Exempt From Scrutiny:
Tax Breaks in Ohio

A Report From

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Policy Matters Ohio, the publisher of this study, is a nonprofit, nonpartisan research institute dedicated to researching an economy that works for Ohio. Policy Matters seeks to broaden debate about economic policy by doing research on issues that matter to working people and their families. With better information, we can achieve more just and efficient economic policy. Areas of inquiry for Policy Matters include work, wages, education, housing, energy, tax and budget policy, and economic development.

Executive Summary

Tax expenditures – exemptions, deductions and credits that cause taxes not to be paid when they would be otherwise – often are overlooked in state budget deliberations. Yet as the Ohio Department of Taxation has noted, they have the same fiscal impact as direct expenditures. The taxation department estimated in its regular report on tax expenditures two years ago that they would total $6.27 billion in fiscal 2006 and $7.12 billion this fiscal year. Though the major tax reform enacted in 2005 changed the value of many exemptions, such expenditures are a significant element in Ohio's state budget, compared with actual state tax revenue of $20.8 billion in FY06. They should be considered in the budget process.

Ohio's tax expenditures not only affect a very substantial share of the state's tax base. Aside from a biennial review of state revenue losses, they receive no regular scrutiny though many have been in effect for decades. Since 1963, brewers and beer importers have gotten a credit on beer and malt beverage taxes for paying part of them a few weeks in advance. The largest tax expenditure, estimated to be worth more than $2 billion a year, exempts machinery, equipment, supplies and fuel used in manufacturing from sales and use taxes. It was last overhauled in 1990. Many tax expenditures like the manufacturing exemption have a reasonable basis, but still need a regular review.

Numerous tax expenditures are aimed at economic development, yet we have little idea of who is getting them or whether they are providing the benefits one would demand of a grant or other outright expenditure. These include a sales and use tax exemption for equipment used in warehouses when the product is primarily shipped out of Ohio to certain customers, worth an estimated $6.9 million this fiscal year. In 2003, the General Assembly also capped at $800 the amount of sales tax paid on each jet aircraft purchased in fractional shares by wealthy Ohioans. These and other tax expenditures should find their way into the unified budget for economic development that Gov. Ted Strickland promised in his campaign. The budget should require disclosure of who is benefiting from these expenditures and what beneficiaries provide in return over time.

Some tax expenditures provide an advantage to one industry or even one company, which may disadvantage other companies or industries. For instance, products sent to distribution centers with more than $500 million in annual supplier costs that ship at least half their product out of state are exempt from the new Commercial Activity Tax. Just one distribution center has claimed the exemption. A cap on the amount of corporate franchise tax paid under the net-worth formula is available only to companies with $37.5 million or more in net worth. Smaller companies need not apply.

The CAT tax was supposed to be an antidote for the two taxes it is replacing, the loophole-ridden corporate franchise tax and the often-abated tangible personal property tax. But while the disappearance of these two taxes does mean loopholes will disappear with them, the General Assembly added or extended more than a dozen exemptions or credits to the CAT that will be worth more than $200 million a year. That does not include tax credits worth hundreds of millions of dollars over 20 years for unused net operating loss deductions against the corporate franchise tax. These credits will be available only to companies with large losses.

A number of other states go further than Ohio and include in their tax expenditure reports the purpose of each expenditure, analysis of the effectiveness with which that purpose is being accomplished, and data on the number and type of taxpayers who are benefiting. Others review how much certain tax expenditures benefit taxpayers according to their income level. The Ohio Department of Taxation should receive additional funding in the budget to hire research staff and closely analyze tax expenditures on each of these issues, going beyond the report it will release as a part of the governor's proposed budget.

The Strickland administration should ask for recommendations from the taxation department and other departments on which tax expenditures no longer serve Ohio and should be slated for elimination in the upcoming FY2008-2009 budget. The General Assembly should also schedule hearings on tax expenditures as part of its consideration of the upcoming budget. Existing and new tax expenditures should be subject to a limited term and a regular review.

Ohio's biennial tax expenditure report is a useful tool for understanding the tax system and its exemptions, credits and deductions. However, this tool needs to be sharpened and used more effectively.

