

REPORT TO THE OHIO  
BUDGET PLANNING AND  
MANAGEMENT COMMISSION

POLICY MATTERS OHIO

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AUGUST, 2010

## Executive Summary

The State of Ohio is staring at a huge budget problem next year, as the economic downturn has slashed tax receipts and increased the demand for services. However, Ohio's fiscal fault line is opening up also because of conscious state policy: The tax overhaul of 2005, the biggest in a generation. That year, the Ohio General Assembly approved a 21 percent reduction in the state income tax, the largest source of state tax receipts. It also eliminated two major business taxes, the state's tax on corporate profits and the local property tax on machinery, equipment, inventory, furniture and fixtures. The legislature replaced these two taxes with a new tax on Ohio gross receipts, the Commercial Activity Tax (CAT). Together with other changes to the tax system, these tax reductions are costing the state \$2.1 billion in annual net revenue, according to the Ohio Department of Taxation.

The premise of the tax overhaul was that it would spark Ohio's economy. This was an unlikely claim to begin with, since taxes are not a key determinant of state economic performance. A good illustration: South Dakota, a state with no income tax and the lowest overall state and local taxes in the country as a share of personal income, had the second-lowest unemployment rate in the country in June. North Dakota, a state with an income tax and the fifth-highest overall tax levels, had the lowest rate.

Sure enough, the tax cuts have not proven to be the magic potion for Ohio's economy. Key measures of economic performance show the opposite: Ohio's economy has produced relatively fewer jobs, fewer manufacturing jobs, less overall output and lower personal income growth than the country as a whole since the tax overhaul was approved in June 2005. Ohio's share of the nation's jobs has shrunk since then from 4.06 percent to 3.87 percent. The tax changes are not responsible for Ohio's relative decline, but neither did they improve the state's standing.

More than 40 per cent of the income-tax cuts, when fully implemented next year, will go to the five percent of families with income of \$135,000 or more a year, according to the Institute on Taxation and Economic Policy. Meanwhile, the bottom three-fifths of Ohio families by income will receive just 13 percent of the total tax cut. This reinforced a system in which low- and middle-income families already pay more of their income in state and local taxes than affluent families do. Yet in 2006, the richest one percent of Ohio families took in slightly more pretax income than the bottom half of the population.

In addition, as the Ohio Business Roundtable noted in a 2008 court filing: "The new business tax system substantially lowered the overall tax burden on business." Annual business tax savings are well north of \$1 billion a year. This reduction came after a long-term decline in business taxes that reduced the business share of Ohio state and local taxes to about 30 percent from nearly 40 percent in the late 1970s.

Every two years, as part of the biennial budget, the Ohio Department of Taxation produces a report itemizing credits, deductions and exemptions in the tax code that reduce the amount of

revenue the state would otherwise receive. The taxation department estimated in its report last year that in both Fiscal Years 2010 and 2011, 122 such exemptions and credits amounted to more than \$7 billion in foregone revenue to the state's General Revenue Fund. "Tax expenditures result in a loss of tax revenue to state government, thereby reducing the funds available for other government programs," ODT noted in the report. "In essence, a tax expenditure has the same fiscal impact as a direct government expenditure." However, many tax expenditures have continued for decades without review.

Such exemptions range from the small to the gigantic: A sales-tax exemption for pollution control equipment, most of which is mandated and utilities must purchase. A corporate-franchise tax exemption for goodwill, appreciation and abandoned property of financial institutions that is considerably larger than the entire amount of such tax collected annually. Property-tax exemptions reimbursed by the state that the last two Republican governors unsuccessfully sought to means-test, so that they would not be available to wealthy homeowners. A sales-tax exemption for machinery, equipment and supplies used in manufacturing worth \$1.7 billion a year that has not been reexamined since it was overhauled 20 years ago. A sales-tax cap for wealthy buyers of shares in jet aircraft. A loophole that means no sales tax is charged on lobbyists' services.

Other states such as Arizona and Washington have regular reviews of their tax expenditures. States such as Oklahoma, Colorado, Iowa and Kansas have reduced tax credits, in particular. The Ohio Manufacturers' Association recently noted how the state sales tax "has become riddled with exemptions, carve-outs and credits," and called for a comprehensive examination of the tax.

State support for early childhood education, mental health programs, libraries and numerous other services have come under the knife as revenues have fallen. Yet tax expenditures – which have every bit as much impact on the state budget -- did not receive the same treatment. They should be pared. Beyond a review of specific tax expenditures, which would make sense even in good times, the budget commission should set goals for substantial reductions in tax expenditures and begin planning how they can be implemented. It should ask the taxation department and the Legislative Service Commission to detail their understanding of why each of these expenditures was originally approved and whether that purpose is being met now. The budget commission also should help convene a summit of state and federal legislators to rally support for a long-standing effort to level the playing field so that online and mail-order retailers collect the sales tax just as traditional retailers do.

The 2005 tax cuts did not improve Ohio's economic performance as promised, increased the share of taxes paid by middle- and low-income taxpayers, and deprived the state of needed resources for public services. Based on that, we recommend that we revitalize the income tax, in particular for high earners, and restore revenue from business taxes to levels that existed prior to the 2005 tax changes. This would still leave the business share well below where it was 30 years ago. Ohio's tax system should be overhauled to produce the revenue we need for public services and investments that support our economic success and maintain our quality of life.

## Report to the Budget Planning and Management Commission

Why does the State of Ohio find itself staring at a huge budget problem? To be sure, the economic downturn has slashed tax receipts and increased the demand for services, as in other states. But in Ohio, the fiscal fault line is opening up also because of conscious state policy: The tax overhaul of 2005, the biggest in a generation.

That year, the Ohio General Assembly approved a 21 percent reduction in the state income tax, the largest source of state tax receipts. It also eliminated two major business taxes, the state's tax on corporate profits and the local property tax on machinery, equipment, inventory, furniture and fixtures. The legislature replaced these two taxes with a new tax on Ohio gross receipts, the Commercial Activity Tax. Together with other changes to the tax system, these tax reductions are costing the state \$2.1 billion in annual net revenue, according to the Ohio Department of Taxation.<sup>1</sup> In short, much of the pain we are about to experience is self-inflicted.

