Policy Matters Ohio

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Budget

Ohio’s tax breaks are ready for review

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Introduction

The State of Ohio, like more than two-thirds of the states, reports regularly on tax exemptions, credits and deductions, also known as tax expenditures.[1] But unlike some states, Ohio legislators have not had to review, evaluate and make decisions about these expenditures. This is about to change. House Bill 9 of the 131st General Assembly created Ohio's first "Tax Expenditure Review Committee" to analyze the 129 tax breaks in Ohio's $9+ billion tax expenditure budget.[2] The Ohio House and Senate passed the bill unanimously in December 2016. Members have been appointed and should start meeting this fall to establish a review process. Once they agree on a process, the committee will review each tax break once every eight years and consider things like who it benefits, if it serves the purpose for which it was created and whether to continue it or not.

The governor and legislature took another step towards tax-break transparency in the 2018-19 budget, establishing new reporting on some business tax incentives every other year. Governor Kasich estimated in the budget that by the end of Fiscal Year 2019, there would be $1.5 billion outstanding in seven business tax credits covered by the new reporting requirement. While these are also covered in the Tax Expenditure Report and will be reviewed by the Tax Expenditure Committee, the new requirements will substantially increase the detail available on business tax incentives.

The value of revenues foregone through tax expenditures is significant. By 2019, the value is estimated to be $9.4 billion, more than the funding the state provides to school districts through formula funding and tangible personal property tax reimbursements.[3] Some tax breaks have existed for 80 years or more without review. These tax breaks represent a huge investment, an invisible entitlement that persists over time. It's time for a new era of transparency and accountability.

In this report, Policy Matters Ohio looks at the purpose, size and growth of Ohio tax breaks, and makes recommendations of how the new Tax Expenditure Review Commission should start its review process.

[1] National Conference of State Legislators, Tax Expenditure Budgets and Reports: Best Practices, January 2017 at http://www.ncsl.org/documents/statefed/NCSL_Tax_Expenditures_Best_Practices.pdf

[2] House Bill 9 of the 131st session of the Ohio General Assembly, text and summary at https://www.legislature.ohio.gov/legislation/legislation-summary?id=GA131-HB-9

[3] In FY 2018, formula funding and tangible personal property tax reimbursements (TPP) to school districts will be $8.4 billion and tax breaks will be $9.1 billion; in FY 2019, $8.5 billion goes to the districts in formula funding and TPP and $9.4 billion for tax breaks. Source: Copy of Foundation Funding and TPP Reimbursements, excel worksheet provided from Ohio Legislative Service Commission by Jason Phillips in an e-mail of July 20, 2017.

Tax expenditures 101

Tax expenditures lower tax liability for a person, business or other entity. They represent revenue foregone – revenue the state could take in, but has decided not to.

Ohio's tax expenditures are estimated by the Ohio Department of Taxation and reported as part of the Governor's two-year "executive budget" presented to legislators. According to the tax expenditure report that accompanied the 2018-19 executive budget: "The figures in this report do not represent the estimated revenue gain from repeal of the tax expenditure. Instead, the figures reflect reasonable estimates (rounded to the nearest $100,000 for those estimates of $1 million or more) of the tax benefits realized by recipients of the tax expenditures – what has been referred to as the "revenue foregone."[4]

Ohio's tax expenditures will total $9.1 billion in 2018 and $9.4 billion in 2019, not including new tax breaks passed in the 2018-19 budget bill, after the tax expenditure report was issued. Tax expenditures may be in the form of exemptions, deductions, or credits that reduce the taxes a taxpayer – be it a company or a person – owes.

- <u>A tax exemption</u> allows a taxpayer to not pay a certain tax. For example, purchases of not-for-profit organizations and churches are exempt from sales tax as are many items businesses purchase for use in production.

- <u>A tax deduction</u> is an expense that is subtracted from total income when calculating taxable income.

- <u>A tax credit</u> is the direct dollar-for-dollar reduction of tax liability. For example, the job creation tax credit reduces a company's commercial activity tax. The earned income tax credit reduces the individual income tax. If the tax credit is refundable, individuals or companies can receive its full amount whether or not they have any tax to offset.

