

## Problems in the MBR tax cut package

### Volatility, uncertainty, unsustainability in shift to new sources

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Gov. John Kasich has proposed income-tax cuts that, according to administration estimates, will total more than \$2.6 billion over the next three fiscal years.<sup>1</sup> At the same time, the governor proposed increases in other taxes that would pay for much of these cuts. The new taxes still would not pay for \$174 million of the cuts. This is money that will have to be diverted from meeting important Ohio needs, ranging from restoring aid to local governments to making college more affordable.<sup>2</sup>

Even apart from that shortfall, however, the tax proposal raises a significant question: Will the increases in the severance tax on oil and gas, tobacco taxes, and the Commercial Activity Tax generate the growing, sustainable revenue required to support the permanent income-tax reduction?

This brief examines that issue, and finds that there is considerable uncertainty associated with the proposal, especially the severance tax. While the likely revenues from the other two major tax sources, tobacco taxes and the CAT, are better known, they still pose doubts. Tobacco taxes have been declining for years, apart from when tax increases have led to revenue spikes. And the CAT, the state's major business tax, has been "strongly cyclical," as a top official at the Ohio Department of Taxation (ODT) testified in 2011.<sup>3</sup> While the income tax, too, can decline significantly in an economic slump, it grows with the economy over the long-term, unlike tobacco taxes, and is not dependent on limited resources that will be used up, like the severance tax.

There is good reason to support increases in the taxes Gov. Kasich has proposed, but not for income-tax rate cuts that will go mostly to affluent Ohioans.<sup>4</sup> It would not be financially responsible for the

#### Key findings

- Gov. Kasich's proposed income-tax cuts are not all paid for; an unfunded gap of \$174 million impacts public services.
- The balance of the \$2.6 billion cuts depends on other tax increases.
- Some of the tax hikes are on resources that are not sustainable over time.
- The severance tax boost, in particular, may not produce the growing, sustainable revenue needed to pay for the tax cuts.
- Tobacco and business taxes also pose doubts.

<sup>1</sup> Transforming Ohio for Jobs + Growth, 2014 Mid-Biennium Review, Tax Cuts for Growth, at <http://transforming.ohio.gov/TaxCuts.aspx>.

<sup>2</sup> Some of these needs are cited in "Use Medicaid savings to improve Ohio, not to give even more tax cuts to the affluent," Policy Matters Ohio, October 2013, at [www.policymattersohio.org/404million-oct2013](http://www.policymattersohio.org/404million-oct2013). While funds could also come from existing reserves, that would still divert them from being used to support needed public services.

<sup>3</sup> Testimony of Deputy Tax Commissioner Frederick Church, "Understanding the Commercial Activity Tax in the Context of the 2005 Tax Reform Package," Legislative Study Committee on Ohio's Tax Structure, August 24, 2011, p. 3

<sup>4</sup> "Kasich Tax Plan: Advantage, Top 1 Percent," Policy Matters Ohio, March 14, 2014, at <http://bit.ly/1fUJohH>. As noted in the release, boosting the EITC and personal exemptions for the least affluent are positive steps that would help low-

General Assembly to approve the income-tax cuts when the revenues used to support them are so uncertain.

## Severance tax

The administration's proposal would use the bulk of the proceeds from a severance tax to replace income taxes, underpinning an 8.5 percent cut in the state's personal income tax. The severance tax is expected to become the biggest support for the tax cuts, accounting for \$449 million in fiscal year 2017, or 43 percent of the \$1.04 billion in new revenue that year. Table 1 shows the sources of funding for the proposed income-tax cuts.

	FY15	FY16	FY17
Total income-tax reduction	-\$612	-\$967	-\$1,060
Tobacco taxes	\$204	\$334	\$310
Commercial Activity Tax	\$196	\$269	\$278
Severance tax	\$121	\$304	\$449
Total new taxes	\$521	\$907	\$1,037
<b>Net revenue change</b>	<b>-\$91</b>	<b>-\$60</b>	<b>-\$23</b>
<b>Source:</b> Ohio Department of Taxation			

Taxing the growing oil and gas industry is good public policy. Gov. Kasich's severance tax proposal is simple, transparent and administratively efficient. The rate needs to be higher to cover the needs of impacted communities and fully restore budget cuts of the last state budget (fiscal years 2012-13).<sup>5</sup> And the exclusion of \$8 million in receipts for each well from the tax is overly generous. The distribution plan addresses local needs, includes a long-term investment fund and allows for adequate funding for industry regulation and oversight.<sup>6</sup> However, most of the proceeds of the severance tax would support income tax cuts. This swap of revenue sources – cutting the income tax and backfilling with severance tax – is risky. Oil and gas production in the Utica and Marcellus shale formations so far has not lived up to optimistic projections: severance tax collections as forecast may not replace proposed cuts in the amount projected. On the other hand, if the industry grows robustly, the General

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and moderate-income Ohioans. But these measures do not change the fundamental math of the proposal: It is an additional tax shift from those most able to pay to poor and moderate-income Ohioans.