The premise of the tax overhaul was that it would spark Ohio's economy. This was an unlikely claim to begin with, since taxes are not a key determinant of state economic performance. In a 2006 report, Paul W. Bauer and Mark E. Schweitzer of the Federal Reserve Bank of Cleveland found no statistically significant relationship between average tax rates and state income growth since 1960.<sup>2</sup> Current unemployment rates provide a rough illustration of the lack of connection between taxes and state economic performance: Nevada, a state with no income tax, has the highest unemployment rate in the country, at 14.2 percent. South Dakota, another state without an income tax, has the second lowest rate, at 4.5 percent. And what state has the lowest unemployment rate? North Dakota, at 3.6% -- which also has an income tax. Overall, according to U.S. Census Bureau data for 2007-2008, South Dakota has the lowest state and local taxes in the country as a share of personal income, while North Dakota ranks 5<sup>th</sup> highest. It doesn't take an economist to see that the similar economies of the Dakotas have more to do with their unemployment rates than their tax structures.<sup>3</sup>

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<sup>1</sup> Ohio Department of Taxation, *Fact Sheet: Tax Reform in Ohio*, [http://tax.ohio.gov/divisions/communications/news\\_releases/documents/Tax\\_reform\\_fact\\_sheet.pdf](http://tax.ohio.gov/divisions/communications/news_releases/documents/Tax_reform_fact_sheet.pdf) The department estimated that the four changes cited above would bring an annual tax cut of \$3.5 billion, but this would be offset by other provisions approved at the same time such as an increase in the cigarette tax and the permanent change in the sales tax to 5.5 percent. The income-tax estimate did not take into account the fall-off in the tax since February 2009. However, it reflects the approval of House Bill 318, which temporarily froze rates at 2009 levels, and offsets much of the income-tax decline since then. The ODT estimate has not been adjusted to reflect actual FY2010 data.

<sup>2</sup> Bauer, Paul W. and Mark E. Schweitzer, "Paths to Prosperity: Knowledge is Key for Fourth District States," Economic Commentary, Federal Reserve Bank of Cleveland, August 15, 2006. Available at <http://www.clevelandfed.org/Research/Commentary/2006/0815.pdf> See also: [http://www.clevelandfed.org/about\\_us/annual\\_report/2005/PDF/Essay2005.pdf](http://www.clevelandfed.org/about_us/annual_report/2005/PDF/Essay2005.pdf) Federal Reserve Bank of Cleveland, Annual Report 2005, "Altered States: A Perspective on 75 Years of State Income Growth."

<sup>3</sup> See Ohio Department of Taxation, State and Local Tax Comparisons, 2007-2008, July 22, 2010 [http://www.tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/state\\_and\\_local\\_tax\\_comparison/tc12/documents/T\\_C12CY08.pdf](http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/state_and_local_tax_comparison/tc12/documents/T_C12CY08.pdf)

Advocates of the Ohio tax overhaul did not attempt to claim that it would pay for itself; indeed, an analysis commissioned by the Taft administration found that it would generate additional economic activity amounting to just 7 percent of the lost revenue – and that didn't take into account the spending reductions that would necessarily have to accompany the tax cuts.<sup>4</sup> This reality is too often ignored: If you cut taxes, you will have to cut spending.<sup>5</sup> Thus, measuring the real economic effect of tax cuts means including the spending cuts as well.

The Institute on Taxation and Economic Policy, which has a sophisticated model of state and local tax systems, has found that nearly one dollar in every eight of Ohio's income-tax cuts will be offset by increases in federal taxes on Ohio taxpayers, who have less in-state tax deductions they can itemize on their federal returns. Moreover, some of the increased income from the state tax cuts will be saved, or spent outside the state of Ohio. For these reasons, the income-tax cuts were never likely to generate more economic growth than the reduced spending they required.

Sure enough, the tax cuts have not proven to be the magic potion for Ohio's economy. Key measures of economic performance show the opposite: Ohio's economy has produced relatively fewer jobs, fewer manufacturing jobs, less overall output and lower personal income growth than the country as a whole since the tax overhaul was approved in June 2005. Since then, Ohio's share of the nation's jobs has shrunk from 4.06 percent to 3.87 percent. Our share of manufacturing jobs, despite a modest uptick in the last year, has fallen from 5.7 percent to 5.35 percent in June 2010.<sup>6</sup> Overall, in the five years after the tax overhaul was approved, Ohio lost 385,300 total nonfarm jobs and 189,100 manufacturing jobs.<sup>7</sup> Figure 1 shows how Ohio jobs have fared compared to the nation since 2003:

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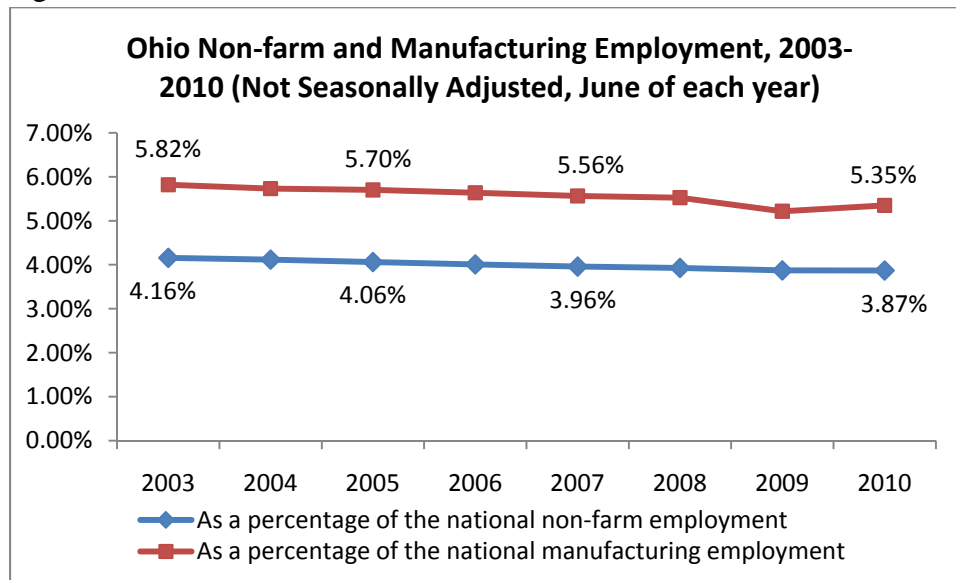
<sup>4</sup> *The Dynamic Economic and Fiscal Impact of the Ohio Administration's Proposed Changes to the Commercial Activity Tax, Corporate Franchise Tax, Personal Income Tax, Tangible Personal Property Tax, and Sales Tax*, Prepared for the Ohio Department of Development and the State of Ohio, REMI Consulting Inc, April 18, 2005. For an analysis of this report, see Honeck, Jon and Zach Schiller, Policy Matters Ohio, *REMI Report Presents Just Half the Equation*, May 2005, [http://www.policymattersohio.org/pdf/REMI\\_Report\\_Brief\\_May\\_2005.pdf](http://www.policymattersohio.org/pdf/REMI_Report_Brief_May_2005.pdf)

<sup>5</sup> Thankfully, Ohio avoided more drastic spending reductions recently because of one-time revenue, especially federal stimulus dollars.

<sup>6</sup> Bureau of Labor Statistics, Ohio Department of Job & Family Services. BLS has reported revised data for the United States for June 2010, which lowered both the total number of nonfarm jobs and manufacturing jobs, respectively. Ohio's preliminary data will not be revised until later in August. Ohio's overall share of total jobs and manufacturing jobs is fractionally higher, but does not differ from the percentages listed here.

