes (a) expansion of business activity that exports outside the regional economy, (b) substitution for imports to the regional economy, (c) increased productivity, (d) improved resource utilization, i.e., reduction of unemployment and underemployment. Just how a program is going to yield specific results needs to be clearly spelled out.
- **Principle 4. Incentive programs are to be targeted to firms where the program will clearly make a difference.** Firms are not equal in their ability to contribute to the economic well-being of a region, as is evident by substantial variation in industry output, income, and employment multipliers. This is a basic fact of economic expansion that needs to be heeded. Targeting may also be necessary in order to compete with incentives offered by other jurisdictions. The epitome of targeting is a "deal-closing" fund which is used by many jurisdictions to provide the marginal difference to a business making the location decision. "Deal-closing" funds are commonly used to incentivize job creation or retention by defraying costs for infrastructure, employee training or tax incentives.

  Carefully administered targeting programs can reduce the overall cost to a state of its incentive programs. Targeting can avoid turning economic development incentives into generalized business "entitlements" which cost the state money but which do not change the behavior of business firms and thus do not promote economic development.
- **Principle 5. Incentive programs should be neutral with respect to the types of industries that qualify for the program.** Service industries are dominating growth in US businesses. If a firm's application meets the tests of export expansion, import substitution, or other enhancements to resource utilization, it should not matter what industry the firm is identified with.
- **Principle 6. Incentive programs should have built-in evaluation mechanisms.** Without the capability to evaluate the benefits and costs of a program, there is little or no rationale for undertaking the program in the first place. Evaluation programs and generation of the appropriate data sources for evaluation need to be specified before the program is undertaken. The evaluation process needs to be followed closely according to plan.
- **Principle 7. Incentive programs should have sunset provisions and other features that enhance accountability.** Sunset provisions focus attention on the evaluation process and outcomes, and, thus, should be components of these programs. Industry is probably more mobile now than it has ever been, historically. Economic development initiatives should not fall into the trap of attempting to attract footloose industries and other copy-cat initiatives.
- **Principle 8. Incentive systems should be based on rules versus discretion.** Basing decisions on who gets incentives on a set of well-defined guidelines of eligibility is key to the ultimate potential for favorable evaluation.

In 2008, the IRC added an additional principle.

- **Principle 9. Incentive systems using tax credits should seek to maximize the dollars flowing to the intended purpose.** Thus, all tax credits should be designated as directly transferable, given that (i) even when designated to be "nontransferable" by the enabling legislation, the benefits of tax credits can be bought and sold nonetheless, and (ii) the derivative transfers of nontransferable tax credits significantly increases the costs to the state thereby decreasing the overall economic benefit to Oklahoma.

- Creating an Incentives Review Committee with the responsibility to evaluate tax incentives. The 9-member Incentives Review Committee (IRC) was created by SB 1516 in 2004 out of recommendations developed by Governor Henry's EDGE Task Force of 2003. The IRC, which meets monthly, is charged with conducting a review each year of one or more tax incentives, which includes determining whether the incentive is effective in achieving its desired outcome. Its four annual reports have evaluated the Investment/New Jobs Tax Credit (2005), the Ad Valorem Tax Exemption and Tax Increment Financing districts (2006), the Small Business Capital Credit, Rural Small Business Capital Credit and Venture Capital Credit (2007), and the Insurance Premium Tax credit (2008). The reports, which are distributed to the governor, house speaker, and speaker president pro tem, have included recommendations regarding each incentive. The IRC has not, however, conducted formal follow-up on the impact of their evaluation and recommendations on policy decisions.

- Adopting formal criteria for evaluating tax incentives. The legislation creating the IRC specified that the evaluation of tax incentives should address twelve questions, which include determining the economic impact and fiscal impact of an incentive, as well as whether it is the most fiscally effective means of achieving its stated purpose. Based on a review of the economic development literature, the IRC identified eight principles of sound tax incentives (see box, previous page). Each of its annual reports has applied these principles to the incentive under review. This has helped the committee determine the ways in which the incentive meets or fails to meet the standards of good policy and served as the basis for recommendations to the Legislature.