<sup>5</sup> Policy Matters Ohio, in conjunction with the Pennsylvania Budget and Policy Center and the West Virginia Center on Budget and Policy, sent a letter on March 9, 2014, to the governors of all three states recommending that a regional severance tax of no less than that of West Virginia – 5 percent of value – be established in all three states to address local needs, fund state services and provide for the future while eliminating harmful interstate competition.

See [www.policymattersohio.org/governors-mar2014](http://www.policymattersohio.org/governors-mar2014).

<sup>6</sup> Funding from severance tax revenues will first be provided to the Ohio Department of Natural Resources to cover costs of industry oversight and regulation, geological mapping, land reclamation and related uses. Of the remainder, 20 percent is considered earmarked for local government uses, both short and long term: 10 percent would be distributed to communities and areas impacted by drilling, another 5 percent to an infrastructure fund for local government, and 5 percent to a long term investment fund for future needs, after 2025.

Revenue Fund could be increasingly based on severance tax collections that are uncertain, volatile and not sustainable over time.

The administration proposal will be considered as part of ongoing deliberations on another proposal, House Bill 375 in the House Ways and Means Committee. Both HB 375 and its substitute put forward in February tax at lower rates than the governor's proposal and provide tax holidays for capital cost recovery, income tax credits for those who pay the severance tax and an exclusion from the commercial activity tax. HB 375 provides a smaller share of funding to local governments than the governor, and funding for the Ohio Department of Natural Resources is capped. Remaining revenues are dedicated to the income tax reduction fund. Compromises between the governor and the House may be made and new proposals presented. We raise concern here about volatility, uncertainty and sustainability in the context of the governor's proposal, but these issues should be taken into consideration in forthcoming proposals as well.

Severance taxes are a welcome addition to the tax portfolio of a state or a nation because they may be shifted to buyers from other states who purchase the product at an out-of-state point of processing.<sup>7</sup> Since the severance tax is deductible from federal corporate income taxes, each dollar in such state tax is offset by the effective federal tax rate of the producer (the nominal federal tax rate is 35 percent, so this is, in nominal terms, a \$.35 cent deduction against federal taxes.)<sup>8</sup> Energy sectors enter recessions late and rebound with national recoveries, so severance tax collections may cushion recessionary downswings in tax collections.<sup>9</sup>

Most state severance taxes are based on value of production and price swings in the market cause instability in collections. Analysts have raised this concern since horizontal drilling (fracking) started expanding in parts of Ohio. In 2012, an Ernst and Young report commissioned by the Ohio Business Roundtable analyzed this problem in the context of tax cuts contemplated at the time:

*"The severance tax base will also depend on the level of natural gas and oil prices.... As a result of this price volatility, there may be substantial year-to-year swings in the incremental amount of severance taxes earmarked for personal income tax rate reductions."*<sup>10</sup>

Volatility in the price of oil and gas is illustrated in the two graphs below. Figure 1 shows the annual percent change in gross receipts, price and oil and gas produced in Ohio between 2003 and 2012. Change in gross receipts correlates closely with swings in market prices.

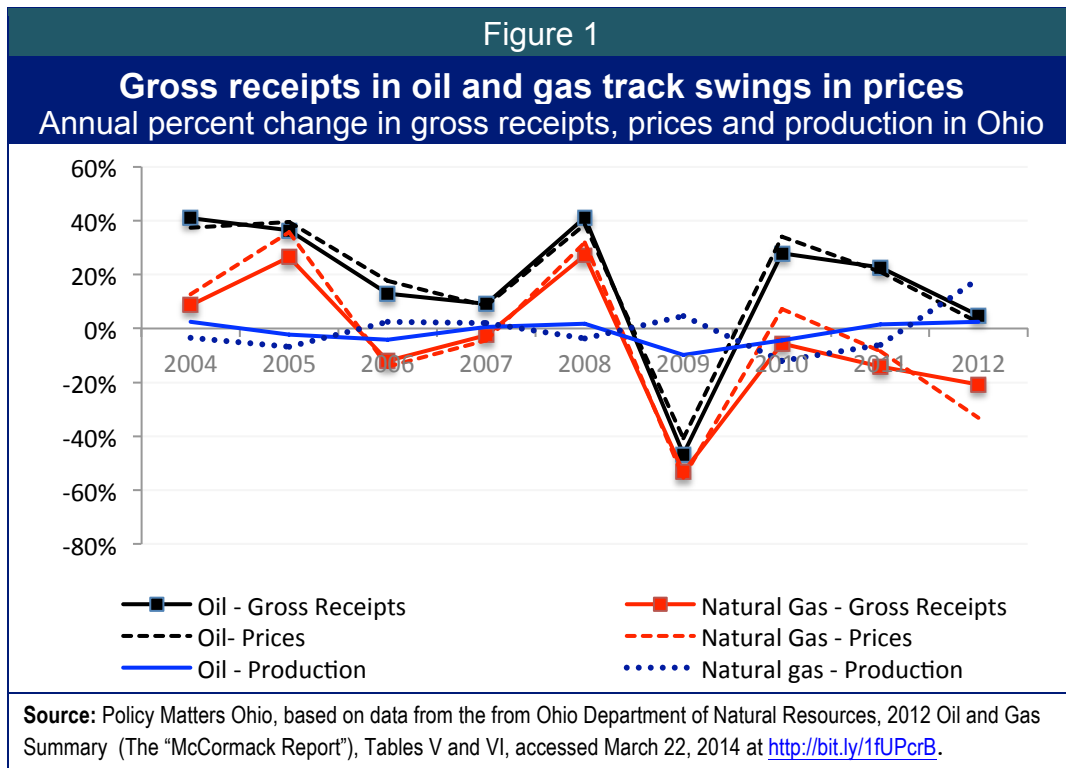
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<sup>7</sup> James Prescott and Tim Smith, "Use of Severance Taxes in Tenth District States," Economic Review, Federal Reserve Bank of Kansas, April 1985 accessed March 22, 2014, at <http://bit.ly/1jn2ncz>.