<sup>7</sup> These figures are not seasonally adjusted. The job-loss totals over the five-year period when seasonally adjusted are similar: 373,700 total nonfarm and 183,500 in manufacturing. See U.S. Bureau of Labor Statistics, <http://data.bls.gov/cgi-bin/surveymost?sm>

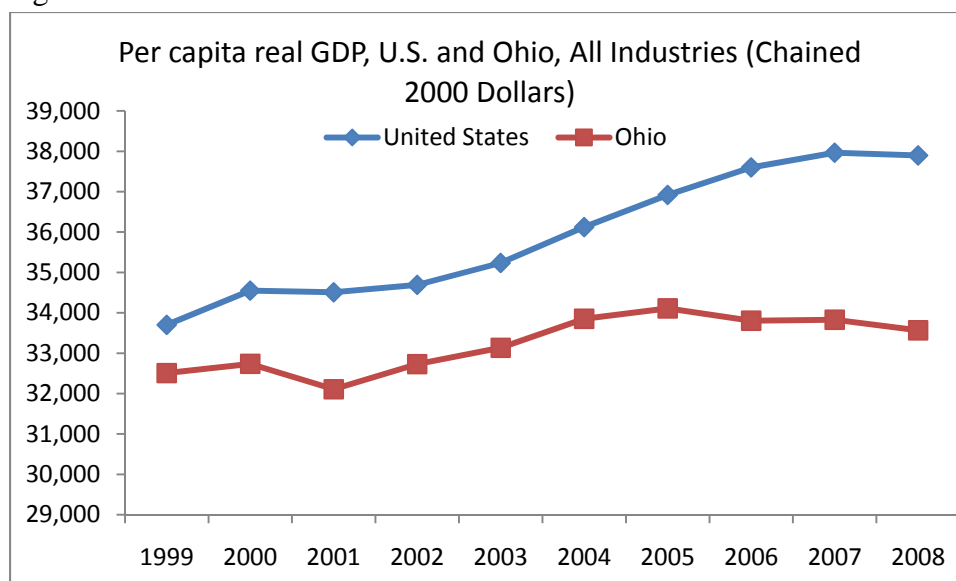
Figure 1.



Source: U.S. Bureau of Labor Statistics, Ohio Department of Job & Family Services

Ohio’s real per capita Gross State Product stagnated when U.S. real per capita GDP rose between 2005 and 2008, the last year for which Ohio data are available. Ohio’s real gross state product per capita fell from \$34,111 to \$33,568 during that period. Figure 2 compares inflation-adjusted output between Ohio and the nation:

Figure 2.



Source: U.S. Department of Commerce, Bureau of Economic Analysis

Ohio personal income growth also did not keep pace with the nation as a whole between 2005 and 2009. Ohio gained some ground compared to the country in 2009, as the personal income decline, 1.3 percent, was somewhat less than in the United States, 1.7 percent.<sup>8</sup>

U.S. government data show no sustained gain in Ohio's share of capital investments made by manufacturers since the 2005 tax overhaul. The data show that Ohio's share bounced up and down between 5 and 6 percent of the national total between 1997 and 2004. In 2005, it fell to 4.9 percent, and after rising to 5.6 percent the following year, settled at 4.9 percent in 2007 and 2008, the last year for which data are available.<sup>9</sup>

In short, Ohio's relative economic performance has not improved since the 2005 tax cuts that have slashed revenue available for public services. It is plausible that gains in sectors where Ohio is strong, such as the automotive industry, might allow the state to show relative gains at some point. Such a welcome development would reflect our economic base more than anything else.

### **Who benefits from the tax cuts?**

More than 40 per cent of the income-tax cuts, when fully implemented next year, will go to the five percent of families with income of \$135,000 or more a year.<sup>10</sup> Meanwhile, the bottom three-fifths of Ohio families by income will receive just 13 percent of the total tax cut. The one percent of families who make \$319,000 or more will average an annual tax cut of \$10,000. Meanwhile, the one-fifth of families in the middle of the income spectrum making between \$32,000 and \$48,000 will save \$180, while the bottom fifth, making below \$17,000, will see just a \$20 savings on average. Table 1 shows how families with different income levels will benefit from the income-tax cuts:

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<sup>8</sup> U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Accounts, see <http://www.bea.gov/regional/bearfacts/action.cfm> First-quarter 2010 figures show Ohio with a slightly larger personal-income gain (1.05 percent) than the nation as a whole (0.94 percent) compared to the fourth quarter of 2009. See [http://www.bea.gov/newsreleases/regional/spi/sqpi\\_newsrelease.htm](http://www.bea.gov/newsreleases/regional/spi/sqpi_newsrelease.htm)

<sup>9</sup> U.S. Census Bureau, Annual Survey of Manufactures, [http://factfinder.census.gov/servlet/DatasetMainPageServlet?\\_lang=en&\\_ts=295179634947&\\_ds\\_name=AM0831G\\_S101&\\_program=EAS](http://factfinder.census.gov/servlet/DatasetMainPageServlet?_lang=en&_ts=295179634947&_ds_name=AM0831G_S101&_program=EAS) and Economic Census, [http://factfinder.census.gov/servlet/DatasetMainPageServlet?\\_program=ECN&\\_tabId=ECN1&\\_submenuId=datasets\\_4&\\_lang=en&\\_ts=246366688395](http://factfinder.census.gov/servlet/DatasetMainPageServlet?_program=ECN&_tabId=ECN1&_submenuId=datasets_4&_lang=en&_ts=246366688395)

<sup>10</sup> Data supplied to Policy Matters Ohio by the Institute on Taxation and Economic Policy, July 2010. See Table 1.

Table 1

Ohio Impact of 2005 Income Tax Rate Cuts When Fully Implemented							
2010 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$17,000	\$17,000 - \$32,000	\$32,000 - \$48,000	\$48,000 - \$74,000	\$74,000 - \$135,000	\$135,000 - \$319,000	\$319,000 Or More
Average Income in Group*	\$10,000	\$24,000	\$40,000	\$60,000	\$95,000	\$190,000	\$868,000
State Tax Change as a % of Income	-0.2%	-0.3%	-0.5%	-0.5%	-0.7%	-0.9%	-1.2%
\$ Average State Tax Change	\$ -19	\$ -73	\$ -180	\$ -329	\$ -700	\$ -1,710	\$-10,089
Share of total Tax Change	1%	3%	9%	16%	27%	18%	26%

Source: Institute on Taxation and Economic Policy, July 2010. \*--Average income figures in this row were understated in the original version of this report because of a technical error. These are the correct figures.

This accentuated a tax system that, like most state and local tax systems, falls more heavily on lower- and middle-income Ohioans than it does on the wealthy. ITEP data show that the top-earning one percent of non-elderly Ohio families pay 7.8 percent of their income in state and local taxes on average. By contrast, the lowest fifth pay 12.0 percent on average. Families in the middle fifth of the income spectrum on average pay 11.0 percent. Moreover, recent changes in Ohio's state and local tax system have increased the disparity. The report found that, based on share of income affluent Ohioans pay in state and local taxes compared to that of lower- and middle-income residents, Ohio ranks 28th among states in fairness of its tax system. Last time the study was done, which covered the law as of 2002, Ohio ranked 14th by this measure.<sup>11</sup> A table with more detail is included in Appendix A.