For an item to be in the tax expenditure report, it must meet all four criteria below:

1. <u>It reduces or could reduce one of the taxes that support the state's General Revenue Fund</u> (GRF) of Ohio's main operating budget. Local taxes, or those that do not fund the GRF (like the motor vehicle fuel tax, horse racing tax, and the severance tax) are not included in the tax expenditure report.
2. <u>It would have been part of the defined tax base</u>. To be a tax expenditure, a provision must exempt from taxation a person or activity that otherwise would have been part of the tax base. The sales tax, for instance, covers tangible goods. Only specifically enumerated services are covered. Many others, such as hospital services, are not a part of the defined tax base and are not included as tax expenditures in the report.

[4] Ohio tax expenditure report for 2018-19, p.4, http://www.obm.ohio.gov/Budget/operating/doc/fy-18-19/FY18-19_Tax_Expenditure_Report.pdf

3. It is not subject to an alternative tax. Persons or activities subject to alternative taxes are not considered tax expenditures in the report. For example, insurance companies are excluded from the commercial activity tax under the Ohio Revised Code, but this is not considered a tax expenditure because insurance companies are taxed under insurance premium taxes.
4. It is subject to change by state legislative action. The item must be an exemption, deduction or credit in the Ohio Revised Code. Anything that can be changed purely by a state constitutional amendment, a federal law change, or a federal constitutional amendment is not considered a tax expenditure in the report. Thus, the state constitution's prohibition on charging sales tax for food consumed off the premises is not included in the report.[5]

Tax expenditures by type of tax

Figure 1 shows tax expenditures by type of tax in terms of number and value as a share of total. The tax expenditure report for 2018-19 lists 129 items, accounting for $9.1 billion in revenue foregone in 2018 and $9.4 billion in 2019. Of those items, 32 are worth less than a million dollars a year.[6] The growth rate forecast for the Fiscal Year 2018-19 budget period is 8.3 percent, compared to 2.1 percent for taxpayer revenues in the General Revenue Fund.[7]

- The sales tax has the most tax expenditures: 56 of the 129 items in this year's tax expenditure report, making up 43 percent of all tax expenditures. Their value, at $6.2 billion,[8] accounts for two thirds of the value of revenue foregone due to tax expenditures in 2019.
- The personal income tax is the next largest category: The 37 personal income tax credits, deductions and exemptions account for 29 percent of the 129 tax expenditures. Their value, at $2.4 billion, makes up 25.4 percent of the total value in 2019.
- There are 20 tax expenditures taken against the commercial activity tax (CAT), the state's primary business tax, of the 129 tax expenditures listed in this year's report (about 16 percent). The 2019 value of $624.5 million dollars in CAT revenues foregone accounts for 7.4 percent of the value of all tax expenditures.
- here are 16 other tax expenditures taken against the financial institutions tax, the insurance tax, the public utility tax, the alcoholic beverage tax, the cigarette and tobacco users tax, and the kilowatt hour tax. Their value in 2019 is $150 million, 1.6 percent of total tax expenditure value in that year.

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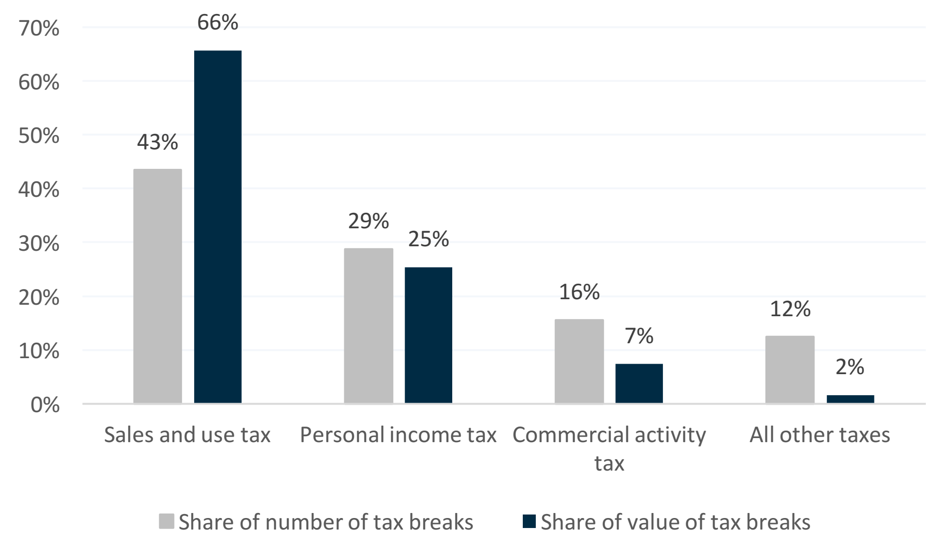
[5] *Id.*
[6] *Id.*
[7] Increase in tax expenditures based on the tax expenditure report and increase in the taxpayer revenues in the General Revenue Fund is based on the June 22, 2017 forecast of the Legislative Service Commission at http://bit.ly/2xYk935
[8] The values for revenues foregone for the sales tax, the personal income tax, the commercial activity tax and the other taxes mentioned in this section do not include those items with value of less than a million dollars a year. The Taxation Department does not provide an estimate for tax expenditures that are this small.