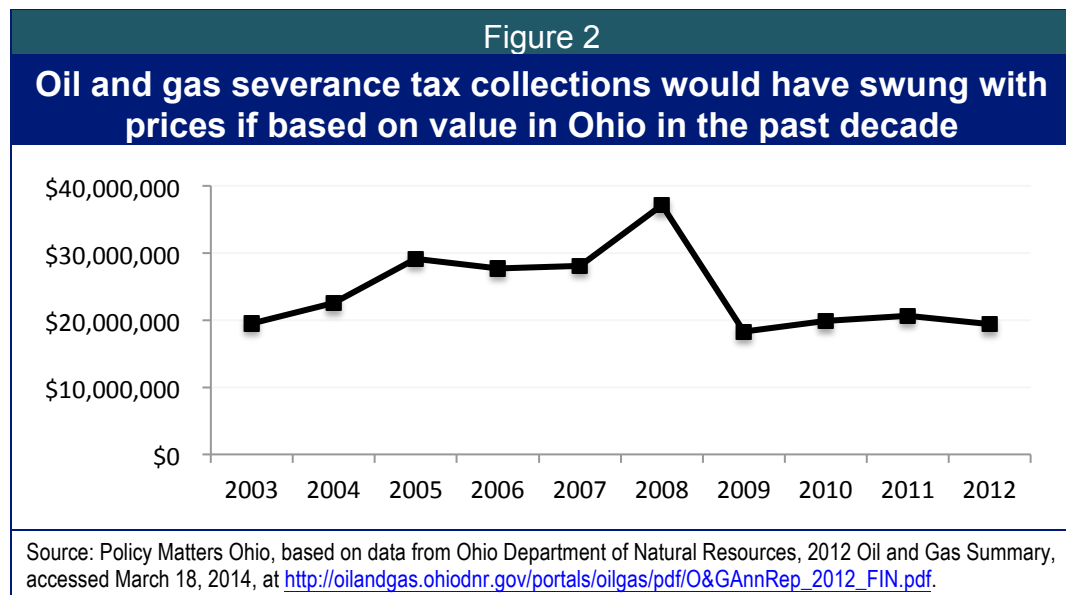
<sup>8</sup> Policy Matters Ohio, "Beyond the Boom," Dec. 2011, at <http://www.policymattersohio.org/beyond-boom-dec2011>.

<sup>9</sup> Mark Sneed, "Are the energy states still energy states?" Economic Review, Federal Reserve Bank of Kansas, 4<sup>th</sup> quarter 2009 accessed March 21, 2014, at [www.kc.frb.org/Publicat/EconRev/PDF/09q4Sneed.pdf](http://www.kc.frb.org/Publicat/EconRev/PDF/09q4Sneed.pdf).

<sup>10</sup> Ernst & Young, "Analysis of Ohio Severance Tax Provisions of H.B. 487," Prepared for the Ohio Business Roundtable May 15, 2012 accessed March 18, 2014, at <http://bit.ly/1fUOJ8B>.



Ohio’s severance tax on oil and gas is presently based on volume. If it had been based on value, collections would have gyrated with price over the past decade. Figure 2 illustrates levels of oil and gas severance tax that would have been collected on Ohio oil and gas production if a 2.75 percent rate had been in place on gross receipts instead of volume.



Value is the right approach to taxing natural resource extraction because it appropriately measures the worth of the resource being extracted. However, severance tax collections need to be used in ways that can absorb the volatility of the tax base. Energy-intensive states have used severance tax

proceeds to pay for external costs of production: wear and tear on roads, bridges, sewers, and water infrastructure; new demands on safety and emergency services; housing; social services, public health and educational infrastructure. Some energy states dedicate severance tax revenues to specific uses that build a stronger future: research and development, long term investment funds that underwrite education with interest earnings, or specific economic development planning.<sup>11</sup>

The administration proposal provides for flexible funding of industry oversight and regulation, reclamation activities and geographic mapping. Twenty percent of the remainder is dedicated to funding for communities impacted by drilling and an investment fund for after the boom. The problem is that most of the funds are used for income tax cuts. The swap replaces major funds for important public services with a less predictable source.