In short, the 2005 tax cuts did not improve Ohio's economic performance as promised, increased the share of taxes paid by middle- and low-income taxpayers, and deprived the state of needed resources for public services. Based on that, we recommend that we:

- Revitalize the income tax, in particular for high earners
- Restore revenue from business taxes and
- Vigorously attack tax exemptions, credits and deductions that riddle the tax code.

A good start would be to approve House Bill 308, which would restore the 7.5 percent income-tax rate on income over \$200,000 and create a new 8.5 percent rate on income above \$500,000. Together with a continued freeze of other rates at 2010 levels, this would generate \$950 million a year.<sup>12</sup> High-income Ohioans are most able to pay additional taxes, as they have seen gains from

<sup>11</sup> Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, November 2009. Released in Ohio by Policy Matters Ohio and the Center for Community Solutions, and available at <http://www.policymattersohio.org/WhoPays2009.htm> The report reviewed every state's tax system based on permanent changes in law enacted through October 2009 and income levels from 2007.

<sup>12</sup> Schiller, Zach, Policy Matters Ohio, *Boosting Revenue: Tapping Top Earners to Meet Ohio's Needs*, October 2009. The \$950 million figure might have to be revised downward somewhat, since income-tax revenue has fallen.

economic growth in recent decades. In 2006, the richest one percent of Ohio families took in slightly more pretax income than the bottom half of the population.<sup>13</sup>

Critics of Ohio's income tax claim that the tax is driving people out of the state, particularly upper-income Ohioans. However, affluent Americans have not flocked to live in states without income taxes; such states overall do not have a greater share of affluent taxpayers. The Center on Budget and Policy Priorities, a Washington, D.C., research organization, found that in 2005, 19.2 percent of taxpayers with income of more than \$200,000 lived in states without a personal income tax, while 19.6 percent of all taxpayers live in those states.

### **Business Taxes**

Overall, the 2005 tax changes resulted in a major reduction in business taxes. The Ohio Business Roundtable noted in a 2008 court filing: "The new business tax system substantially lowered the overall tax burden on business."<sup>14</sup> The state taxation department estimates annual savings to business taxpayers of approximately \$3.2 billion a year from the elimination of the Tangible Personal Property tax and the corporate franchise tax for nonfinancial companies.<sup>15</sup> Based on CAT tax revenues of \$1.34 billion in FY10, this means they are receiving a cut of \$1.8 billion a year from this swap.<sup>16</sup> This reduction came after a long-term decline in business taxes that reduced the business share of Ohio state and local taxes to about 30 percent from nearly 40 percent in the late 1970s.<sup>17</sup>

The main rationale for the 2005 tax changes – to reverse Ohio's poor economic performance relative to the nation – has not been validated. The business tax cuts should be revisited, with an eye toward restoring revenue provided prior to the 2005 tax overhaul. This would still leave the business share well below where it was 30 years ago. The budget commission should consider recommending the restoration of the corporate franchise tax; Ohio is one of only six states in the country without a general tax on business profits. This could be brought back in strengthened form, so that it would be harder for multi-state businesses to shift income from Ohio to other states.<sup>18</sup>

When the General Assembly approved House Bill 66 in 2005, it was uncertain how much the new Commercial Activity Tax would raise. As a result, it included a trigger mechanism, under which the rate of CAT would be adjusted upward or downward if the tax raised 10 percent more

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<sup>13</sup> Institute on Taxation and Economic Policy, "Latest IRS Data Reveal Fundamental Mismatches in the States," Aug. 5, 2008. <http://www.itepnet.org/2006soistatemismatches.pdf>

<sup>14</sup> Memorandum in Support of Jurisdiction of Amicus Curiae Ohio Business Roundtable, Ohio Grocers Association et. al. v. William W. Wilkins (Richard A. Levin), in his official capacity as Ohio Tax Commissioner, Ohio Supreme Court Case No. 08-2018, Oct. 17, 2008, p. 2

<sup>15</sup> See ODT, *Fact Sheet: Tax Reform in Ohio*

<sup>16</sup> Overall business tax savings are somewhat less than this because of other tax changes in HB 66, but the savings are clearly well north of \$1 billion a year.

<sup>17</sup> Schiller, Zach, Policy Matters Ohio, *Business Tax Revamp: A Deficit in the Making*, January 2009, p. 10

<sup>18</sup> See *Business Tax Revamp: A Deficit in the Making*, p. 23

or less than expected in three different target periods. The \$1.34 billion in CAT taxes collected in Fiscal Year 2010 was \$58 million below estimate and \$260 million below the Strickland administration's estimate when the governor introduced his budget in early 2009. The CAT is projected to bring in \$1.385 billion in FY11, \$269 million short of the amount needed to fully reimburse school districts and local governments for lost tangible personal property tax<sup>19</sup> and 14 percent below the \$1.61 billion set in state law that it was targeted to raise. However, even if this underperformance continues, it will not result in an increase in the CAT rate because the General Assembly subsequently eliminated the upward trigger.

Reinstating the CAT trigger would restore the original aim of HB 66. It would have the additional benefit of eliminating the need for the state to dip into the General Revenue Fund to reimburse school districts and localities for the loss of Tangible Personal Property tax revenue. The commission should also recommend an increase in the CAT rate. Prior to the phase-out of the corporate franchise tax, nonfinancial companies used to calculate that tax based on their net worth and their income, and pay whichever amount was higher. Similarly, companies today could figure their income tax and CAT tax, and pay whichever was higher. The rates could be set in order to generate, with an inflation adjustment, what the two eliminated taxes did prior to the 2005 overhaul. This is not a large amount, by historical standards.<sup>20</sup>

Various studies have shown that Ohio's business taxes are not out of line with those in other states. In a study released this year, Peter Fisher of the University of Iowa and Alan Peters of the University of Sydney, Australia, modeled business taxes for a 250-employee facility in Pennsylvania, Ohio, New York, New Jersey, Maryland, North Carolina and West Virginia. They looked at how building a new plant would affect after-tax profits in eight manufacturing sectors, holding everything else constant besides taxes and incentives. Returns were comparable in all the states except Ohio, where they were higher.<sup>21</sup>

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<sup>19</sup> Email from John Kohlstrand, Ohio Department of Taxation, July 28, 2010. Under HB 66, the CAT was designated for such reimbursements, phasing out over a multi-year period. School districts subsequently have won continued reimbursement, but no long-term provision has been made yet for local governments

<sup>20</sup> Both of the two taxes that the General Assembly eliminated, the Tangible Personal Property tax and the corporate franchise tax for nonfinancial companies, generated considerably less in 2005 than they had 30 years earlier, adjusted for inflation. In the mid-1970s, the corporate franchise tax accounted for 16 percent of the taxes supporting the General Revenue fund. By FY05, prior to the tax overhaul, that share was just 4 percent. See Schiller, *Business Tax Revamp: A Deficit In the Making*, pp. 23-24 for more discussion of this proposal.

