Policy Matters Ohio

Executive Summary
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Business tax break proposal: Costly, unfocused and unlikely to bring new jobs

By Zach Schiller

Governor Kasich has proposed eliminating the Ohio income tax for hundreds of thousands of business owners who pay the tax on their companies' profits. The plan covers owners of businesses with $2 million or less in annual receipts. It would roughly double, to $700 million a year, the overall size of a tax deduction for business owners created less than two years ago. This deduction quickly became the 9th largest state tax break, but has yet to show results in job growth. While draining revenue needed to pay for vital public services, the proposed new tax break – like its predecessor – would be poorly targeted and is unlikely to result in significant new job creation. It would also expand opportunities for tax avoidance.

Key findings

- A new tax break for business owners would cost $350 million a year.
- An existing tax deduction for business owners has not resulted in job growth.
- Most qualifying owners employ no one but themselves and are unlikely to add employees because of tax break averaging less than $1,000 a year.
- The proposed exemption would increase opportunities for tax avoidance.

The expanded business tax break is estimated to cost about $350 million a year. The benefits will be scattered over 380,000 individuals, most of whose businesses do not employ anyone but the owner (these are known as "pass-through entities," because their profits are taxed when they pass through to their owners). A national study in 2011 by researchers at the U.S. Treasury Department found that only 11 percent of taxpayers reporting business income – and 2.7 percent of all income-tax payers – own a bona fide small business with employees other than the owner. And though there are 1 million Ohio pass-through businesses with receipts of $2 million a year or less, fewer than 300,000 private employers pay unemployment tax, which essentially means that they employ someone.

Most people reporting income from a pass-through business on their personal income tax returns are self-employed, and have little interest in hiring anyone. "Only a tiny share of new businesses are seeking to develop a new product, service, technology or business model that has the potential to be the next Google, Facebook, or Amazon," testified Michael Mazerov, senior fellow at the Center on Budget and Policy Priorities, at an Ohio House Finance Committee hearing two years ago. "So tax cuts for everyone is a very expensive way to try to help the very few that are even in a position to create a meaningful number of jobs."

Most of those who benefit also will get too little in savings to add employees in any meaningful way. The average gain will be under $1,000 a year, and most owners will get far less. Assuming a healthy 10 percent profit margin and no other income, the owner of a business with $500,000 in annual receipts would save $364.35, according to calculations by the state taxation department. The bulk of owners who would be eligible for the tax break have businesses with receipts under that amount.

Confronted with the reality that a business owner can't create a single new job based on the savings, proponents now argue that every dollar counts for a small business, and some will grow because of the tax break. While it no doubt will prove helpful to some individual businesses, this reflects an overall misunderstanding of why most businesses grow. Business owners expand when they anticipate greater demand for their products or services, not because they have a few hundred dollars more in their wallets. Citing the large number of business owners who have not claimed the existing deduction for business income, Dan Navin, assistant vice president of tax and economic policy for the Ohio Chamber of Commerce, noted in testimony that "the fact is that small businesses are not clamoring for the proposed exemption from income tax…" And indeed, Ohio's own recent history of tax cuts – including the deduction created two years ago for business owners – have not generated the jobs that their authors promised.

The existing tax break for small-business owners shows little sign of creating jobs. Over the 20 months since the tax break was approved, Ohio jobs have grown no faster than they did in the 20 months preceding that – in fact, the growth actually has been slightly slower. The number of businesses adding employees for the first time barely grew, and new employment added by such small firms actually fell in the first year after the new deduction was enacted. In the fourth quarter of 2014, there were fewer Ohio companies with employees than nine years earlier when major state tax cuts were enacted, and the share of the national total was nearly identical to when the business tax break was approved.

This expanded tax break could lead to tax avoidance. The tax exemption for business income applies only for owners of entities with $2 million or less in annual receipts; for the owner of a business with receipts of $2,000,001, the tax break goes away. A number of business representatives have noted that this could encourage companies to break into separate entities to stay under the threshold. Whether or not many business owners adopt such a strategy, there is a real possibility that some employees could become independent contractors, with no net gain to jobs or the economy. An employee working as plumber or landscaper or any other number of occupations could start a business, make arrangements with her former employer to do work as a contractor, and eliminate her Ohio income-tax liability.

The tax break means less for vital public services. Governor Kasich has proposed to finance much of the business-income tax exemption and income-tax rate cuts with other tax increases. But some of the cuts – $523 million over two years, including of the effects on local taxes – are not paid for with tax increases. This will reduce the resources available to pay for vital public services, including investments needed by small businesses. These include paving the streets, providing adequate police and fire protection and educating the workforce of the future.

Governor Kasich's proposed business-income tax exemption has drawn opposition from across the political spectrum. It is unlikely to produce additional jobs, just as a previous tax break for business owners has not shown evidence of doing so. It would cost vital revenue, while creating new opportunities to avoid taxes. The General Assembly should reject the proposal.