- Controlling abuses and loopholes in tax credit incentive programs. In at least one prominent instance, involving a number of credits intended to encourage venture capital, the OTC discovered evidence that investors were exploiting loopholes in the law to claim the credit in unintended, but legal, ways. In one year, the cost of the program soared from $2 million to $66 million, as investors found ways to claim tax credits without putting funds at risk. The Legislature stepped in to amend the law in 2006, and one of the affected credits, the Venture Capital Credit, was allowed to sunset out of existence in 2008. However, the other credits — the Small Business Capital Credit and Rural Small Business Capital Credit — continue to operate and have seen their fiscal impact snowball in recent years amidst allegations of abuse.[24]

Recent legislative sessions have seen legislators pay increased attention to tax expenditures and offer various proposals to increase their level of scrutiny. These include:

- Legislation offered by Senator Mike Mazzei in 2008, SB 2024, would have sunsetted virtually all tax preferences, including sales tax exemptions, over the course of several years, while tasking the Incentives Review Committee with studying each incentive prior to its expiration. The bill passed the Senate Finance Committee but then died.
- A 2009 bill authored by President Pro Tem Glenn Coffee, SB 646, which would have created a new Office of Accountability, Innovation and Privatization, included as one of the new Office's roles to prepare an annual list of tax preferences for which a tax incentive review will be conducted, subject to available funding. The bill failed to get reported out of conference committee at the end of session.
- A 2009 bill, HB 1097, authored by Representative David Dank and Senator Randy Brogdon, created a nine-member task force to study transferable tax credits. The task force held three hearings in the fall of 2009 that focused on the legal mechanisms by which LLCs (limited liability corporations) can be used to make investments and claim credits.
- Several bills introduced in 2010 would add further oversight and evaluation requirements for tax credits and eliminate specific credits and exemptions (see page 849).

While this increased level of scrutiny of tax expenditures is commendable, the work of the Incentives Review Committee in particular has identified definite weaknesses with Oklahoma's system of tax incentives. The concerns that have been identified by the IRC include:

- It can be difficult or impossible to gather information on who benefits from a tax incentive program. In its report on the Investment/New Jobs Tax Credit (ITC), the Incentives Review Committee wrote that "the committee was repeatedly frustrated by the lack of available data concerning the ITC."[25] The Taxpayer Transparency Act was intended to address this

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[24]Michael McNutt, Oklahoma legislator Mike Reynolds says tax credit plan is abuse target, Oklahoman, October 17, 2009. The Web site prowlingowl.com has extensive information alleging misuse of the capital formation credits.

[25]Incentive Review Committee, 2005 Report of the Incentive Review Committee, p. 20.

concern by requiring the disclosure of information on recipients of tax credits. The information now posted on Openbooks.gov appears to provide a comprehensive list of companies and individuals that claimed each income tax credit in 2007 and 2008.

- Many incentives lack an ongoing monitoring mechanism to ensure that credits are being claimed appropriately. In its report on the Investment/New Jobs Tax Credit (ITC), the IRC wrote that, "The committee is deeply concerned about the apparent lack of monitoring of firms claiming the ITC. The Tax Commission indicated. . . . that the only way a firm claiming the ITC had the eligibility for the credit verified was during an audit of its income taxes."[26] This appears to be a prevalent problem in tax incentive programs, with the Tax Commission having neither the authority nor resources to determine if credits are being claimed for bona fide economic activity.
- Many incentives lack built-in evaluation mechanisms. While the IRC or other external bodies can conduct periodic evaluation of tax incentive programs, built-in structures and processes are needed to determine on a timely and on-going basis if a program is serving its economic development goals of generating investment and creating jobs. In its evaluation of the ITC, the Incentives Review Committee wrote that, "The program is lacking considerably in mechanisms for evaluation. . . . Little forethought has been given to evaluation."[27] The IRC came to a similar finding about the Ad Valorem Manufacturing Exemption and about the venture capital credits prior to the 2007 changes to the law.[28]
- Some programs do not target resources efficiently. One of the evaluation principles adopted by the IRC is that "incentive programs are to be targeted to firms where the program will clearly make a difference". The goal is that incentives should make a decisive difference in encouraging firms to engage in activities that promote economic development. The IRC has judged each of the programs it has reviewed favorably in this regard. However, a recent study of oil and gas tax exemptions found that while most companies had claimed gross production tax incentive rebates, the rebates were ranked as the least important factor among ten variables affecting a producer's decision to drill.[29]
- Some programs are ineffective. The 2006 report of the IRC very clearly concluded that the Ad Valorem Manufacturing Exemption, which offers a five-year property tax exemption to manufacturers for locating or expanding operations and increasing employment, "has not proven successful in that the costs to the state have exceeded the benefits."[30] This finding corresponds with that those of an earlier study of the ad valorem manufacturing exemption by Larkin Warner.[31] The additional investment and employment associated with the program were found to fall short of the program's cost, which have approached $50 million annually.