Introduction

As Ohio produces its biennial budget this year, there will be months of deliberations over how much the state should spend on education, health care, prisons and dozens of other programs. This report examines a major class of expenditures that often is overlooked in the budget deliberations: Tax expenditures. These are exemptions, deductions and credits that cause taxes not to be paid when they would be otherwise. As the Ohio Department of Taxation (ODT) noted in its last official report on the subject, "a tax expenditure has the same fiscal impact as a direct government expenditure," since it reduces the funds available for other government programs.[1]

Two years ago, as required under statute, the taxation department estimated the effect of eliminating 135 different tax expenditures, ranging from the $20 personal exemption credit individuals receive on their state income tax to the sales tax exemption on property used to prepare eggs for sale.[2] The department concluded in the biennial report that if the state were to repeal all of these exemptions, credits and deductions, the state would take in an additional $6.27 billion in FY06 and $7.12 billion in this fiscal year.[3]

The major tax reform enacted later in 2005 changed the value of many exemptions, since it called for phasing out or reducing some taxes and increasing others.[4] A new tax expenditure report, to be released with the executive budget, will estimate the cost of

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[1] State of Ohio Executive budget, Fiscal Years 2006 and 2007, Book Two, Tax Expenditure Report, Prepared by the Department of Taxation and Submitted to the 126th General Assembly by Governor Bob Taft, February 2005, p. 1. See http://www.obm.ohio.gov/budget/operating/executive/0607/bb0607_book2.pdf, accessed Jan. 17, 2007.

[2] Ibid, p. 1. "The report includes the legal citation, date of enactment, a description of the tax expenditure, and estimates the revenue impact from repealing the tax expenditure for fiscal 2006 and 2007." It covers eight General Revenue Fund taxes; other taxes that do not provide revenue to the GRF, such as the motor vehicle fuel tax and the horse racing tax, are not covered. The ODT used four criteria in defining tax expenditures: 1) The item reduces, or has the potential to reduce, one of the state's General Revenue Fund taxes, 2) The item would have been part of the defined tax base, 3) The item is not subject to an alternative tax, and 4) The item is subject to change by state legislative action and is listed as an exemption, deduction or credit in the Ohio Revised Code. See p. 2-3 of the report for more description.

[3] The report estimated the revenue gain for the General Revenue Fund and other funds, primarily local government funds, in each of the two fiscal years as if the tax expenditure were repealed on July 1, 2005. This means most of the FY2006 figures reflect less than a full year's gain, since tax increases can't be imposed retroactively. The ODT included in its estimates potential taxpayer changes in behavior in response to the repealed tax expenditure, and factored out the effect of overlapping tax expenditures when two different tax provisions might exempt the same activity. It provided separate figures on the value of each tax expenditure when these two factors were ignored. Policy Matters Ohio uses the former number – the estimated amount the state would gain if the tax expenditure were repealed – in this report unless otherwise noted. This is the more conservative estimate.

[4] The phase-out of the corporate franchise tax and reduction in the individual income will reduce the value of exemptions against those taxes, while the increase in the sales tax compared to the permanent 5.0 percent rate used for the last tax expenditure report will boost the value of sales-tax exemptions. Meanwhile, new exemptions have been created for the newly created commercial activity tax. Numerous effective exemptions are excluded from the report; for instance, Ohio's sales tax does not cover numerous services, but these are not included in the report as they are not considered part of the base. See *Taxing Issues, Implications of Tax Expenditures on Ohio's Revenue System*, by Richard G. Sheridan, David A. Ellis and Richard Marountas, Federation for Community Planning, October 2002, p. 2.

such exemptions, deductions and credits in FY08-09. Many of the estimates are approximations, based on ODT analysis of available statistics and reasonable assumptions. However, in comparison with overall tax revenue of $20.8 billion in FY06, such expenditures are obviously a significant element of Ohio's state budget.[5]

Ohio's tax expenditures not only affect a very substantial share of the state's tax base, they receive no regular scrutiny by the General Assembly, though many have been in effect for decades. Many are aimed at economic development, yet we have little idea of who is getting them or whether they are providing the benefits one would demand of a grant or other outright expenditure. Some tax expenditures provide an advantage to one industry or even one company, which may disadvantage other companies or industries. And though a substantial number of tax loopholes are being phased out together with the state's corporate franchise tax, the General Assembly added numerous other tax breaks when it created the commercial activity tax.

Gov. Ted Strickland has said that current estimated spending levels proposed by agencies under the Taft Administration exceed available revenue growth by $1 billion to $1.5 billion over the next biennium.[6] This underlines the need to carefully examine tax expenditures as part of the budget process. This report highlights some of the state's tax expenditures and makes recommendations for review of them.

