KANSAS LEGISLATIVE DIVISION of POST AUDIT

The Rundown podcast transcript for Performance Audit report titled ***Angel Investor Tax Credit Program*** – Released November 2020

Brad Hoff, Host and Recruiting and Training Manager: [00:00]
From the Kansas Legislative Division of Post Audit, this is The Rundown, your source for news and updates from LPA, including performance audits recently released to the Kansas legislature. I'm Brad Hoff. In November 2020, Legislative Post Audit released a performance audit evaluating the angel investor tax credit program in the state of Kansas. I'm with Andy Brienzo, principal auditor at Legislative Post Audit, who supervised this audit. Andy, welcome back to The Rundown and thanks for taking the time to discuss this report with me.

Andy Brienzo, Principal Auditor and Supervisor: [00:42]
Thank you for having me Brad.

Brad Hoff, Host and Recruiting and Training Manager: [00:43]
Now this audit is actually the first of LPA's new economic development incentive evaluations, which state law now requires LPA to do. Tell me about this.

Andy Brienzo, Principal Auditor and Supervisor: [00:59]
That's right. So 2019 House bill 2223 directed Legislative Post Audit to start doing evaluations of economic development incentive programs. So there's three elements that the law requires us to include in our evaluations. The first is a description of the program that we're evaluating its history and its goals. The second is a literature review that looks at the effectiveness of the program being evaluated and includes an inventory of similar incentive programs in other states. And the third is an estimate of the economic and fiscal impact of the incentive program. There's a variety of different things that could include that the law lays out. This is stuff like the extent to which the incentive program might be changing business behavior, the results of the program for the economy of Kansas as a whole, an assessment of whether the incentive program is achieving its goals as a variety of different things that a Legislative Post Audit has the discretion to look at and the overall purpose really is as stated in law is to enable evidence-based policy determinations by the legislature with respect to economic development incentive programs. And as you mentioned, this is the first one that we've done. So, this is a new area for us, and we're actually pretty excited about getting started on it.

Brad Hoff, Host and Recruiting and Training Manager: [02:25]
So, this first audit focused specifically on the angel investor tax credit program. Talk about the program and how it works.

Andy Brienzo, Principal Auditor and Supervisor: [02:36]
So, this is a program the legislature created in 2004 and it actually is set to sunset in 2021, unless the legislature extends it during the upcoming 2021 legislative session. So, statute allocates $6 million currently for commerce to distribute in tax credits each year through 2021 and they can roll these allocations over to subsequent years if they don't award the full $6 million, but this money is used to provide one-time tax credits that reduce investors' Kansas tax liabilities, dollar for dollar. Generally they go toward investors' income taxes. They can also go actually to insurance companies, premium taxes and investors receive these credits when they make an investment in a participating business. So, the credit equals up to 50% of their investment. They can receive up to $50,000 for each investment in a participating business and $250,000 total for each year and businesses in return have to give investors equity. Now this program is administered by the Kansas Department of Commerce and [Department of] Revenue. So, Commerce is responsible for reviewing applications for the program from businesses and determining which ones can participate. They also determine how much each business can award in tax credits to its investors and then revenue is primarily just responsible for processing investors, tax credits, kind of on the back end, after they've been awarded credits for making investments under the program.

Brad Hoff, Host and Recruiting and Training Manager: [04:14]
What are the goals of the program?

Andy Brienzo, Principal Auditor and Supervisor: [04:17]
The overarching goal for the program is to increase investment opportunities for start-up businesses in Kansas, and specifically for businesses that are developing innovative and proprietary products or services. It's also meant to target businesses that the secretary of Commerce determines to have the greatest potential for benefit to the state's economy. So, state law requires businesses to be qualified by the Department of Commerce before their investors can receive tax credits and they have to meet a few criteria to qualify. So, they have to be headquartered and do business primarily in Kansas and Commerce officials told us this means they've got 80% of their operations or 60% of their employees located in Kansas businesses. Also, typically must be less than five years old and have $5 million or less in revenue in the most recent tax year and as I mentioned before, they must have an innovative and proprietary product or service. The statute importantly prohibits certain types of businesses from qualifying. So, this includes industries like banking, insurance, legal firms, accounting firms, construction, and it's also important to note that the statute doesn't provide benchmarks for measuring program success. So, the legislature didn't actually outline its expectations for the program beyond its general purpose of

increasing investment opportunities for innovative and proprietary start-ups. So, Commerce officials told us, they look primarily at how long businesses stay in operation to determine the program success. They said they consider the program be successful businesses last at least five years and then they also look secondarily at whether the participating businesses have created jobs.

Brad Hoff, Host and Recruiting and Training Manager: [06:08]
What does the research say about the effectiveness of similar tax credit programs in general?