<sup>21</sup> Fisher, Peter and Alan Peters, "How Taxes and Economic Development Incentives Affect Returns on New Manufacturing Investment in Pennsylvania and Surrounding States," in LeRoy, Greg et. al., "Growing Pennsylvania's High-Tech Economy: Choosing Effective Investments," A Report by Good Jobs First, January 2010, pp. 9-16. Of course, some of Ohio's advantage reflects the recent tax cuts. Fisher and Peters note that their research doesn't indicate what the actual rates of return will be, since taxes represent a small share of overall costs, and other factors such as labor, land, construction, transportation and energy largely would drive such differences. See <http://www.goodjobsfirst.org/pdf/PAhightech2010%20-%20FINAL.pdf>

## Tax expenditures

Every two years, as part of the biennial budget, the Ohio Department of Taxation produces a report itemizing credits, deductions and exemptions in the tax code that reduce the amount of revenue the state would otherwise receive. The taxation department estimated in its report last year that in both Fiscal Years 2010 and 2011, 122 such exemptions and credits amounted to more than \$7 billion in foregone revenue to the state's General Revenue Fund. The total for FY11 was \$7.73 billion. "Tax expenditures result in a loss of tax revenue to state government, thereby reducing the funds available for other government programs," ODT noted in the report. "In essence, a tax expenditure has the same fiscal impact as a direct government expenditure."<sup>22</sup> Table 2 below lists the 20 largest tax expenditures, according to the taxation department:

Table 2

Top 20 Tax Expenditures, FY2011, by Foregone General Revenue Fund Revenue				
Rank	Type of tax against which exemption is taken	Tax expenditure description	Foregone FY2011 Revenue (millions of dollars)	Originally Enacted
1	Sales and use	Property used primarily in manufacturing tangible personal property	1,724.30	1935
2	Sales and use	Sales of prescription drugs and selected medical items	696.9	1961
3	Individual income	Personal, spousal, and dependent deduction	519.8	1972
4	Sales and use	Building and construction materials and services used in certain structures	435.5	1959
5	Individual income	Social Security and railroad retirement benefits	362	1972
6	Sales and use	Sales to churches and certain other non-profit organizations	347.5	1935
7	Sales and use	Sales of tangible personal property and services to electricity providers	331.8	2000
8	Sales and use	Packaging and packaging equipment	230.4	1961
9	Individual income	Joint filer credit	225.2	1973
10	Commercial activity	Exclusion of first \$1 million of taxable gross receipts	222.8	2005
11	Corporate franchise	Goodwill, appreciation, and abandoned property of financial institutions	186.8	1933
12	Sales and use	Transportation of persons and property	177.4	1935
13	Sales and use	Tangible personal property used or consumed in agriculture and mining	153	1935
14	Individual income	\$20 personal exemption credit	152.5	1983
15	Individual income	Resident credit for income taxed by another state	141.1	1972
16	Individual income	Retirement income credit	135.1	1983
17	Sales and use	Sales to the state, its political subdivisions and certain other states	129.3	1935
18	Sales and use	Value of motor vehicle trade-ins	120.2	1981
19	Sales and use	Tangible personal property used directly in providing public utility services	117.6	1935
20	Commercial activity*	Job creation credit	101.5	1993

\*This credit also is available against the individual income tax. It became available against the CAT instead of the corporate franchise tax in Fiscal Year 2009.

Source: Ohio Department of Taxation, Policy Matters Ohio

<sup>22</sup> State of Ohio, Executive Budget, Fiscal Years 2010 and 2011, Book Two, Tax Expenditure Report, Prepared by the Department of Taxation and Submitted to the 128<sup>th</sup> General Assembly by Governor Ted Strickland, February 2009, p. 1. The report is available at <http://obm.ohio.gov/SectionPages/Budget/FY1011/ExecutiveBudget.aspx>

It is beyond the scope of this submission to review all of the state's tax expenditures. But below are some examples that could use a look.

In 1963, nine years before the U.S. Environmental Protection Agency was created, the Ohio General Assembly approved a new sales-tax exemption for pollution-control equipment.<sup>23</sup> This fiscal year, according to the state taxation department, the cost of this exemption will be \$2.3 million, though the department is likely to raise that amount significantly in its next report.<sup>24</sup> Most of the equipment purchases utilities make for pollution control are mandated by environmental rules. Thus, by providing the sales-tax exemption, the state is providing an incentive for something that would be happening anyway. This leads one to wonder: Exactly what is the purpose of this tax break, and is it more important to maintain than the services that will have to be cut if it is maintained? The state estimates that the value in FY11 of the corporate-franchise tax exemption for goodwill, appreciation and abandoned property of financial institutions, \$186.8 million, is considerably greater than the \$132.4 estimate for *total* tax to be collected.<sup>25</sup> The sheer size of this exemption, and the likelihood that it can be used to shield assets from taxation, suggest it should be analyzed and possibly limited.<sup>26</sup>

In Fiscal 2010, the state reimbursed school districts and local governments for \$1.69 billion in three local property-tax relief programs, one for 10 percent, another for 2.5 percent for owner occupants, and a third for the homestead exemption that goes to elderly and disabled homeowners.<sup>27</sup> Gov. George Voinovich and Gov. Bob Taft each tried to means-test the two property tax rollbacks, so that they would not go to the wealthiest homeowners. Each failed. The homestead exemption, too, was broadened more than necessary when it was expanded in 2007; as then House Speaker Jon Husted argued, it should have been limited.<sup>28</sup>

Though their origins may be murky, many tax expenditures have continued for decades, draining state revenue, providing a special advantage, without an accounting for whether they serve their

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<sup>23</sup> Some changes to this section of Ohio law, which also includes an exemption from local personal property tax, were made by the General Assembly in 2003.

<sup>24</sup> Christopher Hall of the Tax Analysis Division explains that the department will include the exemption for utilities, which previously was excluded. Email, July 29, 2010.

<sup>25</sup> State of Ohio, Executive Budget, Fiscal Years 2010 and 2011, Book Two, Tax Expenditure Report, Prepared by the Department of Taxation and Submitted to the 128<sup>th</sup> General Assembly by Governor Ted Strickland, February 2009. FY11 Corporate Franchise tax estimate received from Ohio Department of Taxation, July 23, 2010

<sup>26</sup> Under this exclusion, banks may be able to reduce their tax by shifting income-producing assets into out-of-state subsidiaries in exchange for stock in those subsidiaries. If the stock's value increases, the appreciation – which would normally be taxed – is exempt from Ohio taxation under this exclusion. This is one way that this exclusion may allow banks to avoid taxation.