As the Federation for Community Planning (now the Center for Community Solutions) pointed out in a 2002 report on the subject, there are two types of tax incentives. "Some are used to encourage business investment in the state or one of its localities. Others are used to promote social policy goals."[7] Among the latter, for instance, are the personal exemption on the individual income tax, which was estimated to cost the state $619.6 million in FY07, and the sales tax exemption on prescription drugs and medical supplies, which costs $247.7 million. The exemption of food for off-premises consumption from the sales tax is not included in the tax expenditure report because it is part of the Ohio Constitution and cannot be changed simply through legislative action. This illustrates that the curtailment of some of the largest tax expenditures is neither likely nor desirable. Table 1 lists the 10 largest tax expenditures in FY07 as estimated by the taxation department two years ago:

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[5] Legislative Service Commission, *Table 1, GRF, LGF and LPEF Revenue History, FY1975 – 2007*. See http://www.lbo.state.oh.us/fiscal/budget/testimony/126ga/HistoricalRevenue2006-09.pdf, accessed Jan. 30, 2007. This tax revenue figure includes taxes deposited into the GRF and into local government funds.
[6] "Strickland Discusses Ohio Budget Realities," See http://www.governor.ohio.gov/News/January2007/tabid/103/Default.aspx, accessed Jan. 22, 2007.
[7] *Taxing Issues, Implications of Tax Expenditures on Ohio's Revenue System*, p. 3.

Table 1

Top 10 Tax Expenditures, FY07, by Foregone Revenue

Type of Tax Against Which Exemption is Taken	Tax Expenditure Description	Foregone FY07 revenue (millions of dollars)
Sales and Use Tax	Property used primarily in manufacturing tangible personal property	2,054.5
Individual Income Tax	Personal exemption deduction	619.6
Sales and Use Tax	Packaging and packaging equipment	312.6
Individual Income Tax	Joint filer credit	273.1
Sales and Use Tax	Sales of prescription drugs and selected medical supplies	247.7
Sales and Use Tax	Sales to churches and certain other types of non-profit organizations	225.7
Sales and Use Tax	Sales of tangible personal property and services to providers of electricity	207.4
Sales and Use Tax	Transportation of persons or property	191.3
Individual Income Tax	$20 personal exemption credit	184.1
Individual Income Tax	Social Security and railroad retirement benefits exemption	182.6

Source: Tax Expenditure Report, Ohio Department of Taxation, February 2005. Amounts reflect revenue the state General Revenue Fund and other funds, primarily local government funds, would gain if exemption or credit was repealed as of July 1, 2005.

No Regular Scrutiny

Once a tax expenditure is approved by the General Assembly, it continues indefinitely. Only rarely is one repealed, such as when the sales and use[8] tax exemption for investment metal bullion and coins was wiped out because of the Tom Noe scandal in 2005. Generally, however, they are not subject to any regular scrutiny by the General Assembly.[9] Thus, they represent a privileged state expenditure, unlike spending for public education, prisons, health care or any other purpose. 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 original purpose or any legitimate purpose at all.

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[8]Use tax is a companion tax to the sales tax. It is due on purchases made out of state but consumed within the state.

[9]As the Tax Expenditure Report puts it: "Unlike direct expenditures, tax expenditures are not analyzed and reviewed as part of the budget process. They may remain in effect indefinitely, with no scrutiny by policy makers." Tax Expenditure Report, p. 1.

For instance, brewers and beer importers receive a credit on the beer and malt beverage taxes they pay just for paying part of them a few weeks in advance. Under the statute, which has been on the books since 1963, if companies pay such taxes for a given month on the 18th of that month, they are entitled to a 3 percent credit. In addition, if the advance payment doesn't cover the full amount due, they also receive another, smaller discount.[10] The taxation department estimated the cost of these discounts, plus another for wine and mixed beverage distributors, at $1.3 million a year in both fiscal 2006 and 2007.[11] The law says that the beer tax credit and discount "shall be in consideration for advancing the payment of the tax and other services performed by the permit holder and other taxpayers in the collection of the tax."[12] However, there is little to explain why payers of this tax should receive such special treatment.

By far the largest tax expenditure is the sales and use tax exemption for machinery, equipment, supplies and fuel used in manufacturing. This tax break alone is worth more than $2 billion this fiscal year, according to the last tax expenditure report, or more than a quarter of all those covered by the report. Economists generally endorse this tax break, a form of which is employed by most states that have sales and use taxes. Manufactured products are later taxed when they are sold, so this prevents multiple taxation of the same goods and materials.

The General Assembly last overhauled this exemption in 1990, when business groups joined the Ohio Department of Taxation and others in revamping it after an Ohio Supreme Court decision that would have substantially expanded the exemption. The exemption is now defined with 64 specific examples in the state's administrative code,[13] and experts say the 1990 definition reduced the amount of litigation over the exemption. However, the sheer size of this expenditure begs for it to be examined closely more than once in 17 years. It amounts to the equivalent of roughly a penny and a half of the state sales tax, or four-fifths of what the state spends in its operating budget for higher education.

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[10] This discount amounts to 3 percent of the difference between the advance payment and the tax due, or 3 percent of 10 percent of their liability, whichever is smaller. For example, a brewer that paid $100 in advance whose taxes wound up totaling $120 would get a discount of $3.30; had its taxes turned out to be $100, the discount would be $3.00.