Andy Brienzo, Principal Auditor and Supervisor: [06:16]
Overall, the literature suggests these types of programs increase investment, but they may not help businesses succeed longer term. So, we looked at the current literature on angel investor tax credit programs and similar programs effectiveness. We included academic research and other states' evaluation reports. A couple studies we reviewed suggests that these programs do increase the number of investors and the amount of investments in start-ups. So, for example, one academic study that we reviewed looked at these programs in 31 states across 30 years, and this study found a 31% increase in the overall number of investors and a 14% to 25% increase in the average investment amount, but other studies show that these increases in investor and investment quantity are not linked with increases in quality. So, they showed that investors who use these types of programs are often inexperienced. They're more likely to be first-time investors and less likely to be professional angel investors compared to the average start-up investor. Investments made under these types of programs actually tend to go to lower quality businesses according to the literature. So, they have lower sales and employment compared to similar start-up investments. Finally, one study suggested these programs help businesses keep operating and create jobs in the short term, which is consistent really with any early-stage capital infusion, but a couple of studies we reviewed showed that businesses had lower growth and productivity after these initial years. So, these programs may not ultimately improve important measures of success like start-up creation, employment, and success were called successful exits, which are mergers and acquisitions and stock offerings.

Brad Hoff, Host and Recruiting and Training Manager: [08:05]
Before we start discussing the report's findings specific to Kansas' angel investor tax credit program, take some time to explain to our listeners to help them understand that LPA's analysis was focused primarily on the program's general goals, not economic or fiscal impact. So, explain why the team took this approach.

Andy Brienzo, Principal Auditor and Supervisor: [08:34]
So, the angel investor tax credit program's primary goal is to stimulate investment in Kansas start-ups. So, we looked at where program investment came from and went. We also focused on the programs, other sort of general goals, which is supporting

innovation and job creation and helping participating businesses keep operating, but we didn't quantify programs direct, indirect, and induced economic effects or its return on investment or ROI. We also didn't determine whether it changed businesses' behavior. In other words, whether it made them do things that they would not have done in the absence of the program, part of this is because we didn't have the necessary data, but it's also because this program doesn't really lend itself neatly to these types of analyses. A lot of other programs provide an incentive directly to a business. So, a business is receiving a tax credit or a tax exemption, for example, or maybe a cash subsidy. So, as a direct economic effect, that's flowing to a business. This one is a little bit different because it actually provides the incentives to the investors rather than to the businesses, which makes these types of measures a little bit less applicable. We also didn't precisely quantify the program's fiscal impact to the state. The tax credits that are awarded under the program reflect maximum potential impact. Now we talked to revenue officials and they told us there really aren't very many reasons why investors wouldn't use the credits that they've been awarded, but they couldn't definitively predict what would happen with the credits that were awarded under the program in the years that we reviewed. So, the fiscal impact to the state could be less than what I'm about to go over if these credits are not fully used.

Brad Hoff, Host and Recruiting and Training Manager: [10:24]
For part of its analysis, the audit team focused on the investments made under the angel investor tax credit program from 2015 to 2018. What did the team find in terms of overall dollars invested, tax credits received, and where this investment came from?

Andy Brienzo, Principal Auditor and Supervisor: [10:47]
So, during the four years that you mentioned 2015 to 2018, 78, Kansas start-ups received $51.5 million in angel investment from 716 investors and during that same time period these investors received $20.2 million in income tax credits through the program. So, on average, this means that these 78 Kansas start-ups receive $2.54 in private investment for every dollar the state gave up in income tax revenue that most of these investors were Kansas, but actually more than a quarter were from out of state. So, the data we looked at showed that Kansans invested $37.5 million during 2015 to 2018 and most of this investment came from Johnson, Sedgwick, and Douglas counties and actually $21.2 million or 56% of in-state investment came from Johnson County investors alone and in exchange for this $37.5 million in investment, Kansas investors received $14.6 million in total income tax credits. So, we assume these credits will be used and if they are used, this reflects the cost to the state for these Kansans investments. Now, in addition, investors from 30 states and territories outside Kansas invested $14 million or 27% of the total during 2015 to 2018. Most out-of-state investment came from three states - Missouri, Texas, and Florida, and actually $6.4 million or about 46% of all out-of-state investment came from Missouri alone and then investors from outside Kansas received $5.6 million in total income

tax credits. And again, these credits reflect the cost to the state for the investments that came in from outside of Kansas and actually investment from outside Kansas is particularly valuable because it adds new money to the state's economy that wasn't there previously.

Brad Hoff, Host and Recruiting and Training Manager: [12:50]
While the angel investor tax credit program is a statewide program businesses and only eight counties received investment dollars from this four year period, 2015 to 2018, where are those eight counties and the investment amount they received?