<sup>27</sup> J. Pari Sabety, Director, Office of Budget and Management, Monthly Financial Report, July 10, 2010, p. 20, available at <http://obm.ohio.gov/>

<sup>28</sup> See William Hershey, "Husted Pursues Budget Changes," *The Dayton Daily News*, June 12, 2007, and "Penny Wise," Editorial, *The Plain Dealer*, June 12, 2007.

original purpose or any purpose at all. For example, brewers and beer importers receive a credit on beer and malt beverage taxes they pay just for paying part of them a few weeks in advance.<sup>29</sup>

The largest tax expenditure, a sales-tax exemption for machinery, equipment, supplies and fuel used in manufacturing, is worth more than \$1.7 billion a year, according to the tax expenditure report. Last fiscal year, by comparison, the state's 5.5 percent sales tax brought in \$7.08 billion.<sup>30</sup> Yet this exemption has not been reexamined since it was overhauled in 1990.<sup>31</sup>

Buyers of fractional shares in jet aircraft – in effect, timeshares for those wealthy enough – only pay a tiny share of the sales tax they would otherwise because of an \$800 cap on the total tax levied per aircraft. This can mean savings of hundreds of thousands of dollars for affluent buyers.

According to the most recent tax expenditure report, 527,846 Ohioans received the exemption on their state income tax for Social Security and railroad retirement benefits for Tax Year 2006. This data reveals that 36,000 Ohioans with taxable income above \$150,000 received the exemption, which was worth \$45 million to them altogether. The 6,591 taxpayers with income above \$500,000 saved \$10 million that year because of the exemption.

A number of states have regular examinations of their tax expenditures. For example:

- Arizona reviews its tax expenditures every five years. A review committee composed of House and Senate members reviews income- and corporate-tax credits, and recommends whether the expenditure should be amended, repealed or retained.<sup>32</sup>
- Under a bill passed last year, Oregon created sunset dates for most income and corporate excise tax credits, and new credits will sunset in six years unless statute states otherwise. Oregon's biennial tax expenditure report generally includes an evaluation of most tax credits, and the governor recommends whether those coming due should be retained.<sup>33</sup>
- The State of Washington established a system under a 2006 law under which a commission sets up a 10-year review schedule for all exemptions, deductions, credits and other tax preferences. The staff of the Joint Legislative Audit and Review Committee conducts a review and looks at 10 factors for each expenditure, including

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<sup>29</sup> See Zach Schiller, Policy Matters Ohio, *Exempt from Scrutiny*, February 2007, available at <http://www.policymattersohio.org/ExemptFromScrutiny2007.htm>

<sup>30</sup> In its last tax expenditure report, the tax department used the same estimate for this expenditure each year for four years, as it did not want to assume a particular economic growth rate in a volatile economy. GRF sales tax collections have declined from \$7.61 billion in FY08. Thus, the value of this and other exemptions may not be quite what was originally estimated. However, this is clearly still a giant tax expenditure.

<sup>31</sup> See *Exempt from Scrutiny*, p. 6

<sup>32</sup> See Arizona Revised Statutes, see

<http://www.azleg.state.az.us/FormatDocument.asp?inDoc=/ars/43/00221.htm&Title=43&DocType=ARS>

<sup>33</sup> Staff Measure Summary, Senate Finance & Revenue Committee, 75<sup>th</sup> Oregon Legislative Assembly, 2009 Regular Session, HB 2067B

its objectives, effectiveness in achieving those objectives, who benefits, economic impact (including if it were terminated), and a comparison to other states. JLARC recommends whether to continue, modify or terminate each tax preference to the commission, which comments on it before submitting it to key legislative committees.<sup>34</sup>

Ohio should follow these states' example. The budget commission should set a schedule to go over every one of the state's 122 tax expenditures listed in the last tax expenditure report, starting with the 91 where the foregone revenue is more than \$1 million a year.<sup>35</sup> The Ohio Department of Taxation and the Legislative Service Commission should be asked to detail their understanding of why each of these expenditures was originally approved, and whether that purpose is being met now.

As it considers how to deal with the looming budget gap, the commission also should consider reductions in tax credits. A number of states have taken action to reduce tax expenditures, and especially tax credits, in light of fiscal distress.<sup>36</sup> Last spring, Oklahoma approved a two-year moratorium on a number of tax credits, while deferring the payment of others.<sup>37</sup> Colorado ended its sales-tax exemptions for direct mail advertising materials, energy used in manufacturing, candy and soda, downloaded software, food wrappers and condiments, and agricultural input such as pesticides, according to *State Tax Notes*.<sup>38</sup> It also repealed the income-tax credit for certain alternative-fuel cars and limited the income-tax deduction for business operating losses to \$250,000 a year. Iowa, while not going as far in cutting credits as a special tax credit review panel had recommended, suspended its scandal-plagued film credit for two years and took other steps to reduce credits.<sup>39</sup> And Kansas gave a two-year, 10 percent "haircut" to a slew of tax

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<sup>34</sup> Citizen Commission for Performance Measurement of Tax Preferences, see <http://www.citizentaxpref.wa.gov/default.htm>. A JLARC report this year analyzed 58 preferences. Its preliminary report on the 10 preferences that got a full review called for continuation of seven, legislative reexamination or clarification of one, and termination of two others. See [http://www.leg.wa.gov/JLARC/AuditAndStudyReports/2010/Documents/2010TaxPreferencePerformanceAudit\\_Full.pdf](http://www.leg.wa.gov/JLARC/AuditAndStudyReports/2010/Documents/2010TaxPreferencePerformanceAudit_Full.pdf)

<sup>35</sup> The taxation department estimates 31 others each result in foregone revenue of less than \$1 million a year. As noted in the report, "revenue foregone" is not the same as the revenue gain from repeal of a tax expenditure, which would take into account other factors. It shows the benefit realized by taxpayers. See pp. 3-4 of the tax expenditure report.

<sup>36</sup> *The Wall Street Journal* noted in a recent story that a number of state governments "seeking to plug yawning budget holes are shutting down tax credit and incentive programs that are supposed to lure businesses and create jobs." See Connor Dougherty, "States Cut Tax Incentives for New Business," *The Wall Street Journal*, May 10, 2010, p. A8

<sup>37</sup> White, Nicola M., "Oklahoma Governor Signs Bill to Suspend Tax Credits," *State Tax Notes*, June 9, 2010. Some of these credits later were deferred instead of suspended.

<sup>38</sup> Hanel, Joe, "Colorado Governor Signs 'Amazon' Law, Bills to Repeal Tax Breaks," *State Tax Notes*, Feb. 25, 2010

<sup>39</sup> Hancock, Jason, "Governor Will Sign Tax Credit Reform," *The Iowa Independent*, March 23, 2010 <http://iowaindependent.com/30430/governor-will-sign-tax-credit-reform-bill>

credits, ranging from certain research and development expenditures to expenses associated with plugging abandoned gas or oil wells.<sup>40</sup>

Ohio's state support for early childhood education, mental health programs, libraries and numerous other services have come under the knife as revenues have fallen. Yet tax expenditures – which have every bit as much impact on the state budget -- did not receive the same treatment. They should be pared. Beyond a review of specific tax expenditures, which would make sense even in good times, the commission should set goals for substantial reductions in tax expenditures and begin planning how they can be implemented. There should be no sacred cows.