[11] Wine and mixed beverage distributors are eligible for a 3 percent discount if they pay their taxes on a timely basis by the 18th of each month (One industry official guesses that the discount may exist so the state doesn't have to spend the effort to try and collect from those who don't pay). However, the beer exemption accounted for more than four-fifths of such tax receipts in fiscal 2005. See 2005 Annual Report, Ohio Department of Taxation, p. 43. Some other taxes, such as the Other Tobacco Products Tax and the Replacement Tire Fee, also provide discounts for timely payment.

[12] Ohio Revised Code, Section 4303.33(A). One tax department official says the services probably mean the cost of preparing the report.

[13] Ohio Administrative Code, Section 5703-9-21, See http://onlinedocs.andersonpublishing.com/oh/lpExt.dll?f=templates&fn=main-h.htm&cp=OAC, accessed Jan. 30, 2007.

The "Least Good" Piece of Public Policy

Not all tax expenditures are decades old; some are being created nearly every year.[14] Two years ago, for instance, when the General Assembly was considering a new commercial activity tax (CAT), it wrote into the law a special provision favoring companies that ship into or out of the foreign trade zone at Rickenbacker Airport in Columbus. Such products were exempted from the CAT during the two-year term of the budget. Other Ohio foreign trade zones protested, as well they might, saying this would put them at a disadvantage. House Speaker Jon Husted later called the legislature's exemption the "least good" piece of public policy included in the 2005 budget act.[15] Last year, the General Assembly changed the exemption, so that now it covers only distribution centers with more than $500 million in annual supplier costs that ship at least half their product out of state, but is no longer limited to Rickenbacker. Though the tax department figured that 10 or 15 distribution centers might claim the exemption, only one has done so: Cardinal Health National Logistics Center.[16]

Granting such special advantages as the General Assembly did with the original Rickenbacker exemption contradicts a taxation principle known as "horizontal equity": Treating similar taxpayers the same way. As the Findlay *Courier* editorialized last year when the House looked to extend the Rickenbacker break to other foreign trade zones, "…what's fair for one foreign trade zone should be fair for them all. It's hardly fair to grant a competitive advantage to just one of them. We're either going to grant tax breaks or we're not. We think that "not" is the appropriate answer at this point."[17] While the General Assembly reduced the damage by limiting the exemption and it no longer specifically favors Rickenbacker as the original law did, it also favored very large companies at the expense of smaller ones that may not be able to take advantage of the exemption. The loss of revenue may not add up to as much as the ODT estimated – $37.5 million in FY2010, when the CAT is fully implemented[18] – but it still will either require higher taxes on other businesses or reduce the ability of the state to provide needed services.

Another tax break written into the new CAT – the credit for unused net operating loss deductions – will not affect the FY2008-09 budget, but will be a costly drain on the state treasury over the long term. These credits, which transfer such deductions that had not been used against the corporate franchise tax provided they amount to more than $50

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[14] The General Assembly has a fiscal analysis prepared as it is considering legislation to enact new credits or modify old ones.

[15] Gongwer News Service, Gongwer Ohio Report, Jan. 5, 2006.

[16] See http://tax.ohio.gov/divisions/communications/documents/Cardinal_QDC_Certificate_9_15_06.pdf for a copy of the certificate. This tax exemption, like a number of other exemptions and credits built into the definition of what the CAT covers, may not be included in the new tax expenditure report because the report does not cover items specifically exempted by the Ohio Revised Code that do not happen to be part of the tax base. See Tax Expenditure Report, p. 2.

[17] Findlay *Courier*, March 22, 2006. See http://www.thecourier.com/opinion/editoral/ar_ED_032206.asp, accessed Feb. 3, 2007.

[18] Impact of House Bill 530 CAT-related changes, received from the Ohio Department of Taxation, Nov. 29, 2006.

million, must be spread over a 20-year period starting in 2010. Claims for more than $900 million in credits have been filed by corporations, although that amount is likely to be whittled down somewhat, since ODT will do audits and companies will have to document their claims.[19] This means that decades after the state has stopped taxing companies based on their profits, it will still be giving tax credits for losses. This provision also is available only to big money-losers. Small companies that had losses need not apply.