Risk associated with energy markets is exacerbated in Ohio by uncertainty of the resource itself. Forecasts of industry growth change with new information about drilling results from companies actively exploring the Utica shale formation. While some wells are promising, the nature and extent of the reserves and even internal characteristics of the formations that may facilitate or impede production are not yet proven.<sup>12</sup>

In 2011, Kleinhenz & Associates, writing for the Ohio Oil and Gas Energy Education Program, forecast that in 2013 Ohio would see 785 horizontal wells drilled, with 143 producing.<sup>13</sup> The Ohio Shale Coalition, coordinated by the Ohio Chamber of Commerce, projected in 2012 that 843 horizontal wells would be in production in Ohio during 2013.<sup>14</sup> The Ohio Department of Taxation's model for the governor's severance tax proposal in 2012 suggested 731 horizontal wells would be in production in 2013 and 1,656 in 2014.<sup>15</sup> The Ohio Department of Natural Resources Division of Oil and Gas reported that 25 horizontal wells have been drilled (cumulatively) in the Marcellus Shale play and 770 in the Utica as of the week of March 15; 396 (cumulatively) are or have been producing wells.<sup>16</sup>

Inconsistency in projections has to do with the nascent phase of industry development, but optimistic projections have not been borne out. Inconsistency continues in analysis of current proposals as well. The Ohio Oil and Gas Association (OOGA) forecast associated with HB 375 as introduced, presented by Scott Ziance of Vorys, Sater, Seymour and Pease LLP in testimony to the Ohio House Ways and Means committee, Jan. 8, 2014, assumes 1,000 new wells will be drilled annually during the forecast

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<sup>11</sup> See appendix of Policy Matters Ohio report on recent severance tax proposals. Uses of the severance tax in several energy intensive states are covered in "House Bill 375 and other severance tax proposals," at <http://bit.ly/OOeykW>; See also our response to requests about how other energy states distribute funds to local governments at <http://bit.ly/Lbwion>.

<sup>12</sup> In the question-and-answer session following testimony on January 8, Ohio Oil and Gas Association official Tom Stewart explained to legislators that high hopes for oil production in segments of the Utica have dimmed as characteristics of the formation in some places do not produce conditions necessary for effective levels of production.

<sup>13</sup> "Ohio's Natural Gas and Crude Oil Exploration and Production Industry and the Emerging Utica Gas Formation: Economic Impact Study," Kleinhenz & Associates for the Ohio Oil and Gas Energy Education Program, September 2011.

<sup>14</sup> "An analysis of the economic potential for shale formations in Ohio," Ohio Shale Coalition at [http://urban.csuohio.edu/publications/center/center\\_for\\_economic\\_development/Ec\\_Impact\\_Ohio\\_Utica\\_Shale\\_2012](http://urban.csuohio.edu/publications/center/center_for_economic_development/Ec_Impact_Ohio_Utica_Shale_2012).

<sup>15</sup> E-mailed communication from the Ohio Department of Taxation, "Severance Tax Proposal 4m Model Summary v2, attributed in that spreadsheet to estimates of ODNr and Dr. Chase of Marietta College," Jan. 22, 2012.

<sup>16</sup> Ohio Department of Natural Resources, Shale Activity (cumulative) at <http://oilandgas.ohiodnr.gov/shale>.

period and that new wells start production on January 1 of each year.<sup>17</sup> The Ohio Legislative Service Commission estimates that new wells entering production – under their “high scenario” – will be 336 in calendar year 2014, 420 in 2015, 516 in 2016, 581 in 2017 and 629 in 2018.<sup>18</sup> As of the date of this policy brief, the Ohio Department of Taxation has not yet provided the details underlying its projections. Uncertainty in pricing and production, however, is a hallmark of this tax, and may play key roles in the differences illustrated here.

Difficulty in forecasting revenues of the Ohio severance tax is highlighted in the wide difference between projections of the administration proposal in HB 472 provided by the Legislative Service Commission (LSC) and those of the Ohio Department of Taxation, presented in testimony by Tax Commissioner Joe Testa.<sup>19</sup> Using the LSC “low scenario,” the difference in forecast collections the first two fiscal years of the proposed severance tax is \$355 million; if production came in in a fashion more like that of the “high scenario,” the difference would still be higher than \$200 million.

Year	Ohio Dept. of Taxation	Ohio Legislative Service Commission		Difference between forecasts	
		Low scenario	High scenario	Low scenario	High scenario
FY2015	\$121	\$29	\$80	(\$92)	(\$41)
FY2016	\$304	\$41	\$144	(\$263)	(\$160)
<b>Total</b>	<b>\$425</b>	<b>\$70</b>	<b>\$224</b>	<b>(\$355)</b>	<b>(\$201)</b>

**Source:** Policy Matters Ohio, based on Testimony of Tax Commissioner Joe Testa to the House Ways & Means Committee, March 12, 2014, and Ohio Legislative Service Commission Comparison Document for HB 472 as introduced.

Forecasts of production are complicated by uncertainty in production of pipeline and processing capacity. LSC officials cited in Gongwer News Service pointed out that many wells already drilled are not producing because they are dry or possibly because of a halt in production due to lack of pipeline or processing facility capacity.<sup>20</sup> The building of processing facilities themselves may be constrained by lack of infrastructure in rural counties where the drilling is undertaken.<sup>21</sup>

Sustainability is a final factor to be considered. Natural resources do not last forever. Oil production boomed in northwest Ohio in the late 1800s, peaked in the 1890s, and then subsided to a negligible level for the next century. Coal mining once supported employment in southeastern Ohio but is now

<sup>17</sup>Scott Ziance of Vorys, Sater, Seymour and Pease LLC, Proponent Testimony on HB 375, presented to the 130<sup>th</sup> Ohio General Assembly, and Ohio Oil and Gas Association, Jan. 8, 2014, at [www.ohiohouse.gov/committee/ways-and-means](http://www.ohiohouse.gov/committee/ways-and-means).