Figure 1

Tax expenditures by number and value as a share of total, by type of tax



Source: Source: Policy Matters Ohio, based on Ohio Taxation Department tax expenditure report for 2018-19

Tax expenditures by type of use

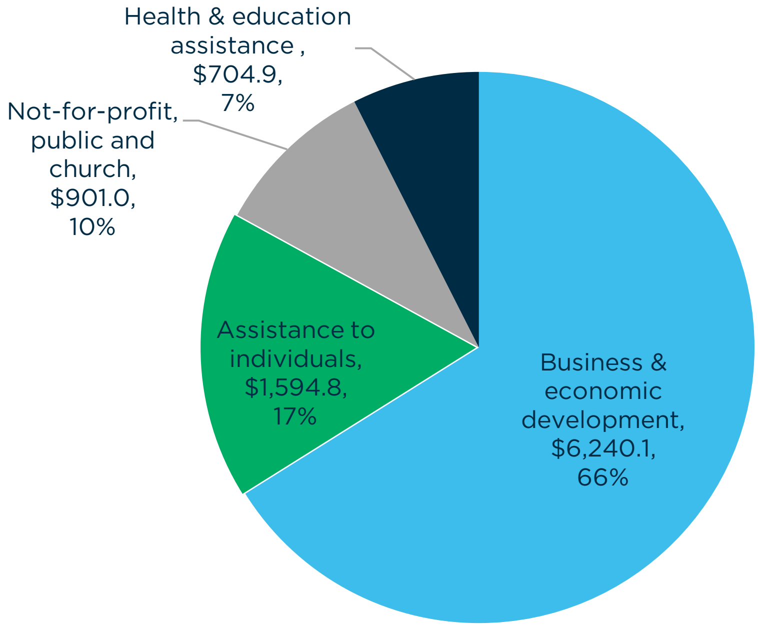
Figure 2 breaks out the value of tax expenditures by type of use. The four categories: business and economic development, assistance to individuals, assistance to churches, non-profits and public sector entities and assistance to individuals for health and education, is based on groupings used by the Ohio Department of Taxation in earlier tax expenditure reports.[9]

- The largest number of tax expenditures are for business and economic development. The 86 tax breaks in this category represent revenue foregone of $6.2 billion dollars in 2019 and account for two-thirds of total tax expenditures.
- There are 22 tax expenditures that provide assistance to individuals, accounting for $1.6 billion of revenue foregone in 2019.
- Twelve tax expenditures address the health and education of Ohio residents and total about $700 million.
- Nine benefit non-profits, public sector or religious organizations and account for $900 million in foregone revenue.