The same bias in favor of big companies can be found in another major tax expenditure, the net worth cap. Under Ohio's corporate franchise tax, companies calculate their liability based on their net income or net worth, and pay whichever amount is larger. However, under the net-worth formula, liability is capped at $150,000. Thus, companies with net worth of more than $37.5 million do not pay any more than the $150,000 cap. According to taxation department data, 19 of the 50 largest companies in Ohio were liable for exactly $150,000 in corporate franchise tax for tax year 2004, suggesting that they were at the cap.[20] The department originally estimated the cost of this tax expenditure at $130.9 million in FY07. Though the phase-out of the corporate franchise tax means the size of this expenditure is declining, the department has estimated the revenue from repealing it would be $44.1 million in FY08 and $31.5 million in FY09.[21]

In the budget it approved in 2003, the General Assembly extended its largesse to wealthy Ohioans who buy fractional shares of jet aircraft that fly them around the country. The purchaser of a one-sixteenth share in a Hawker 400XP for $406,250[22] only has to pay $50 in state sales tax, instead of the $22,343 he or she would have to pay. The purchaser of a sixteenth of a Gulfstream 550 would pay $144,375 in Ohio sales tax, but only has to pay $50. A total of just $800 per aircraft must be paid in sales tax; fractional buyers pay their percentage share of the $800 total. Altogether, the last tax expenditure report estimated that this tax break would produce $3.5 million in FY07 revenue if it were repealed.[23] At the time this new tax break was passed, proponents argued that together with another new sales-tax break on parts and services bought for fractionally owned aircraft, it would produce economic benefits for the state.[24] That is certainly deserving of analysis. However, such claims generally should be viewed with skepticism. A 2002 review of

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[19] Church, Frederick and Christopher Hall, *Ohio Tax Reform: Cuts and Repeals and that Darn CAT*, State Tax Notes, January 8, 2007, p. 30.

[20] Figures are for liability before litter tax. See appendix of *Strengthen, Don't Scrap, Ohio's Corporate Franchise Tax*, Zach Schiller, Policy Matters Ohio, May 2005. http://www.policymattersohio.org/Ohio_CFT_Study_2005_05.htm

[21] Information from Christopher Hall, Ohio Department of Taxation, Tax Analysis Division, Jan. 10, 2007

[22] Sales prices cited in "Buffett's Baby is Taking a Bumpy Ride," by Geraldine Fabrikant, *The New York Times*, June 25, 2006.

[23] Tax Expenditure Report, p. 71, accessed Jan. 17, 2007. A new calculation for the upcoming state report estimates the exemption at $0.9 million in FY08 and $1.0 million in FY09. These lower amounts are based on the indication by one of the two Ohio companies benefiting indirectly from this break that without it, it would find ways to minimize its customers' Ohio tax exposure. The taxation department assumed that the other Ohio company qualifying for this break – there are two – would do the same thing. *Memo re Tax Expenditure #126: $800 cap on qualified fractionally owned aircraft*, From Jodi Miller, Tax Analyst, Tax Analysis Division, to Christopher Hall, administrator, Tax Analysis Division, January 28, 2007.

[24] Hunt, Spencer, "Taft wants tax break for NetJets," *The Cincinnati Enquirer*, June 2, 2003.

Ohio's tax expenditures noted that, "A host of scholarly research supports the conclusion that targeted tax expenditures have little or no effect on business relocation or expansion."[25]

Tax Expenditures for Economic Development

The tax code includes dozens of tax expenditures directed at individual industries and transactions. Sales and use tax exemptions include (estimated FY07 cost is in parentheses):

- Equipment used in warehouses and distribution centers when the product is primarily shipped out of Ohio either to retail stores of the warehouse owner or to customers when the warehouse is owned by a mail-order business ($6.9 million).
- A 25 percent sales tax refund for purchases of computers, software and similar property by electronic information service providers ($2.9 million).[26]
- Motor racing vehicles, repair services and other related items to professional motor racing teams (less than $1 million).
- Telecommunication services used primarily to perform the functions of a call center that employs at least 50 people ($49 million).[27]
- Drugs distributed to physicians as free samples ($5.6 million)

Other exemptions that are aimed at promoting economic development apply more broadly, such as the sales and use tax exemption on property used in research and development (FY07 cost: $128.8 million).

These and other tax expenditures should find their way into the single "unified budget" for economic development that Gov. Ted Strickland and Lt. Gov. Lee Fisher outlined in their campaign platform. Their Turnaround Ohio plan stated:

> "The first requirement for us to address our economic future sensibly is knowledge. But today, it's virtually impossible to get a clear overall picture of who is getting what incentives and what promises have been made. All state agencies that control taxpayer development dollars, from Development, Transportation, and Agriculture, to the Board of Regents, Third Frontier Fund and more, will be required to publicly and comprehensively report subsidies to

[25] Sheridan, Richard G., David A. Elllis and Richard Marountas, *Taxing Issues, Implications of Tax Expenditures on Ohio's Revenue System*, Federation for Community Planning, October 2002, p. 8.