Andy Brienzo, Principal Auditor and Supervisor: [13:11]
As I mentioned before, 78 businesses received investment during these four years that we looked at. Now, one business moved between counties actually during the years that we reviewed. So, it actually appears twice. So the numbers I'm about to give you don't add to 78, they add to 79, but so 48 businesses in Johnson County received $32.6 million or about 63% of total investment. So, most investment that was made under the program, went to Johnson County. 27 businesses in Sedgwick, Douglas and Wyandotte counties received $17.1 million total. So, that's about a 1/3 of total investment and then four businesses Cowley, McPherson, Riley, and Shawnee counties received $1.7 million and each of these counties just had one business in them

Brad Hoff, Host and Recruiting and Training Manager: [14:03]
For the nearly 80 businesses that received investment dollars. What types of industries did they operate in and how does that compare to the program's goal to support innovative start-ups?

Andy Brienzo, Principal Auditor and Supervisor: [14:18]
Statute requires that participating businesses have an innovative and proprietary product or service. So, we reviewed the industries that the participating businesses worked in in 2015 to 2018 and they operated in 31 different industries during this time period. And this includes things like scientific research, information technology, pharmaceutical, and medicine manufacturing. We talked to officials from the Department of Commerce about this. They told us that they thought these are the types of high-tech industries that legislators aimed for the program to be benefiting. We agreed. These generally appear to be the right types of industries for this program. These are the companies that we looked at. They did things like create new therapies for cancer in dogs and therapies for bone density loss in humans. These are definitely innovative areas. We couldn't determine whether the program spurs innovation among these businesses though, because we didn't have patent information or other data that would really show us how much innovation is really going on, but these are the types of industries that we think are appropriate for this program.

Brad Hoff, Host and Recruiting and Training Manager: [15:34]
The audit team also completed a comparative analyses between businesses that participated in the angel investor tax credit program in those businesses that did not. Walk me through what you found in these analyses specific to how long businesses stayed open, their ability to create jobs, and how these results compared to the program's goals.

Andy Brienzo, Principal Auditor and Supervisor: [16:04]
So, just as a reminder, Commerce officials told us that they primarily use participating businesses, operating life to determine program success. And they also look at job creation. So we looked at data from 2009 to 2019 to determine whether businesses that participated in this program were still operating at the three-year and the five-year marks and then we also looked at how many jobs they created. In these 10 years, 219 businesses participated and we had enough data to review 181 of them. In order to get at how well these businesses fared compared to non-participants, we compared them to a control group of similar Kansas businesses that didn't participate and then we worked with a venture capitalist in Kansas to identify a group of 79 non-participating, but similar businesses and we had enough data to review 65 of them. There were a lot of assumptions that we use in our statistical analysis on that. I'll just go over very briefly. So, some businesses operating in operated in multiple locations and we combined their employment numbers that could have overstated the number of jobs they created somewhat. We also assumed businesses that didn't pay for unemployment insurance had an owner, but no employees, we counted them as being in business, but not as creating any jobs and then finally some of the data we reviewed only covered the second quarter of each year. So, our analysis really shows changes between, but not within years and we assume that businesses that appeared in our data and then suddenly dropped out in a given year, had gone out of business, and no longer had any employees. Overall, few of the businesses that participated in the program lasted for three to five years, but in actuality, they weren't statistically different from our control group. So, in other words, our analysis showed participating businesses lasted about as long as non- participating businesses. So, 39% of participating businesses we reviewed operating for three years and 28% lasted for five years. And then in our control group, 53% lasted for three years and 38% lasted for five years. Now, we can't see whether these percentages prove the program is successful because as I mentioned, state law doesn't have benchmarks in this area that determined what percentage is adequate and commerce hasn't set specific benchmarks either. So, as a result, we didn't have anything to compare our results to. The other thing we did was look at job creation. So, each of the 181 participating businesses that we reviewed created one job every two years on average, which is about half as many as our 65 business control groups. So, on average, they created about one job each year. Now this difference is statistically significant at a 95% confidence level. And what that means is that it's likely participating businesses created fewer jobs than non-participating businesses. We also looked at how long participating businesses kept the jobs they

created during 2009 to 2019. And on average, as I mentioned, they created about one job every two years, but for every job that created during this period, in other words, during 2009 to 2019. By 2019, they had lost 0.8 jobs. So, most of the jobs they created didn't last. So, overall the businesses that participated in the program that we reviewed created 212 net jobs. So, they increased from 298 to 510 jobs total in these 10 years. And again, we can't say whether these job numbers prove the program is successful because there are no benchmarks for us to compare our results to.