<sup>18</sup> Ohio Legislative Service Commission, Fiscal Note and Local Impact Statement, Sub. House Bill 375 of the 130<sup>th</sup> General Assembly (Table 10) accessed March 22, 2014, at [www.lsc.state.oh.us/fiscal/fiscalnotes/130ga/hb0375h1.pdf](http://www.lsc.state.oh.us/fiscal/fiscalnotes/130ga/hb0375h1.pdf).

<sup>19</sup> Ohio Tax Commissioner Joe Testa, “Mid-Biennium Budget Review Testimony,” House Ways and Means Committee (of the 130<sup>th</sup> General Assembly) March 12, 2014, at [www.ohiohouse.gov/committee/ways-and-means](http://www.ohiohouse.gov/committee/ways-and-means).

<sup>20</sup>“LSC, OBM at odds over projections in severance tax revenues in MBR” accessed March 22, 2014, at [www.gongwer-oh.com/programming/news.cfm?newsedition\\_id=8305102 - sthash.wLu1Kf8A.dpuf](http://www.gongwer-oh.com/programming/news.cfm?newsedition_id=8305102 - sthash.wLu1Kf8A.dpuf).

<sup>21</sup> Testimony of Greg DiDonato of Ohio Mid-Eastern Governments Association (OMEGA) on House Bill 375 to the House Ways and Means Committee of the 130<sup>th</sup> General Assembly, Jan. 22, 2014, accessed March 22, 2014, at [www.ohiohouse.gov/committee/ways-and-means](http://www.ohiohouse.gov/committee/ways-and-means).



diminished. The natural resource industry extracts and then leaves. Tying the fortunes of state government too closely to any one industry is a mistake, but particularly so with natural resource extraction. The only certainty is at the end: we know the resource will be depleted and will not produce tax revenue. But we don't know when that will be.

The industry is causing costs to impacted communities. The industry needs to pay adequate taxes to cover these costs, to support the people of the state and to provide recompense for removal of precious, finite natural resources. But uses of those revenues should be designed around the unique characteristics and risks of the severance tax base.

## Other taxes

LSC and taxation department estimates vary for other elements of the tax proposal as well, though generally not to the same degree. Some of these differences will be reconciled or reduced; for instance, the taxation department estimate for the Commercial Activity Tax in fiscal year 2015 only includes three-quarters of the year, because of when the new rate will be effective; in its initial estimate, the LSC counted the tax covering the entire year. “We stand by our estimates,” budget director Timothy S. Keen told *The Columbus Dispatch*. “However, as it moves through the process, the difference of the different revenue estimates will have to be resolved.”<sup>22</sup>

The Kasich administration tax proposal calls for increasing the rate of the CAT from 0.26 percent to 0.30 percent on Ohio gross receipts. The CAT, the state's main business tax, has had its ups and downs since being created in 2005. In the first two years, it exceeded estimates. In his 2011 testimony, addressing how the CAT had done during the recession, then-Deputy Tax Commissioner Church noted that, “the CAT is less volatile than the corporate income tax, but more volatile than ODT expected.”<sup>23</sup> During the recession, he said, CAT taxable gross receipts fell by more than 15 percent on a year-to-year basis for three consecutive quarters. In fiscal years 2009 and 2010, because CAT receipts fell short of estimates, the General Revenue Fund had to subsidize the reimbursement of local governments and school districts for phase-out of the tangible personal property tax.

After performing above estimates in fiscal years 2011 and 2012, last fiscal year the CAT fell short of estimates by \$122.5 million, or 7.2 percent.<sup>24</sup> Budget director Keen said in testimony last June that “Multiple factors have contributed to the CAT shortfall: slower growth in taxable receipts, very rapid growth in credits claimed against the tax, and a recent law change that created a larger one-time revenue loss in FY 2013 than OBM originally anticipated.”<sup>25</sup> The amount of Job Creation Tax

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<sup>22</sup> Siegel, Jim, “Legislators going slow on Kasich tax proposals, *The Columbus Dispatch*, March 23, 2014, at <http://www.dispatch.com/content/stories/local/2014/03/23/legislators-going-slow-on-kasich-proposals.html>

<sup>23</sup> Church, op. cit., p. 27

<sup>24</sup> Office of Budget and Management, Monthly Financial Report, July 2013, p.12 at <http://1.usa.gov/1h2611s>.

<sup>25</sup> Timothy S. Keen, Director, Office of Budget and Management, Amended Substitute House Bill 59, Conference Committee Testimony on the FY2014-2015 Main Operating Budget, June 18, 2013. A considerable portion of the shortfall was due to the law change, which allowed taxpayers to take all of their \$1 million gross receipts exclusion at the beginning of the calendar year, instead of \$250,000 each quarter. This change is revenue neutral over the long term, the OBM noted in its monthly financial report (see Ibid).