Recommendation 2A: Add sunset provisions to all tax incentives that are not currently sunsetted.

Recommendation 2B: Enact a statutory requirement that before any sunsetted incentive can be reauthorized, it must undergo a formal "performance review" and legislative recommendation by the Incentive Review Committee or similar entity.

The review should involve gathering similar information to that required under current statute for the work of the Incentive Review Committee, including an analysis of whether the program is meeting its objectives in a cost-effective manner. The review should lead to a formal recommendation of whether the program should be maintained, amended, or repealed.

Recommendation 2C: Strengthen ongoing monitoring and evaluation of existing tax credits

- Legislation on existing tax incentives should be reviewed; where appropriate, tax incentive programs should identify clear purposes for the program.
- Businesses that are recipients of tax incentives should submit regular data on new investment and job creation or retention that is attributable to the tax incentive. This information

[26]*Id.*

[27]*Id.,* p. 7.

[28]On the Ad Valorem Manufacturing Exemption, see IRC, 2006 Report of the Incentive Review Committee, p. 9. On the venture capital credits, see IRC, 2006 Report of the Incentive Review Committee, p. 10.

[29]Steve Agee, Presentation to Appropriations and Budget Committee, Oklahoma House of Representatives, Jan. 22, 2009.

[30]IRC, 2006 Report of the Incentive Review Committee, p. 7.

[31]Larkin Warner and Robert C. Dauffenbach, Two Oklahoma Incentives for Economic Development: Introduction to Ad Valorem Tax Exemption and Quality Jobs Act, State Policy and Economic Development in Oklahoma: 2004, A Report to the Oklahoma 21st Century, Inc., 2004.

should be monitored by the Oklahoma Tax Commission and/or Oklahoma Department of Commerce.

An additional step to strengthen oversight and accountability would be to develop a unified economic development budget (UDB), a single report that compiles information on all forms of development spending — both direct and tax expenditures — in one place.[32] In Texas, legislation enacted in 2001 requires the Comptroller of Public Accounts to collect and make available information related to economic development in Texas, including "state government expenditures supporting economic development, Texas Growth Fund investments, information on local economic development corporations, state tax exemptions and tax incidence, franchise tax credit claims, and impacts of tax exemptions."[33] A unified economic development budget would present policymakers and the public with a more complete picture of the array of policies promoting economic development and allow for comparisons to be made of the impact and cost-effectiveness of different approaches.

Recommendation 2D: Develop a unified economic development budget that compiles information on all forms of development spending, including direct expenditures and tax incentives.

Principle #3: Tax incentives programs should include front-end eligibility evaluations

In the previous section, we considered some of the steps that have been adopted and proposed to improve the accountability of tax incentive programs that are already operating. A related but distinct principle of tax expenditure policy involves creating a formal front-end process within a tax incentive program to determine whether an applicant for a tax credit or incentive should be awarded its benefits.