The commission should focus special attention on sales-tax expenditures, since they account for an estimated \$5 billion this fiscal year, or close to two-thirds of the total. The Ohio Manufacturers' Association recently noted that the state sales tax "has become riddled with exemptions, carve-outs and credits." It went on: "While some carve-outs have more merit than others (because Ohio needs to be competitive with other states' sales tax schemes), the resulting diminished sales tax base puts pressure on the remaining taxpayers – in other words, the tax rate must rise to make up for the exempted taxpayers. The time is right for a comprehensive examination of the state sales tax by lawmakers."<sup>41</sup>

The commission should begin by asking the LSC to report on how other states are approaching the sales-tax expenditure issue. While some sales-tax expenditures can be eliminated entirely, the best approach for others might be to set caps on exemption amounts, so at certain dollar amounts, the tax would kick in. On the face of it, this probably would be easier to administer than flat percentage reductions.

Other elements of the tax code that are not specifically deemed to be tax expenditures by the state also could be tightened, including:

- The dealers in intangibles tax, an obsolete tax whose elimination has been recommended by two state-commissioned studies on the tax system. This tax allows payday lenders and mortgage brokers to pay a lower tax rate than banks do under the franchise tax.
- The 2006 loosening of the residency test, which allows many affluent individuals to avoid paying the Ohio income tax;
- The sales tax on services, or perhaps more correctly, the absence of it. Though services account for an increasing share of the economy, Ohio's sales tax does not automatically cover them; they must be explicitly included in the tax code. The budget commission should reexamine the proposal made by Gov. Taft in 2003 to

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<sup>40</sup> Supplemental Note on Senate Substitute for Substitute for House Bill No. 2365, As Amended by Senate Committee of the Whole, Session of 2009

<sup>41</sup> Ohio Manufacturers' Association, "The Policy Point: A Competitive Ohio Tax System," *Retooling Ohio*, Vol. 8, 2010, available at [http://www.informz.net/ohiomfg/data/images/oma-04756\\_retooling\\_tax\\_2010.08\\_v3.pdf](http://www.informz.net/ohiomfg/data/images/oma-04756_retooling_tax_2010.08_v3.pdf)

cover a broader array of services, starting with expenditures for lobbying. Ohio lobbyists won't move to Indianapolis or Lansing if customers must pay sales tax on their services.

A number of these loopholes were included in a 2008 Policy Matters Ohio report on a dozen tax breaks that should be limited or eliminated.<sup>42</sup> A table from the report is included in Appendix B.<sup>43</sup>

The budget commission also should help convene a summit of state and federal legislators to rally support for the Streamlined Sales Tax Project, which would level the playing field between online and traditional retailers, and a bill in Congress supporting it. Under state law, Ohioans owe sales or use tax on taxable items they buy or use in the state. However, the U.S. Supreme Court has ruled that retailers cannot be required to collect such taxes unless they have a physical presence in the state. Ohio participates in the SSTP, a long-standing multi-state initiative to make sales tax laws, rules, and systems more uniform across states and thus make it easier for retailers to collect sales taxes from their customers and remit them to the states. A bill recently introduced in Congress, HR 5560, would empower states that have implemented the Streamlined Sales Tax Agreement to require remote sellers with sales above a certain amount to collect and remit their state and local sales taxes, provided they also satisfied a number of other requirements. A study last year pegged Ohio's annual revenue loss from non-collection of sales and use tax on electronic commerce at \$274 million in 2011, increasing to \$307.9 million in 2012. That covers electronic commerce and does not include other forms of remote commerce such as mail orders and telephone orders.<sup>44</sup> Such taxes can also add up: Based on documents in a recent case before the state tax commissioner, L.L. Bean Inc. would have been liable for more than \$2 million in state sales tax in the year ended March 31, 2008, had it been required to collect it.<sup>45</sup>

Policy Matters Ohio will not attempt here to estimate the budget gap in the upcoming biennium. However, it is important not to look exclusively at the amounts of one-time revenue being used in the current budget. The FY2010-11 budget was inadequate to support the services and investments Ohio needs. Thus, the gap is actually larger than a listing of one-time revenue sources would indicate. Public services maintain our quality of life and support critical economic development goals. Our tax system needs to sustain those services.

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<sup>42</sup> Schiller, Zach, Policy Matters Ohio, *Limiting Loopholes: A Dozen Tax Breaks Ohio Can Do Without*, September 2008. See <http://www.policymattersohio.org/LimitingLoopholes2008.htm>

<sup>43</sup> The 2008 report estimated foregone revenue from each loophole. These amounts have not been updated.

<sup>44</sup> Bruce, Donald, William F. Fox and LeAnn Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," The University of Tennessee, April 2009, see <http://cber.utk.edu/ecommm/ecom0409.pdf>

<sup>45</sup> Policy Matters Ohio calculated that estimate based on the Commercial Activity Tax that the company would have paid had it paid the CAT during that period. This estimate does not include additional sales taxes levied at the local level. See Office of the Tax Commissioner, Ohio Department of Taxation, Final Determination, Aug. 10, 2010, p. 5

## Appendices

### Notes on Appendices

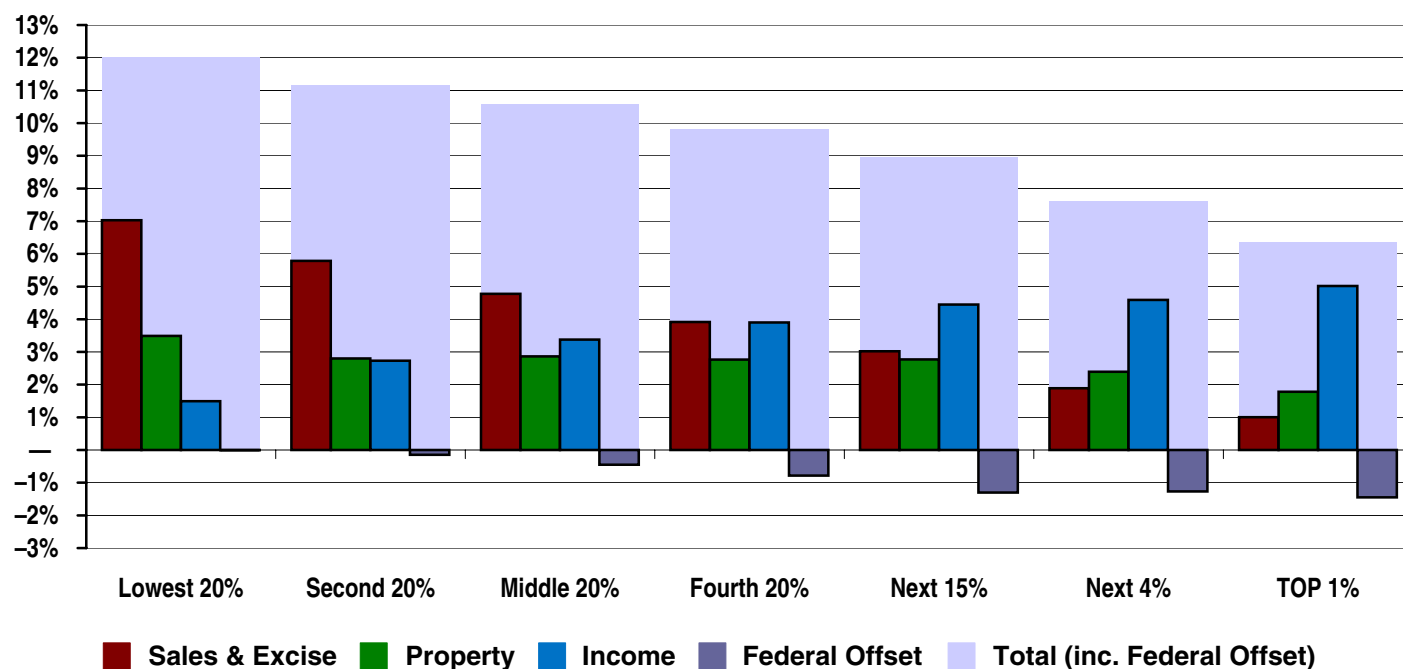
As described on page 5, the Institute on Taxation and Economic Policy produced a report last year, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. It was released in Ohio by Policy Matters Ohio and the Center for Community Solutions, and is available at <http://www.policymattersohio.org/WhoPays2009.htm>. The report reviewed every state's tax system based on permanent changes in law enacted through October 2009 and income levels from 2007. **Appendix A** shows the results of that analysis for Ohio.