Credits for businesses bounced from \$54.2 million in fiscal year 2011 to \$28.8 million in fiscal year 2012 to \$68.5 million in fiscal year 2013.<sup>26</sup>

In 2012, the Ohio Supreme Court ruled that the state could not use CAT paid on motor fuel for non-highway purposes. This resulted in the creation of a new tax, now called the Petroleum Activity Tax, which the taxation department estimated would generate \$125 million in fiscal year 2015 and more than \$170 million in both fiscal years 2016 and 2017. This revenue is supposed to duplicate what the CAT would have generated if it still covered motor fuel, and is not included in the CAT starting July 1, 2014. While major litigation such as that challenge to the CAT has already occurred, courts have not yet ruled on whether the CAT covers major Internet and catalog retailers that don't have a physical presence in the state, but meet the tax law's bright-line standard for coverage. The Board of Tax Appeals on March 6 confirmed an earlier ruling of Tax Commissioner Richard Levin that L.L. Bean had to pay the tax, but did not take up the company's constitutional challenge, saying that was a matter for the courts.<sup>27</sup> Thus, the final outcome remains uncertain. With continued growth in Internet retailing, the outcome of this will affect CAT receipts.

When the CAT was first approved, the General Assembly approved a trigger mechanism that would have increased or decreased the rate if the tax generated 10 percent more or less than specific benchmark amounts.<sup>28</sup> Likewise, when the new Financial Institutions Tax was created in 2012, replacing the Corporate Franchise Tax on financial institutions and the Dealers in Intangibles Tax, a trigger mechanism was included. No trigger has been included with Gov. Kasich's proposal despite the revenue uncertainties.

Of course, the income tax also fluctuates, and collections fell dramatically during the recession. And some of the administration's revenue estimates could reduce the gap between the revenues that would be reduced by its proposed tax cuts and those that would be gained from the tax increases. For instance, the taxation department has estimated the cost of its 8.5 percent income-tax rate cuts, an expanded Earned Income Tax Credit and increases in personal exemptions to the income tax on their own, without regard to the interplay of these changes. In fact, higher personal exemptions will mean the EITC is worth less than it would be worth standing alone. So in this case, the administration's estimates could overstate the extent of the tax cuts.<sup>29</sup>

### **Tobacco taxes**

The Kasich administration proposes to raise the cigarette tax, now at \$1.25 a pack, by 60 cents over two years. In addition, it would raise the tax on other tobacco products to a level equivalent to the cigarette tax, so it would be 41 percent in fiscal year 2015 and 49 percent in fiscal year 2016, and

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<sup>26</sup> Ohio Department of Taxation, Commercial Activity Tax (CAT) Credit Summary, 1/22/2004. The Job Retention Tax Credit also saw significant change, doubling in FY13 to more than \$23 million. Both of these credits saw additional increases in the first half of FY14 compared to a year earlier.

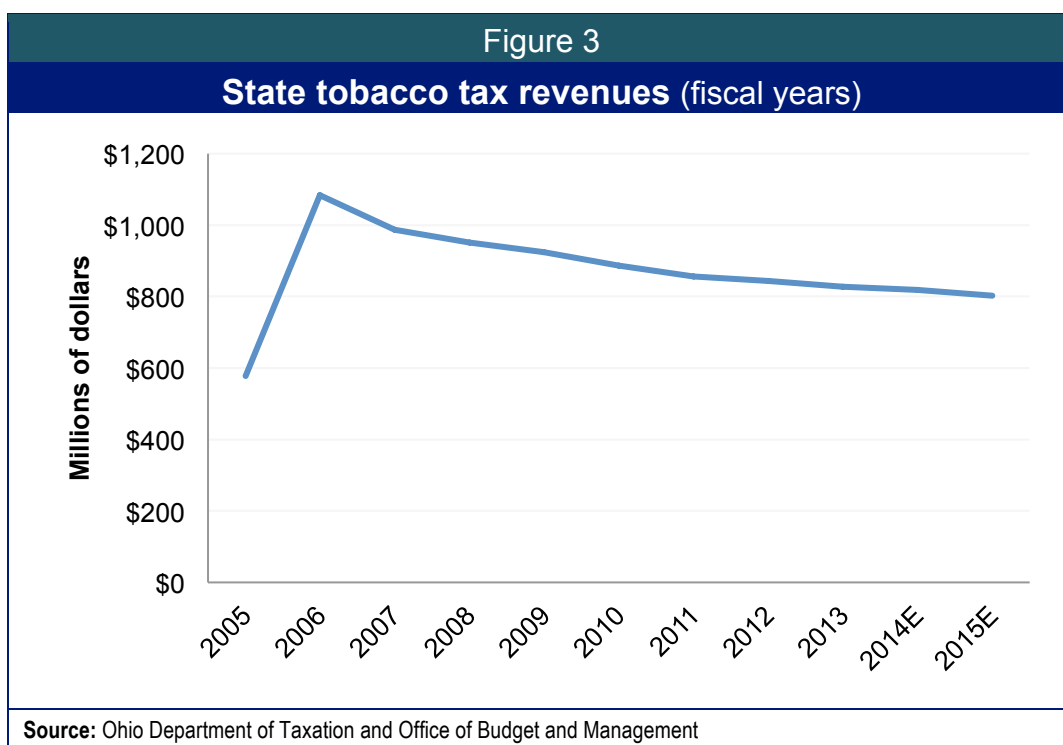
<sup>27</sup> Ohio Board of Tax Appeals, *L.L. Bean Inc. v. Richard A. Levin*, Tax Commissioner of Ohio, Case No. 2010-2853, March 6, 2014.