[26] According to the taxation department, the revenue estimate for the upcoming report will be smaller than the $2.9 million per year estimate in the last report. A substantial amount of such claims are denied, which apparently was not taken into account in the last report. E-mail communication from Christopher Hall, Tax Analysis Division, Ohio Department of Taxation, Feb. 6, 2007.

[27] Based on a different methodology than it had used earlier, the taxation department estimated the revenue impact from eliminating this exemption at $14.7 million in FY08 and $15.9 million in FY09. *Memo re Tax Expenditure #127: Sales of telecommunication services used primarily to perform the functions of a qualified call center,* From Jodi Miller, Tax Analyst, Tax Analysis Division, to Christopher Hall, administrator, Tax Analysis Division, February 6, 2007.

> business, including business tax expenditures (exemptions, abatements, etc.), for public inspection and legislative review."[28]

When a business receives state aid in the form of a grant or loan, the recipient is plain.[29] However, with some limited exceptions,[30] there is no public disclosure of the beneficiaries of these tax breaks, or whether they have generated public benefits. Have new jobs been created? If so, what do they pay, and do they include benefits? If public benefits have not resulted, are there provisions to rescind or reduce the tax expenditure to that recipient? The planned unified economic development budget should require disclosure of who is receiving the benefit of these expenditures, and what those beneficiaries provide in return over time.

More CAT Loopholes

The commercial activity tax was supposed to be an antidote to the loophole-ridden corporate franchise tax and the often-abated tangible personal property tax. However, the General Assembly did not attempt to recapture any of the revenue lost from these taxes because of all the loopholes; quite the contrary, the CAT will not replace anywhere near the revenue that these two taxes produced, even in their weakened state.[31] And while the disappearance of those taxes does mean loopholes will disappear with them, legislators enacted numerous exemptions in the CAT at its very creation. Altogether, the General Assembly enacted more than a dozen exemptions and exclusions worth $141 million a year when the CAT is fully implemented.[32] While some of these exemptions prevent the CAT from being levied on other taxes, others like the distribution-center exemption are special-interest carve-outs.

For instance, the tax exempts certain affiliates of financial institutions and insurance companies. This goes beyond the original concept for the tax, which excluded financial companies and left them subject to the corporate franchise tax. Exempting some of their affiliates as well means that in certain instances, a company owned by a bank will be taxed under the corporate franchise tax, while the same company as a freestanding entity will be taxed under the CAT. During the debate over the CAT, then Lt. Gov. Bruce Johnson called this exemption "exceptionally dangerous" and went on to say:

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[28] *Jobs Worthy of Ohioans: The Strickland/Fisher Strategy for Job Creation in Ohio,* http://www.tedstrickland.com/content/314/jobs-worthy-of-ohioans-the-stricklandfisher-strategy-for-job-creation-in-ohio, accessed Jan. 16, 2007.

[29] Each year, the Ohio Department of Development publishes its Loan/Grant Report. While it does not provide information on previous loans and grants – say, what the wage levels, jobs created or investments made compared to what was originally contemplated – it outlines who the recipients of each loan and grant were for that year. See http://www.odod.state.oh.us/cms/uploadedfiles/Research/x105.pdf for the 2005 report.

[30] For instance, Job Creation Tax Credits are publicly awarded and the state annually reports on the status of credits that have been given. See http://www.odod.state.oh.us/edd/jctc/, accessed Jan. 23, 2007.

[31] Church, Frederick and Christopher Hall, *Ohio Tax Reform: Cuts and Repeals and That Darn CAT,* State Tax Notes, Jan. 8, 2007, p. 34. Church and Hall note that the net result of the CAT replacing the corporate franchise and tangible personal property (TPP) tax was a large business tax cut.

[32] The two-year exemption for motor-vehicle fuel, due to expire at the end of June, is not included in that total. Tax Commissioner Richard Levin said recently that the exemption should be allowed to expire.

> "This exemption creates an unfair competitive advantage for those affiliates not subject to the new business privilege tax. Their competitors, even though they provide the same services and sell the same products, will be forced to do business on an uneven playing field. The Tax Department will be forced to administer two separate business taxes on similarly situated operations. This carve-out clearly violates the principle of establishing a broad base to ensure a low rate."[33]

Nevertheless, this exemption became a part of the new tax, though it was narrowed from the extremely broad form it took in one earlier version of the CAT. The tax department has estimated that it will cost $34.6 million in FY2010, when the CAT is fully implemented, plus another $6 million in additional revenue losses from companies that come up with new ways to take advantage of this exemption. These affiliates are expected to pay $5 million in the corporate franchise tax, so the net negative impact of this exemption is estimated at $35.6 million.[34]

In addition, the General Assembly approved the continuation of four tax breaks currently taken against the corporate franchise tax, which otherwise would expire with that tax.[35] Instead, starting in FY2009, they will be available against the new CAT. The state taxation department estimates these will cost $65.7 million in FY09.[36]

Reports in Other States

In the 1990s, Virginia's Department of Taxation published detailed studies of the state's sales and use tax expenditures, comparing them to others around the country and particularly in neighboring states. At the time, for instance, it found that Ohio was one of 13 states whose sales and use tax exemption for property used in manufacturing covered component materials, machinery and tools, fuel and power, and consumable supplies.[37]

The Virginia studies discussed national trends, compared Virginia exemptions with other states, provided a synopsis of the most significant issues involving the category of exemption, and discussed those taxpayers and entities which were similar but did not benefit from the exemptions, among other things.

