Policy Matters Ohio

Tax Policy

March 22, 2016

Testimony to the 2020 Tax Policy Commission on tax expenditures

By Zach Schiller

Chairmen Peterson and McClain and members of the committee: My name is Zach Schiller and I am research director at Policy Matters Ohio, a nonprofit, nonpartisan organization with the mission of creating a more prosperous, equitable, sustainable and inclusive Ohio. Thank you for the opportunity to testify regarding the exemptions, credits and deductions in the state tax code known as 'tax expenditures.'

We are glad that the committee has taken up the broad topic of tax expenditures, going beyond tax credits. My comments will address tax expenditures. I hope that when the commission takes up other elements of the state's tax structure I will have the opportunity to make additional recommendations.

Overall, as you know, Ohio's 128 tax expenditures add up to nearly $9 billion a year in foregone revenue, roughly the same amount as what we spend on K-12 education. Tax credits account for just 34, or less than $1 billion, of this total. Policy Matters Ohio has done research on tax expenditures in Ohio for many years. Our most recent analysis, reviewing the state tax expenditure report, was released last month (see http://www.policymattersohio.org/taxbreaks-feb2016). Among many other things, we found that:

- More than half of the total value of tax expenditures goes to business and economic development;
- Sales-tax expenditures account for nearly two-thirds of the total value, and
- Between Fiscal Years 2014 and 2017, the historic structure rehabilitation tax credit is expected to grow faster than any of the larger tax expenditures (those worth at least $10 million in 2017). I hope you will review our findings.

Some tax expenditures have worthwhile purposes. Take the earned income tax credit (EITC). As a group, lower- and middle-income Ohioans pay more of their income in state and local taxes than upper-income Ohioans do. Though with changes Ohio's state EITC could be a much more powerful anti-poverty tool, it provides help for at least some working families to help ends meet and counteract the regressive nature of our tax system.

However worthwhile they may be, tax expenditures deserve the same scrutiny as legislative appropriations. 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 purpose at all. The 2020 Tax Policy

Commission should request that the Department of Taxation and the Legislative Service Commission detail their understanding of why each of these expenditures was originally approved, and whether that purpose is being met now. Beyond the commission's own review, a permanent mechanism for regularly analyzing every tax expenditure should be approved.

House Bill 9 would take a useful step in that direction by requiring a review of tax expenditures every eight years. The bill should be strengthened in a number of ways. To begin with, a more frequent review would be useful. Rep. John Adams recommended tax expenditures be reviewed every two years in his report on a special House committee that heard testimony in five cities across the state in 2011 on this and other tax issues.

House Bill 9 would have a more significant impact if it included automatic sunsets for tax expenditures, so they expired unless the General Assembly reauthorized them. There is no guarantee that the state will continue spending each biennium on specific line items, and there should be no such guarantee for spending through the tax code. The worth of each expenditure should be proven, just as legislative appropriations are tested in the budget process. In addition, the Legislative Service Commission should be given the resources to do a thorough study of each tax expenditure prior to its examination by the review committee. The governor, who under the bill must include the review committee's most recent report in the budget proposal, should also recommend whether any recently evaluated tax expenditures should be continued, modified, or terminated.

The legislative committee that would be created under House Bill 9 should remain a legislative committee, without representation of business or other outside interests. The committee can seek expert advice from whomever it chooses, business included, and it's reasonable to expect it will do so. However, over half the value of tax expenditures goes to businesses. Including business representation would create conflicts of interest, or perceived conflicts of interest, when the review should be overseen by legislators.

The General Assembly also should be cautious about relying on dynamic analysis of tax expenditures. A dynamic analysis tries to predict how tax changes might affect the economy, which could in turn boost or shrink revenues over time. Ohio's last public experience with such modeling – the analysis of the proposed 2005 tax package of Gov. Taft – was not salutary. The analysis made no attempt to include the economic effects of the spending cuts or tax increases that would be needed to make up for the loss of tax revenue. As a result, it didn't provide a meaningful picture of what the tax cuts would mean. The state does not use dynamic modeling in its budget-making process. Budget Director Tim Keen, a member of this committee, noted during a budget hearing last year that, "To me, dynamic modeling for use in revenue estimates does not meet the test of conservative forecasting and conservative revenue projection." Results from such analysis depend heavily on the assumptions used, and the effects are likely to be both small and uncertain.

The Tax Expenditure Report should be expanded to include estimates of the effects of each tax expenditure on local governments, a description of who benefits from each tax expenditure, estimates of the number of beneficiaries for each tax expenditure, and if possible, the effects on Ohioans of different income groups. Each of these things is already done in some other states.

This would speed the work of the review committee to be created under House Bill 9, which would be examining these issues, while making more information available to the public about tax expenditures on an ongoing basis.

A significant number of existing tax expenditures should be repealed or limited. These include a number that Governor Kasich recommended limiting or eliminating in his executive budget last year. For instance, he proposed:

- Eliminating the tax credit and discount that sellers of beer, wine and mixed beverages get for paying their alcoholic beverage tax a few weeks in advance;
- Limiting the amounts retailers can receive for collecting the sales tax, known as the vendor discount. Most states either have no discount at all or cap the amount, ensuring that big retailers do not reap a windfall. Indeed, Tax Commissioner Joe Testa said in testimony that Ohio's 0.75 percent discount "essentially functions as a profit center" for big-volume retailers. According to data in the 2009 tax expenditure report, more than half of the $50.7 million received in such discounts in 2008 went to the 687 retailers that collected at least $1 million in tax, while the 197,487 other retailers got the rest;
- Cutting the sales-tax exemption for trade-ins of used cars and boats in half, and
- Repealing the 2.5 percent discount that distributors of cigars, chewing tobacco and other tobacco products get for timely payment of their taxes. "It shouldn't be necessary to reward businesses for paying their tax on time," as Testa noted.