Brad Hoff, Host and Recruiting and Training Manager: [19:53]
Now, the report includes a disclaimer that the audit team could not determine whether participating businesses stayed open or created jobs because of the program or something else. Explain why that is.

Andy Brienzo, Principal Auditor and Supervisor: [20:11]
So, that's true. And it's because we didn't have the data required to control for all the other variables that could have affected our comparison. And this includes things like the geographic locations of the businesses or the backgrounds of the people that own them. We also didn't have data on successful exits, which is mergers and acquisitions and stock offerings, which Commerce officials told us are an important goal for participating businesses, but there are two scenarios that may explain our comparison results. And we can't say based on our analysis, which is more likely. So, the program on the one hand may help lower businesses perform more like their higher quality peers. So, the businesses that participate in the angel investor tax credit program might differ from the businesses that don't. So, for example, Commerce officials said that non-participating businesses may be higher quality because they are presumably receiving investment outside of the program, which means that they don't need to offer their investors a tax credit in order to get them to invest. If that's true and the program attracts businesses that are lower quality, in other words, businesses that need to offer people a tax credit in order to get them to invest, then our results suggests the program may be effective. It may have helped lower quality businesses perform better than the otherwise would have if the program didn't exist. On the other hand, the program may not have a meaningful impact. So, if the program attracts businesses that are roughly the same quality as businesses that did not participate, then our results suggest the program may not actually be effective. So, the participating businesses we reviewed actually performed slightly worse overall than the businesses that did not participate.

Brad Hoff, Host and Recruiting and Training Manager: [21:56]
Kansas law requires participating businesses in the angel investor program to stay in Kansas for at least 10 years after receiving an investment. If they don't, the Department of Commerce is supposed to levy a fine against that business. However, the audit team found that this is not always happening. So, talk about what you

found and how many businesses left early.

Andy Brienzo, Principal Auditor and Supervisor: [22:30]
So, we reviewed 16 participating businesses that received investment during 2011 to 2018 and we looked in particular businesses that had dissolved or converted to a foreign entity and their Secretary of State filings and a foreign entity business is just one that's headquartered in another state or another country. It doesn't necessarily have to be outside of the United States. We thought these businesses, maybe the most likely to have left Kansas early. So, of these 16 businesses at least three appear to have left Kansas sooner than 10 years after receiving investment and investors in these businesses received about $340,000 in tax credits and then there's a fourth business whose investors receive $25,000 in tax credits that also may have left too soon, but we couldn't tell for sure, based on the information that we had. Commerce didn't require any of these businesses to pay a penalty. In fact, it may be too late to do so because the companies left Kansas so long ago or have already returned one actually came back to Kansas after leaving for awhile. We found that Commerce is not proactively monitoring businesses to ensure they stay in Kansas for 10 years and that's probably because commerce officials consider this tenure rule to be detrimental actually to some businesses. So, the literature we reviewed suggests that start-ups generally seek successful exits and requiring participating businesses to remain in Kansas for 10 years may actually limit their opportunities for these types of things and Commerce officials told us fewer businesses likely apply for the program because of this requirement. So, if Commerce officials don't think this is a beneficial requirement that it may actually be hurting the program and they may be less likely to actively enforce this requirement.

Brad Hoff, Host and Recruiting and Training Manager: [24:22]
Finally, what is the main takeaway of this audit report?

Andy Brienzo, Principal Auditor and Supervisor: [24:25]
Although this report includes a lot of information, a lot remains unknown about this program, and there's a couple of different reasons for that. So, this program definitely appears to be handing out less in credits that is being invested by angel investors. So, from that perspective it's positive for the state, but we don't know how much of this investment would have happened anyway. In other words, how much these investors may have invested in these businesses in the absence of the credit program and therefore how much the state might be handing out in credits for things that investors were going to do. Anyway, we also can't say for sure, what impact the program is having on participating businesses. As I mentioned before, it's possible it's either helping lower quality businesses perform more like they're higher quality peers, or it could be having no effect. We couldn't tell based on our analysis and then finally, without specific benchmarks for the program laid out in statute, we can't really tell if the program is achieving what policy makers hoped it would achieve, but we can say this program does appear to be generally benefiting the

kinds of innovative start-ups that policymakers were aiming for.

Brad Hoff, Host and Recruiting and Training Manager: [25:43]
Andy Brienzo is a principal auditor at Legislative Post Audit. He supervised an audit report evaluating the angel investor tax credit program in the state of Kansas. Andy, thank you for your time and discussing the report's findings with me.

Andy Brienzo, Principal Auditor and Supervisor: [25:58]
Thank you, Brad.

Brad Hoff, Host and Recruiting and Training Manager: [25:59]
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