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[33] Lt. Gov. Bruce Johnson, Ohio Department of Development, Conference Committee Testimony, Am. Sub. H.B. 66, June 9, 2005.
[34] Ohio Department of Taxation, HB 66 changes to the Administration's proposed CAT plan - Estimated impacts, and E-mail communication from Christopher Hall, Tax Analysis Division, Ohio Department of Taxation, Dec. 20, 2006.
[35] These are the job creation tax credit, the job retention tax credit, the credit for qualified research expenses and for research and development loan payments.
[36] E-mail communication from Christopher Hall, Tax Analysis Division, Ohio Department of Taxation, Jan. 31, 2007. In this case, the $65.7 million figure refers to the value of the credits, not how much the state would gain if it repealed them. That amount would be much lower – an estimated $20 million. This largely involves the job creation tax credit. The state cannot legally cancel existing job creation tax credit agreements, so the lower number reflecting the impact on revenue includes only the impact of no longer undertaking any new agreements beginning in FY 2008.
[37] *Virginia Sales and Use Tax Expenditure Study*, Vol. 2, No. 2, December 1995.

Regular tax expenditure reports in some other states provide more information than Ohio's report, allowing for a more thorough understanding of the expenditures. They provide explanations of the purpose, analysis of the effectiveness with which that purpose is being accomplished, and data on the number and type of taxpayers who are benefiting. They may also organize them by program and include local property tax expenditures.[38]

Some states attempt to review how much certain tax expenditures benefit taxpayers according to their income level.[39] A number of states also require regular review of tax expenditures. For instance, in Arizona, a review committee composed of House and Senate members reviews income-tax credits. Each credit comes up for review every five years, and the committee must recommend whether the expenditure should be amended, repealed or retained.[40] Under Washington law, the governor reviews the state tax exemption report every four years and may submit recommendations to the legislature about any of them that should be modified or repealed.[41]

Other states have added recently to the information they require in their regular tax expenditure reports. California now requires its annual tax expenditure report to include a description of the legislative intent behind each one, the number of beneficiaries of personal and corporate income tax expenditures, a description of any comparable federal provision, and other information.

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[38] For instance, besides listing each tax expenditure and the statutory authority for it, the Oregon report includes "the purpose for which each was enacted; estimates of the revenue loss for the coming biennium; the revenue loss for the preceding biennium; a determination of whether each tax expenditure is the most fiscally effective means of achieving its purpose; and a determination of whether each tax expenditure has achieved its purpose, including an analysis of the persons that benefit from that expenditure. Each tax expenditure is to be categorized according to the programs or functions that it supports. Finally, for those expenditures that will sunset next biennium, the report is to include the governor's opinion on whether the sunset should be allowed to take effect as scheduled or be revised to a different date." *Tax Expenditure Report, State of Oregon, 2007-2009*, p. 2. See http://www.oregon.gov/DOR/STATS/docs/ExpR07-09/FullReport.pdf. States such as Minnesota provide some information on the number of taxpayers benefiting from tax expenditures. State of Minnesota, *Tax Expenditure Budget, Fiscal Years 2006-2009*, Minnesota Department of Revenue, Tax Research Division, see http://www.taxes.state.mn.us/taxes/legal_policy/other_supporting_content/2006_tax_expenditure.pdf, accessed Feb. 5, 2007.

[39] See reports from Montana, http://mt.gov/revenue/formsandresources/biennialreports/tax_expend.pdf, and Texas, http://www.window.state.tx.us/taxinfo/incidence05/incidence05.pdf

[40] Arizona Revised Statutes, Title 43, Taxation of Income, Chapter 2, Article 2. See http://www.azleg.state.az.us/ArizonaRevisedStatutes.asp?Title=43, accessed Feb. 6, 2007.

[41] Washington State Department of Revenue, Tax Exemptions 2004, Appendix One, Authorizing Statute for Exemption Study http://dor.wa.gov/docs/reports/2004/Tax_Exemptions_2004/APPEN_1.pdf, accessed Feb. 6, 2007.