<sup>28</sup> The upward trigger later was removed.

<sup>29</sup> In its initial estimates, the LSC found that the increased EITC would be worth \$20.6 million to the General Revenue Fund in FY 2015 if all the other personal income tax changes were adopted, and \$28.9 million when measured in isolation, without the other changes. See LSC, Comparative Document, House Bill 472, As Introduced, p. 98, at [www.lsc.state.oh.us/fiscal/mbr130/comparedoc-in.pdf](http://www.lsc.state.oh.us/fiscal/mbr130/comparedoc-in.pdf) By comparison, the taxation department estimated the cost at \$40 million each year.



institute that tax on electronic cigarettes, which are currently untaxed. As Figure 1 shows, in recent years, cigarette and other tobacco taxes taken together have declined in Ohio except when a state tax increase went into effect in fiscal year 2006.<sup>30</sup>



The taxation department appears to have been conservative in estimating the additional revenue from the higher cigarette tax. It assumed that consumption would decline 1.7 percent a year before any increase, and that in addition, each 1 percent increase in price would reduce consumption by 1 percent (this is called a “price elasticity” of 1).<sup>31</sup> According to a 2012 study by the Congressional Budget Office, “Much of the research literature on tobacco estimates the long-run price elasticity of overall demand for cigarettes among adults at somewhere between -0.3 and -0.7, meaning that a 1 percent rise in the price of cigarettes causes overall consumption to decline by between 0.3 percent and 0.7.”<sup>32</sup> The Centers for Disease Control says that, “A 10% increase in price has been estimated to reduce overall cigarette consumption by 3-5%.”<sup>33</sup>

<sup>30</sup> Numbers are not adjusted for inflation. Figures for fiscal years 2014 and 2015 are estimates from the Office of Budget and Management prior to the administration’s tax proposal. Net taxes collected on other tobacco products have increased somewhat in recent years, while the much larger amount of cigarette taxes has declined. See Ohio Department of Taxation, 2012 Annual Report, p. 36, at <http://1.usa.gov/1fs1knb>, and e-mail from Ohio Department of Taxation, March 20, 2014. The federal tax on cigarettes also was increased in 2009.

<sup>31</sup> Email from Ohio Department of Taxation, March 20, 2014. For other tobacco products and e-cigarettes, the department assumed flat consumption before any price increase, and used a price elasticity of -0.5.

<sup>32</sup> Congressional Budget Office, “Raising the Excise Tax on Cigarettes: Effects on Health and the Federal Budget,” June 2012, at [www.cbo.gov/sites/default/files/cbofiles/attachments/06-13-Smoking\\_Reduction.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/06-13-Smoking_Reduction.pdf). The CBO study notes that these are national estimates, and that responses may differ by region.

<sup>33</sup> Centers for Disease Control and Prevention, Smoking & Tobacco Use, at <http://1.usa.gov/1fV6bdh>.

Altogether, the taxation department estimates that the additional tobacco taxes would bring in \$204 million in fiscal year 2015, \$334 million in fiscal year 2016, and \$310 million in fiscal year 2017. These estimates include \$30 million in both fiscal years 2015 and 2016 in one-time tax collected on cigarettes in inventory. They also project 11 months of the new tax each year being collected in both years, because it takes a month before payments start coming in under the higher rate.<sup>34</sup>

Still, there a number of uncertainties attached to this part of the proposal. Ohio's smoking rates are higher than those nationally.<sup>35</sup> In the last couple of years, the decline in state cigarette and other tobacco tax collections slowed to less than 2 percent a year. In 2009, the state eliminated its anti-smoking efforts, and while they have since resumed, they remain very modest. Elsewhere in his Mid-Biennium Review, Gov. Kasich has proposed using additional tobacco settlement money to spend \$29.6 million to restore some of that effort.<sup>36</sup> One would think that this would help drive down smoking rates. And as the LSC indicated, it's not known exactly how much smokers might react to the tax increase by buying cigarettes in other states or over the Internet.

Recently, after the CVS drugstore chain announced that it would stop selling cigarettes, Ohio Attorney General Mike DeWine and his counterparts from 27 states and territories asked Kroger, Wal-Mart, Rite-Aid, Walgreens and other retailers with pharmacies to stop selling all tobacco products.<sup>37</sup> Such developments illustrate the considerable uncertainty that exists about cigarette smoking and the taxation of it. The growth of e-cigarettes creates a new wild card.