Together those changes would have generated more than $130 million in extra state revenue by 2017.

Those are hardly the only tax expenditures in need of limitation or repeal. The state offers a write-off against the commercial activity tax for losses that big companies experienced before the tax was enacted, even though they no longer pay taxes on their income. This credit was only available to companies with such deductions that amounted to more than $50 million, making it clearly discriminatory against smaller businesses. The tax code features a sales-tax exemption worth more than $27 million a year for pollution-control equipment purchased by utilities even though most of it is mandated, and a cap on sales tax for wealthy buyers of shares in jet aircraft, who pay only a fraction of the tax they would otherwise.

Unfortunately, unproductive tax expenditures are not limited to those passed years ago. The largest example is the deduction from the state income tax for owners of businesses such as partnerships, S Corporations and limited liability corporations who pay personal income tax on their profits. The supposed purpose of this break is job creation and economic development. Yet the initial tax break, approved in 2013, did not produce overall job gains for the state, or a significant increase in employment at small businesses that were hiring employees for the first time. Still, it was vastly expanded last year, and could cost upwards of $800 million a year when fully implemented. Business owners in general hire or expand when there is a growing market for their products or services, not because they have more cash in their wallets from lowered taxes. The average tax savings in 2014 from the deduction was about $1,050, with most claiming far less than that. That's hardly enough to hire anyone. Yet it adds up. Say you work as an employee of a landscaping business, and pay income tax on your earnings. If you instead did the identical job, but as a contractor working for your own one-person company, you could use this deduction to avoid all Ohio income tax on the first $250,000 in income. This violates a tenet of sound taxation: That businesses and persons with similar assets and income should be taxed alike.

Other tax breaks that are not specifically deemed to be tax expenditures by the state also could be tightened. For instance, twice in the last decade, the General Assembly has acted to loosen the residency test for the income tax, allowing many affluent individuals to avoid paying the tax. And 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 sales tax now is the largest source of state tax revenue, but its base is narrowing as a share of the economy. This is a subject in need of additional study.

A number of tax expenditures, like the CAT credit for net operating losses mentioned earlier, provide special advantages for large companies. Overall, nearly $81 million or 43 percent of tax credits reported against the commercial activity tax last fiscal year went to the 68 companies with Ohio gross receipts of $1 billion. That was also more than double these billion-dollar-companies' share of CAT tax liability. Meanwhile, the other 159,485 companies that sent in tax returns got just 57 percent of the credits.

Since its initial creation a decade ago, the exclusion from the commercial activity tax of qualifying distribution center receipts has grown to be worth $157 million this year. The LSC estimated when the tax break was created that it would cost up to $39 million in Fiscal Year 2010. Suppliers to big Ohio distribution centers with more than $500 million in sales (and more recently certain metal refiners) don't have to pay the tax on such sales under this exclusion, as long as more than half of what each center ships goes outside Ohio. That makes it the 16th largest tax expenditure. It covers nine facilities. We encourage the commission to examine further who is benefiting from our business tax breaks and whether that is appropriate.

To the degree that the state has eliminated tax expenditures in the last decade or so, it has largely been by repealing entire taxes, not through a discriminating review of tax breaks. Between 2003 and 2013, 49 of Ohio's 138 tax expenditures were eliminated because of the repeal of the estate tax and the corporate franchise tax, and the change in the taxes covering local telephone companies. Yet the total number of tax expenditures fell only to 129, as existing tax credits were transferred for use against other state taxes, and new tax breaks were approved. When the new financial institutions tax was created in place of the corporate franchise tax for financial companies, a major tax break for banks on goodwill and abandoned property went away, too. As the administration described at the time, this had been a major avenue for tax avoidance. Regrettably, the additional revenue generated from the end of this tax break was given back to the banks in the form of rate cuts and the bill also contained new loopholes.

In the last two biennial budget bills, several tax breaks have been means-tested, such as the homestead exemption (for those turning 65), the $50 senior credit and the retirement income credit. The committee should look into the possible means-testing of property-tax rollbacks as well. Besides the homestead exemption, Ohio has two other state programs that provide reductions in taxes to property owners. In each case, the state reimburses school districts and localities for the revenue they would otherwise not receive. One program rolls back the property tax by 10 percent from what non-commercial owners would otherwise pay; the other provides a 2.5 percent rollback for owner-occupied properties. As the Taft administration noted in a 2003 release, "While the rollbacks are tax relief mechanisms, they are not limited to taxpayers that necessarily need tax relief." Gov. Taft proposed at that time to limit these two tax-reduction programs to the first $1 million in market value of each property.

That wasn't the first time that such a cap on eligibility was proposed. In 1995, Gov. George Voinovich put forward in his executive budget a plan to limit the two rollbacks to just the first $200,000 in value. The $33 million in savings over the biennium was to be used to increase funding for primary and secondary education. Neither Taft nor Voinovich's proposals were approved. The General Assembly should consider a cap of no more than $1 million.

As Gov. Voinovich proposed with the rollbacks, funds made available from unproductive tax breaks should be invested in public services, not given away in tax cuts. Ohio can ill afford to continue with unnecessary tax breaks when college is unaffordable to many students, infant mortality is among the highest in the nation, vacant, abandoned properties dot our cities, mass transit is underfunded and insufficient, and availability of pre-kindergarten and child care assistance lags behind that of other states. These and other needs require more investment—investment that a judicious pruning of our overgrown tax expenditures could help provide. Thank you very much for the opportunity to testify.

Policy Matters Ohio is a nonprofit, non-partisan research institute with offices in Cleveland and Columbus.