**Appendix B** lists a dozen tax loopholes that Policy Matters Ohio examined in a 2008 report. Estimates of foregone state revenue from each of these loopholes have not been updated.

# Ohio

## State & Local Taxes in 2007

### Shares of family income for non-elderly taxpayers



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than \$17,000	\$17,000 – \$32,000	\$32,000 – \$50,000	\$50,000 – \$79,000	\$79,000 – \$147,000	\$147,000 – \$352,000	\$352,000 or more
Average Income in Group	\$9,600	\$24,000	\$40,500	\$62,400	\$102,100	\$210,000	\$995,300
<b>Sales &amp; Excise Taxes</b>	<b>7.0%</b>	<b>5.8%</b>	<b>4.8%</b>	<b>3.9%</b>	<b>3.0%</b>	<b>1.9%</b>	<b>1.0%</b>
General Sales—Individuals	2.8%	2.6%	2.3%	2.0%	1.6%	1.0%	0.6%
Other Sales & Excise—Ind.	2.4%	1.6%	1.2%	0.9%	0.7%	0.4%	0.2%
Sales & Excise on Business	1.9%	1.6%	1.3%	1.0%	0.8%	0.5%	0.3%
<b>Property Taxes</b>	<b>3.5%</b>	<b>2.8%</b>	<b>2.9%</b>	<b>2.8%</b>	<b>2.8%</b>	<b>2.4%</b>	<b>1.8%</b>
Property Taxes on Families	3.4%	2.7%	2.8%	2.7%	2.6%	2.1%	0.9%
Other Property Taxes	0.1%	0.1%	0.1%	0.1%	0.2%	0.3%	0.9%
<b>Income Taxes</b>	<b>1.5%</b>	<b>2.7%</b>	<b>3.4%</b>	<b>3.9%</b>	<b>4.4%</b>	<b>4.6%</b>	<b>5.0%</b>
Personal Income Tax	1.5%	2.7%	3.4%	3.9%	4.4%	4.6%	5.0%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%
<b>TOTAL TAXES</b>	<b>12.0%</b>	<b>11.3%</b>	<b>11.0%</b>	<b>10.6%</b>	<b>10.2%</b>	<b>8.9%</b>	<b>7.8%</b>
Federal Deduction Offset	-0.0%	-0.1%	-0.5%	-0.8%	-1.3%	-1.3%	-1.4%
<b>TOTAL AFTER OFFSET</b>	<b>12.0%</b>	<b>11.2%</b>	<b>10.6%</b>	<b>9.8%</b>	<b>8.9%</b>	<b>7.6%</b>	<b>6.4%</b>

Note: Table shows 2007 tax law updated to reflect permanent changes in law enacted through October 2009.

<b>Table 1</b>			
<b>Tax</b>	<b>Loophole</b>	<b>Estimated foregone state revenue in FY2009</b>	<b>Approved</b>
Individual Income Tax	Loosened residency test, allowing more people to avoid the tax	\$25 million to \$30 million	2006
Real property tax	Homestead exemption expansion allows even wealthy homeowners to qualify	At least \$118 million	2007
Real property tax	Owners do not have to pay 10 percent of their tax; owners who occupy their properties receive an additional 2.5 percent rollback. The state reimburses schools and local governments for foregone revenue	At least \$5.2 million (A)	1971, 1979
Dealers in Intangibles Tax	Payday lenders, mortgage brokers and others pay lower tax than banks	More than \$10 million (B)	1931
Commercial Activity Tax/Individual Income Tax	Trusts formed before 1972 can choose which tax to pay	Up to \$18 million	2006
Commercial Activity Tax	Companies with previous big losses can write them off against the CAT	Up to \$45 million a year starting in 2010	2005
Commercial Activity Tax	Suppliers to certain distribution centers don't pay the tax (C)	\$6 million	2006
Sales Tax	Machinery, equipment and software for a new Avon Products distribution center	At least \$3.47 million (D)	2008
Sales Tax	Lobbying and public relations services are not covered	\$11.6 million (E)	1935
Sales Tax	Debt collection is not covered	\$21.5 million (E)	1935
Corporate Franchise Tax	Goodwill, appreciation and abandoned property excluded from net worth tax on financial institutions	NA (F)	1933

(A) -- Based on 2003 estimate by the Taft Administration of revenue gained in FY2005 if tax relief were limited to the first \$1 million in market value of each property. A lower limit would produce more revenue. The 10% rollback was approved in 1971; the 2.5% rollback was approved in 1979.

(B) -- Based on an estimated \$21 million in additional revenue if these companies were instead taxed under the corporate franchise tax, reduced by half based on possible exclusions they might claim

(C) -- Such distribution centers must have at least \$500 million in sales and more than half of those must be shipped outside of Ohio

(D) -- This is a one-time amount for the outfitting of the warehouse. However, the 2007 Tax Expenditure Report estimates the cost of the ongoing exemption for retailers' warehouses at \$6.4 million

(E) -- Based on \$10.5 million for lobbying and \$19.5 million for debt collection shown in Taft proposal for FY2005; the sales tax has been increased from 5.0% to 5.5% since then. The exclusion of these services from taxation is a function of the general definition of the sales-tax base, not an explicit exemption.

(F) -- The current Tax Expenditure Report estimates these exclusions are worth \$112 million in FY09. While tightening this exemption could produce millions of dollars in additional revenue, the exact amount is not known

Source: Policy Matters Ohio, "Limiting Loopholes: A dozen tax breaks Ohio can do without", 2008

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