[9] For example, see the tax expenditure report for 2010-11 at http://www.obm.ohio.gov/Budget/operating/doc/fy-10-11/budget/Tax-Expenditure-Report.pdf

Figure 2

Value (dollars in millions) of tax expenditures by category and share of total



Source: Source: Policy Matters Ohio, based on Ohio Taxation Department tax expenditure report for 2018-19

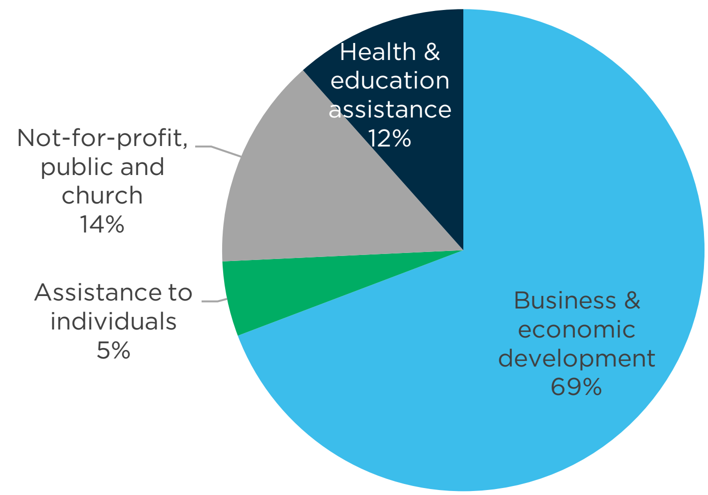
Growth in tax expenditures by type of use (Figure 3)

The tax expenditure budget will grow by $1.4 billion during FY 2018 and 2019, compared to the prior two-year budget period. Figure 3 illustrates how new growth is broken down by category.

- Sixty-nine percent of that $1.4 billion growth is due to tax breaks to business and economic development.
- Health and education assistance accounts for 12 percent of total growth.
- Assistance to individuals will make up 5 percent of the growth projected for 2019-19 relative to the prior budget.
- Tax expenditures for not-for-profits, public sector and religious organizations, will make up 14 percent of total growth.

Figure 3

Share of total growth projected for tax expenditure budget in 2018-19



Source: Source: Policy Matters Ohio, based on Ohio Taxation Department Tax Expenditure Report, 2018-19

The largest tax expenditures

Table 1 shows the top 20 tax expenditures in terms of estimated value of revenue foregone in 2019.

The largest tax expenditure is an exemption from sales tax for goods purchased to use primarily in manufacturing. This is an old tax break dating back to 1935, the year the state sales tax was established. The purpose is to avoid multiple taxation of the same item as it moves through the manufacturing process. There are many similar exemptions ranging from equipment used in agriculture and mining to equipment used in retail sales; packaging; food preparation, printing, and more.

The second largest, another sales tax break, benefits not-for profit, public sector and religious organizations. This, too, dates back to 1935.

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Table 1

Ohio's 20 largest tax expenditures (dollars in millions)

Type of tax	Name of tax exemption	FY 2016	FY 2017	FY 2018	FY 2019	Change	% change
Sales	Property used primarily in manufacturing	$2,071.0	$2,123.7	$2,210.7	$2,299.9	$315.9	7.5%
Sales	Sales to churches and certain other non- profits	$572.5	$586.0	$600.1	$614.2	$55.8	4.8%
Personal income	Ohio "small business" investor income deduction	$360.1	$559.0	$580.4	$599.7	$261.0	28.4%
Personal Income	Personal, spousal, and dependent exemption	$501.4	$517.3	$537.6	$558.2	$77.1	7.6%
Sales	Prescription drugs and selected medical supplies	$450.0	$473.8	$505.9	$540.2	$122.3	13.2%
Sales	TPP used in agriculture or mining	$393.9	$395.1	$404.5	$413.6	$29.1	3.7%
Sales	Sales of TPP and services to electricity providers	$318.1	$326.7	$343.1	$356.8	$55.1	8.5%
Personal Income	Social security and railroad retirement benefits	$280.8	$289.0	$306.9	$320.4	$57.5	10.1%
Sales	Packaging and packaging equipment	$239.0	$245.8	$255.2	$264.7	$35.1	7.2%
Commercial Activity	Exclusion of first $1 million of taxable gross receipts	$242.3	$247.2	$252.2	$257.3	$20.0	4.1%
Sales	Transportation of persons and property	$219.3	$226.8	$234.4	$241.1	$29.4	6.6%
Sales	Building and construction materials used in certain structures	$215.4	$220.9	$226.8	$232.7	$23.2	5.3%
Sales	Value of motor vehicle trade-ins	$195.4	$206.0	$214.4	$217.6	$30.6	7.6%
Personal Income	Joint filer credit	$196.0	$199.4	$206.5	$212.9	$24.0	6.1%
Personal Income	Resident credit for income taxed by another state	$169.4	$174.3	$179.4	$184.6	$20.3	5.9%
Sales	Qualifying distribution center receipts	$154.8	$163.8	$169.0	$174.4	$24.8	7.8%
Sales	Prop. and services sold to telecomm providers	$124.6	$129.7	$135.1	$140.6	$21.4	8.4%
Sales	Sales to the state, its subdivisions & certain other states	$122.8	$122.8	$122.9	$122.9	$0.2	0.1%
Commercial Activity Tax	Job creation credit	$104.4	$108.6	$113.0	$117.3	$17.3	8.1%
Sales	TPP used directly in providing public utility services	$108.3	$116.3	$116.3	$116.3	$8.0	3.6%