The taxation department's estimates for the next two or three years may be conservative. And obviously, as an addictive product, cigarettes provide a fairly predictable revenue source from year to year. However, since the cigarette tax is based on units sold, the amount of tax collected doesn't grow unless consumption does, and so it shrinks relative to the state budget even without declines in cigarette purchases. On a long-term basis, the income tax grows while tobacco taxes shrink.<sup>38</sup> That makes the cigarette tax a bad fit as an income-tax revenue replacement.<sup>39</sup>

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<sup>34</sup> The LSC arrived at higher estimates, but also cautioned that it did not have a reliable way to estimate the increased smuggling attributable to the tax increases. There were also other differences in the estimates between the LSC and ODT.

<sup>35</sup> Gongwer News Service, "Kasich Budget Plan Rekindles Debate Over Tobacco Taxes," Volume #83, Report #49, Article #1, Thursday, March 13, 2014. Cleveland Clinic doctor Daniel Neides "said when the state stopped funding anti-tobacco programs entirely in 2009, Ohio became one of the only states to see increased smoking rates as it dropped from 23rd to 40th in the national rankings of states with the most non-smokers. Currently, more than 25% of Ohioans smoke, while the national average of smokers per state sits at 18%, he said." Accessed March 22, 2014, at [www.gongwer-oh.com/programming/news.cfm?newsedition\\_id=8304902 - sthash.t1arbda5\\_dpbs](http://www.gongwer-oh.com/programming/news.cfm?newsedition_id=8304902 - sthash.t1arbda5_dpbs).

<sup>36</sup> Advocates of stronger tobacco control have praised that move as well as the proposed tobacco tax increases, but say a bigger increase and a much more robust campaign are needed. The American Cancer Society Cancer Action Network, Campaign for Tobacco-Free Kids, American Heart Association and the American Lung Association noted that the governor's proposed allocation of \$26.9 million from the Master Settlement Agreement to the Ohio Department of Health for tobacco prevention and cessation efforts "still falls well short of the \$132 million a year recommended by the Centers for Disease Control and Prevention." According to Gongwer News Service, "they suggested that the state fund these programs with at least \$50 million per year – the amount the state spent before it was severely cut in 2009." Gongwer News Service, "Governor's Budget Items Draw Mixed Reaction From Lawmakers, Stakeholders," March 12, 2014, [www.gongwer-oh.com/programming/news.cfm?newsedition\\_id=8304802 - sthash.JIfymcgp.dpuf](http://www.gongwer-oh.com/programming/news.cfm?newsedition_id=8304802 - sthash.JIfymcgp.dpuf).

<sup>37</sup> Mike DeWine, Ohio Attorney General, "DeWine Spearheads National Effort Calling on Major Pharmacies to Stop Selling Tobacco Products," March 17, 2014, at <http://bit.ly/1fbk0op>.

<sup>38</sup> Between fiscal years 2004 and 2014, personal income tax collections grew from \$8.53 billion to \$9.87 billion despite a 21 percent cut in rates. Ohio Department of Taxation, Selected Ohio Tax Sources Administered by the Tax

## Summary and recommendations

There are strong public-health reasons to increase tobacco taxes. The CDC notes: “Increases in cigarette prices lead to significant reductions in cigarette smoking. This is the single most effective way to reduce smoking.”<sup>40</sup> An increase in the CAT, too, would be reasonable to make up for the major loss of state revenue that occurred after it was created (the CAT only accounted for about half as much revenue as the two taxes it replaced, the corporate franchise tax and the tangible personal property tax).<sup>41</sup> Increasing these taxes would allow the state to increase funding for smoking cessation, invest in its schools, restore public safety and other services delivered by local governments, make college more affordable, and attend to human needs from our shameful sky-high infant mortality to the lack of protective services for our elderly, among many other needs. These taxes should not, however, be raised to support an unnecessary reduction in the income tax.

Although the severance tax is an important and valuable element of any region’s public finance, it needs to be carefully structured to preserve stability and add lasting value to replace the precious natural resources that are removed. Using the proceeds of the severance tax for cuts in the personal income tax neither stabilizes state finances nor builds lasting value for all the people of the state. A better option is to start with a sound structure that is simple, transparent and administratively efficient – like the administration proposal in most respects – and set the rate to cover the needs of impacted communities, industry regulation and oversight, land reclamation, long term investment and restoration of public services. Funds should be used to accommodate the boom and bust of the volatile tax source, not to lower personal income taxes. As the industry grows, or doesn’t grow, severance tax rates may be adjusted. Lowering the income tax based on uncertain replacement revenue is not good fiscal policy.

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Commissioner: Total Collections, Fiscal Years 1974 – 2012, at <http://1.usa.gov/1kYkW48> and Office of Budget and Management, State Debt Overview, Disclosure Documents, Appendix A, p. A-4, at <http://1.usa.gov/1oVus9U>.

<sup>39</sup> Over the long term, a higher cigarette tax could also lead to lower public-health spending, but that is not a part of the financing for the tax changes.

<sup>40</sup> CDC, *op. cit.*

<sup>41</sup> Both of these taxes fall more heavily on low-income Ohioans than they do on the affluent, and so such increases should be combined with other measures, such as a refundable Earned Income Tax Credit without a cap, and a sales-tax credit. See Policy Matters Ohio, “A Credit that Counts,” at <http://www.policymattersohio.org/eitc-oct2013> and “Sales Tax Credit Would Help Lower-Income Ohioans,” at <http://www.policymattersohio.org/sales-tax-credit-apr2013>