Oklahoma has enacted several laws in recent years which reflect recognition of this principle and that can serve as models, or best practices, for other existing programs or future legislation. Examples of programs with front-end evaluations of applications for tax preferences include:

- The Quality Investment Program, approved by the voters as SQ 725 in November 2006, provides financial incentives for at-risk manufacturers that are already operating in Oklahoma but that may be weighing leaving the state or shutting down operations. The legislation creating the program established a seven-member Quality Investment Committee to evaluate applications for payments based on a number of factors. The committee makes recommendations that must be adopted unanimously by the governor, house speaker, and senate president pro tem Oklahoma's Tax Increment Financing (TIF) legislation creates a formal process for review of proposals for the creation of TIF districts, which involve tax preferences for investment in underserved or blighted areas . A TIF Review Committee must be established prior to approval of a TIF project with representation from all affected taxing jurisdictions and the public at large. Approval is contingent on applications meeting specified economic benefit tests. Many TIF proposals have generated considerable controversy, but this controversy is itself an indication of a process that makes decisions on tax treatment on the basis of an open and rule-governed process.
- The Quality Jobs Program, which was first implemented in 1993, offers incentive payments to firms in specified industries that commit to creating good-paying jobs with benefits. Participants in the Quality Jobs Program must submit an application to the Oklahoma Department of Commerce, which conducts a cost-benefit analysis of the anticipated "new direct jobs" associated with the location or expansion of the applying firm. Qualifying companies then enter into contracts with the state. The state makes quarterly payments to companies with Quality Job contracts for three years; if thresholds are achieved, they may extend for an additional seven years. In 2009, the Legislature passed the 21st Century Quality Jobs Act (SB 938), which offers greater incentive payments to firms creating especially high-paying jobs, based on a similar application process and contract. Several smaller and more targeted state programs also tie eligibility to a company's commitment to creating and maintaining good-paying jobs.[34]

In all these cases, the establishment of a front-end eligibility process ensures that an incentive program is based on clear purposes and goals. This in turn facilitates measurement, evaluation, and overall accountability, as recipients of tax preferences can be judged against program goals and their commitments.

[32]*See* Good Jobs First, Researching Audits and Tax Expenditure Budgets, *available at* http://www.goodjobsfirst.org/accountable_development/researching_audits.cfm.

[33]*See* http://www.texasahead.org/economy/sb275/.

[34]The Small Employer Quality Jobs Incentive Act and the Income Tax Credit for Computer Data Processing/Research and Development Jobs have wage and benefit standards. Also the five-year Ad Valorem manufacturing exemption has job standards for distribution and warehouse operations only.

Programs that are based on clearly articulated purposes and that require applicants for subsidies to commit to particular goals are in a much better position to hold companies accountable in cases where commitments are not upheld. Some states have incorporated sanctions in the form of recapturing economic development subsidies when companies fail to meet job creation or wage and benefit standards, or receive subsidies and subsequently pull up stakes from the state entirely.

Oklahoma has not traditionally included such recapture, or "clawback" provisions as part of its incentive programs. However, a bill that was passed in 2009, SB 929, that expanded eligibility for the Ad Valorem manufacturing exemption to otherwise-ineligible marine engine manufacturers, included a provision to make payments subject to "recapture" if a company left the state prior to January 1, 2012. The clawback provision was invoked when the beneficiary of the subsidy, Mercury Marine, announced it was shuttering its Stillwater operations after using the Oklahoma subsidies to wring concessions from its workers and state and local governments in Wisconsin.[35]

Recommendation 3A: Establish formal eligibility processes for new and existing incentive programs

- As with the tax incentive programs discussed in this section, new and existing incentives should, in most instances, include a formal eligibility process that will allow for an evaluation of applicants applying for assistance.
- Programs should provide clear benchmarks and standards for evaluating economic benefit.

Recommendation 3B: Promote accountability by creating and enforcing standards for companies receiving incentives.

For programs with investment and job requirements, companies that fail to meet requirements should forfeit future eligibility and/or be required to refund some or all of the amount of their subsidy. A new or existing entity would need to be granted authority for enforcing these standards in a clear, rule-based, and accountable way.