Source: Policy Matters Ohio, based on Ohio Tax Expenditure Report, 2018-19 budget. Note: "TPP" stands for tangible personal property.

The third largest is the "small business" investor deduction, enacted in 2013 and expanded in 2015 and 2016. The tax break permits owners of what are known as "passthrough" businesses such as partnerships and S Corporations to avoid paying any income tax at all on the first $250,000 in profits from those businesses. They're called passthroughs because their owners are taxed on the income when it passes through to them as individuals. Any additional profits are taxed at 3 percent, well below the nearly 5 percent charged at the top bracket on other earned income. Although the tax department calls this a "small business" deduction, it benefits owners of businesses both large and small, and is most useful for high earners who are investors in passthrough businesses. Partners in large law firms, owners of private equity firms, and investors in big companies that are organized as passthrough entities are equally able to qualify.

The tax expenditure report significantly understates the full value of this tax break. That's because the tax department calculated its value by totaling the amount of the projected exemption and multiplying that by 3 percent, the rate now charged on business income over $250,000.[10] That leaves out the revenue loss if such income were taxed under the state's progressive rate structure – and in particular, how much is foregone because of the lower 3 percent rate charged on business income above $250,000. When the full revenue loss is tallied, the expenditure is revealed as much, much larger. The Department of Taxation said this tax break was worth $943 million in tax year 2015, based on actual filings through December for that filing year, when savings that business owners reap from the 3 percent flat rate was included (this element was added later and first became effective for tax year 2015). The department estimated in May based on tax returns filed by that time that the deduction would cost $1.09 billion in tax year 2016.[11] The size of the deduction was increased further that year.

The fourth largest tax break is the personal, spousal and dependent exemption taken by all who pay state personal income taxes. The state income tax became effective in 1972, and this exemption dates back to that enactment.

The fifth largest tax break is the sales-tax exemption for prescription drugs and certain medical supplies.

Tax expenditures with the fastest growth

Table 2 looks at growth rates in items worth more than $20 million a year. We look at the larger breaks because a small tax break (say, $1 million) can exhibit geometric growth (say it grows to $5 million: the growth rate is 500 percent), yet the impact on foregone revenue is negligible in the context of more than $9 billion in tax breaks.

The 46 percent growth in the motion picture tax credit was driven by changes in the law that made it much larger. House Bill 390 of the 131st General Assembly changed the calculation of the credit, eliminated the individual $5 million cap per production, made the credit transferrable, and doubled the maximum amount of credits that could be issued from $40 million per biennium to $40 million per fiscal year. The full value of the credit will be $40 million a year, but because credits are taken against taxes that do not uniformly go into the General Revenue Fund, only an estimated $21 million in each year is shown in the Tax Expenditure Report.[12]

The so-called "small business" investor tax break is among the three largest tax breaks, and based on tax department estimates, it also has one of the fastest growth rates in spite of its huge size. This is partly because of the changes in calculation described above. Also, additional law changes increased the value of the deduction. The Kasich administration has argued that the cost has ended up being lower than it

[10] Ohio Department of Taxation, Memo on Small Business Investor Income Deduction, Dec. 2, 2016
[11] Received from the Office of Budget & Management, "Analysis: Small Business Tax Deduction Vs. Actual Cost," created by the Department of Taxation, May 25, 2017.
[12] Memo on the motion picture tax credit from Doris Mahaffey to Ernest Massie, dated October 25, 2016, received from the Ohio Department of Taxation on March 7, 2017.

estimated when the deduction was enacted, and later, expanded.[13] Since we do not have estimates from the Ohio Office of Budget and Management for the full amount of foregone revenue for Fiscal Years 2018 and 2019, it's hard to know the growth rate. However, it is clear that this break has grown from zero just five years ago to a billion dollars a year today.