Recommendations

In New York State, Gov. Eliot Spitzer recently proposed the elimination of $449 million of tax loopholes, including the adoption of "combined reporting" for companies subject to the state's corporate franchise tax.[42] Like New York, Ohio allows companies that operate multiple entities to report them separately for corporate-franchise tax purposes. Requiring combined reporting by companies that conduct substantial inter-corporate transactions, as 17 states already do, cuts down on opportunities for companies to shift income and avoid taxation.[43] Governors in Pennsylvania and Iowa also have recently proposed combined reporting. Governor Strickland should join them.

Ohio's new tax commissioner Richard Levin said in a recent speech, "I'm going to stand against creating new tax exemptions and new tax credits and keep the focus on tax reductions."[44] This resolve against new loopholes is much needed. However, the administration should go further, and review those already in place.

The Strickland administration should ask for recommendations from the Ohio Department of Taxation and other departments on which tax expenditures no longer serve Ohio and should be slated for elimination in the upcoming FY2008-2009 budget. The General Assembly should also schedule hearings on tax expenditures as part of its consideration of the upcoming budget. The ODT should receive additional funding in the budget to hire research staff and closely analyze tax expenditures beyond the report it will release as a part of the budget. This analysis should include:

- An exploration of what the purpose is for each tax expenditure;
- The effectiveness of each tax expenditure in meeting its purpose;[45]
- Disclosure of how many businesses receive tax expenditures for economic-development purposes (The unified development budget should also include a specific listing of the recipients of these tax expenditures and the public benefits they provide – jobs, wages, investments, etc. – as is already required for some Development Department programs);
- A review when possible of how much individual taxpayers are benefiting from tax expenditures, by income group; and
- A comparison of Ohio tax expenditures with those in other states.

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[42] 2007-08 New York State Executive Budget Briefing Book, http://publications.budget.state.ny.us/fy0708littlebook/index.html, accessed Feb. 6, 2007. See "Promoting Tax Equity" section.

[43] See also *Ohio's Vanishing Corporate Franchise Tax*, Zach Schiller, Policy Matters Ohio, October 2002. http://www.policymattersohio.org/franchisetaxintro.htm, accessed Feb. 6, 2007. At the time of that report, officials at the Ohio Department of Taxation estimated that combined reporting would generate roughly $200 million a year in Ohio. The recent rate reductions in the corporate franchise tax would reduce that number, but the amount would still be considerable. While this is not a tax expenditure according to Ohio's definition, it represents a revenue loss to certain taxpayers able to plan around the tax system, and one that the General Assembly can rectify.

[44] Welsh-Huggins, Andrew, *AP Interview: Tax commissioner will fight calls for tax loopholes*, Associated Press, Jan. 30, 2007.

[45] Currently, the state's tax expenditure reports draw no conclusions about the validity of any tax expenditure. See Tax Expenditure Report, p. 1.

This analysis would allow for a culling of those tax expenditures that are not serving the state; for instance, if a purpose for a specific tax expenditure cannot be clearly identified, the tax expenditure should be scrapped. To ensure that tax expenditures are subject to regular review, existing and new tax expenditures should be subject to a limited term. House Bill 61 in the last legislature would have accomplished a number of these steps.[46]

Ohio's biennial tax expenditure report is a valuable tool for understanding the tax system and its exemptions, credits and deductions. However, this tool needs to be sharpened and used more effectively.

[46] It would have provided for the appraisal of tax expenditures by the General Assembly and their automatic expiration unless renewed. The tax commissioner and the Legislative Service Commission were to assess each expenditure's effectiveness, and a new Tax Expenditure Sunset Review Committee would do its own appraisal and recommend whether tax expenditures should expire or be renewed. It also called for the sunset of such expenditures five years after their creation if they were not renewed. Bills creating or renewing tax expenditures would spell out the purpose, expiration date, class of taxpayers that would benefit and methods to appraise it. See http://www.legislature.state.oh.us/bills.cfm?ID=126_HB_61, accessed Feb. 8, 2007, for the bill and http://www.legislature.state.oh.us/analysis.cfm?ID=126_HB_61&ACT=As%20Introduced&hf=analyses126/h0061-i-126.htm for a bill analysis.

Policy Matters Ohio is a non-profit, non-partisan research institute dedicated to researching an economy that works for all in Ohio. Policy Matters seeks to broaden debate about economic policy by providing research on issues that matter to Ohio's working people and their families. Areas of inquiry for Policy Matters include work, wages, and benefits; education; economic development; energy policy; and tax policy. Generous funding comes from the Joyce, Gund, Cleveland and St. Ann Foundations and the Economic Policy Institute. To those who want a more fair and prosperous economy... Policy Matters.

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