Principle #4: The state's fiscal exposure to tax expenditures should be limited by establishing spending caps and triggers

Unlike budgetary expenditures, which are subject to annual appropriations and to the availability of revenue, tax expenditures tend to be fiscally open-ended. In most cases, any person or business meeting the eligibility criteria can claim a credit, exemption, or deduction, without there being any cap on the total amount made available. Even during times of declining state revenue, budgetary shortfalls, and deep and widespread cuts to agency appropriations, tax preferences are likely to remain untouched, while their cost impacts could even grow, enlarging the budget shortfall. This situation raises a number of troubling policy questions. Given scarce resources, why should an economic development spending program to promote new technologies receive a fixed appropriation or take cuts, while a tax credit to accomplish the same purpose is uncapped? Why in a budget downturn should appropriations to DHS for senior assistance programs be cut while tax preferences for elderly homeowners are not?

Because they are uncapped and open-ended, we do not know what the cost of tax expenditures will be in any given year. In some cases, a change in state or federal law, a court ruling, or a new interpretations of the law by attorneys and accountants can have a dramatic impact on the cost of tax breaks. A number of examples can demonstrate the risk of uncapped tax preferences, even in the absence of a budget downturn.

- As discussed earlier, a loophole in the venture capital tax credit cost the state treasury $66 million in 2005 before the Legislature was able to enact amendments to change the law and curb abuses. As long as companies were complying with the letter of the law, the OTC could do nothing to prevent companies from claiming the credit. More recently, the costs of the Rural Small Business and Rural Venture Capital Company credits and New Jobs/Investment credit have ballooned by tens of millions of dollars.

- In the case of the five-year Ad Valorem Manufacturing Exemption, expansions of the definitions of qualifying manufacturers led to the program cost jumping from under $20 million per year through 2000 to $52.4 million by 2004.[36] However, the funding mechanism by which the state reimburses counties and school districts for lost property tax revenue has remain unchanged (1 percent of income tax revenue). This has led to shortfalls year after year this decade, requiring the Legislature to step in with last-minute supplemental appropriations at the expense of other funding priorities.

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[35]*See* OK Policy's blog post on this, Sunk: Mercury Marine fiasco casts light on costs of state subsidy wars, *available at* http://okpolicy.org/blog/taxes/sunk-mercury-marine-fiasco-casts-light-on-costs-of-state-subsidy-wars/.

[36]Oklahoma Tax Commission Ad Valorem Division, Annual Report to the Oklahoma Tax Commission: Exempt Manufacturing Reimbursements, 62 O.S. Section 193, 2008.

- The OTC's estimate of the cost of the sales tax exemption for resales ballooned from $774 million in fiscal 2006 to $1.493 billion in fiscal 2008. The explanation for this jump is unclear.

While most tax expenditures are unlimited, there are some examples of the state setting funding caps on tax preferences. These include:

- Incentive payments under the Quality Investment Program created by SQ 725 are limited to $10 million in total, with no single company eligible for more than $5 million in subsidies. In addition, the payments, which are made from the state's Constitutional Reserve (Rainy Day) Fund, can be made only in years when the fund has a balance at the beginning of the year of at least $80 million and when revenue for the upcoming fiscal year is projected to increase.
- Since 2006, the total amount of tax rebates claimed on gross production taxes for deep well drilling below 15,000 has been capped. The cap was initially set at $17 million for fiscal 2007, rising to $20 million in fiscal 2008 and $25 million in fiscal 2009 and thereafter. Rebates on deep well drilling had reached $59.6 million in fiscal 2005 before the cap was instituted. By comparison, rebates on horizontally drilled wells, which are not subject to a cap, increased from $17.8 million in fiscal 2006 to $35.6 million in fiscal 2008. In situations where eligible rebate claims for deep well drill exemptions exceed the available cap, the statutes and OTC rules specify a process for allocating the rebates among eligible participants.[37]
- Since 2006, income tax credits for investments in agricultural processing cooperatives have been limited to $2 million annually.[38] The total cost of the credit, according to the 2008 Tax Expenditure Report, is just $110,000.
- The Oklahoma Film Enhancement rebate has an annual cap of $5 million.

These examples seem to be the only instances in current law of overall caps in allowable credits.[39] Establishing caps on additional programs would avert the potential for future instances of abuse through tax dodges and exploitation of loopholes and provide greater predictability for the state budget.

Similar but distinct from caps are triggers that would limit tax expenditures during difficult budget circumstances. Under current law, the Quality Investment Program, which is tied to the balance in the Rainy Day Fund, appears to be the only credit that can be suspended or limited based on the availability of revenues. Between 1998 and 2005, eligibility thresholds for the Sales Tax Relief credit were tied to a revenue trigger, so that in year when revenues were projected to fall, eligibility for the credit was restricted. The trigger concept is also applied in several other provisions in state law that tie tax cuts or appropriation increases to revenue growth.

Recommendation #4A: Limit the cost impact of existing and future tax incentives though caps on overall amounts.

- The Legislature could provide that all future tax credits be subject to a dollar amount cap unless expressly exempted by law.
- For existing incentives, the Incentive Review Committee or some other entity could develop legislative recommendations on implementing reasonable caps based on historical experience and program goals.
- For existing and future incentives involving caps, statutory or administrative rules would determine the procedure for dividing total available credits between qualifying entities.

Recommendation #4B: Limit the cost impact of existing and future tax expenditures through triggers that would suspend or reduce selected preferences in times of budget shortfalls.

Legislation could specify that in years of declining revenue, the amount of specified deductions, credits and exemptions that qualifying entities could claim would be reduced.

Conclusion

The combination of the state fiscal crisis and a long-term trend toward demanding greater openness and accountability suggest that tax expenditures will receive increased scrutiny in the coming months and years. Rather than accept all tax preferences that are currently in law, or reject them en masse as giveaways to special interests, we hope this brief can be valuable in improving the state's tax expenditure system and ensure that in the area of tax preferences, as in the area of direct budgetary

[37]*See* Oklahoma Policy Institute, Oklahoma's Gross Production Taxes and Exemptions, April 2009, *available at* http://okpolicy.org/files/GPTfactsheet.pdf.

[38]68 O.S. 2357.25.

[39]In the Quality Jobs Program, individual companies are capped as to the total amount of credit they can claim over a 10-year period based on a net-benefit calculation of estimated economic impact of newly created jobs conducted at the time the company is accepted into the program. However, companies can get around the cap by entering into a new agreement with the state.

expenditures, the state is allocating public resources in the best possible fashion.

List of Principles and Recommendations

Principle #1 : Provide maximum public transparency into tax expenditures (see p. 853)

Recommendation 1A: Expand Oklahoma's Tax Expenditure Report to provide more detailed and comprehensive information.

Recommendation 1B: Expand the Openbooks.ok.gov Web site to cover a fuller range of tax expenditures and provide more aggregated information.

Recommendation 1C: Consider exempting certain tax credits and/or information on individual taxpayers claiming credits below threshold amounts from the Openbook.gov Web site.

Recommendation 1D: Integrate the information currently provided separately in the Tax Expenditure Report and Openbook.gov

Principle #2: Existing tax expenditures should be formally reviewed and evaluated as to their effectiveness in achieving their purposes (see p. 856)

Recommendation 2A: Add sunset provisions to all tax incentives that are not currently sunsetted.

Recommendation 2B: Enact a statutory requirement that before any sunsetted incentive can be reauthorized, it must undergo a formal "performance review" and legislative recommendation by the Incentive Review Committee or similar entity.

Recommendation 2C: Strengthen ongoing monitoring and evaluation of existing tax credits.

Recommendation 2D: Develop a unified economic development budget that compiles information on all forms of development spending, including direct expenditures and tax incentives.

Principle #3 : Tax incentives programs should include front-end eligibility evaluations (see p. 860)

Recommendation 3A: Establish formal eligibility processes for new and existing incentive programs.

Recommendation 3B: Promote accountability by creating and enforcing standards for companies receiving incentives.

Principle #4: The state's fiscal exposure to tax expenditures should be limited by establishing spending caps and triggers (see p. 861)

Recommendation 4A: Limit the cost impact of existing and future tax incentives through caps on overall amounts.

Recommendation 4B: Limit the cost impact of existing and future tax expenditures through triggers that would suspend or reduce selected preferences in times of budget shortfalls. ✰