Table 2

Ohio's 20 fastest growing tax expenditures worth more than $20 million a year, percentage change from 2016-2017 to 2018-2019 (dollars in millions)

Type of tax	Tax expenditure	FY 2016	FY 2017	FY 2018	FY 2019	Change	% change
Commercial Activity	Motion picture tax credit	$7.8	$21.1	$21.1	$21.1	$13.3	46.0%
Personal Income	Ohio "small business" investor income deduction	$360.1	$559.0	$580.4	$599.7	$261.0	28.4%
Personal Income	Deduction for taxpayers not eligible for employer sponsored medical plan	$32.9	$36.7	$41.1	$43.5	$15.0	21.6%
Commercial Activity	Job retention tax credit	$52.0	$57.7	$63.6	$69.6	$23.5	21.4%
Personal Income	Deduction for excess medical expenses	$46.5	$45.1	$48.5	$58.8	$15.7	17.1%
Sales	Prescription drugs, medical supplies	$450.0	$473.8	$505.9	$540.2	$122.3	13.2%
Personal Income	Exemption for active-duty military income	$20.9	$22.2	$23.5	$24.8	$5.2	12.1%
Sales	Qualified TPP used in making retail sales	$48.0	$50.6	$53.5	$56.7	$11.6	11.8%
Sales	Aviation repair, maintenance svc. & parts	$17.5	$18.5	$19.4	$20.5	$3.9	10.8%
Personal Income	Exemption for uniformed services retirement income	$27.2	$28.6	$30.2	$31.6	$6.0	10.8%
Sales	Artificial limbs, prostheses and other medical equipment	$28.5	$29.7	$31.3	$33.0	$6.1	10.5%
Personal Income	Social security and railroad retirement benefits	$280.8	$289.0	$306.9	$320.4	$57.5	10.1%
Commercial Activity	Credit for increased research and development	$33.6	$35.2	$36.9	$38.6	$6.7	9.7%
Sales	Sales by churches and other non-profits	$41.9	$43.7	$45.7	$47.6	$7.7	9.0%
Sales	Sales of tangible personal property and services to electricity providers	$318.1	$326.7	$343.1	$356.8	$55.1	8.5%
Sales	Property and services sold to telecomm	$124.6	$129.7	$135.1	$140.6	$21.4	8.4%
Commercial Activity	Job creation credit	$104.4	$108.6	$113.0	$117.3	$17.3	8.1%
Personal income	Exemption for disability income	$24.0	$24.8	$25.9	$26.8	$3.9	8.0%
Commercial Activity	Qualifying distribution center receipts	$154.8	$163.8	$169.0	$174.4	$24.8	7.8%
Sales	Value of motor vehicle trade-ins	$195.4	$206.0	$214.4	$217.6	$30.6	7.6%

Source: Policy Matters Ohio, based on Ohio Tax Expenditure Report, 2018-19 budget. Only tax expenditures of greater value than $20 million a year were included; those with the smallest value may show very high growth rates but have negligible impact.

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[13] Received from the Office of Budget & Management, "Analysis: Small Business Tax Deduction Vs. Actual Cost," created by the Department of Taxation, May 25, 2017.

The fast growth rate for the deduction on insurance plans not provided by an employer is driven by the Affordable Care Act's individual mandate and insurance subsidies that allowed many more people to be covered by insurance.

The job retention tax credit is showing rapid growth. This is an economic development incentive tax break, used to encourage companies to retain jobs and capital investment in Ohio and not move them to other states.

Tax expenditures with the largest growth

Table 3 shows growth in terms of total dollar value of revenue foregone, and ranks tax breaks with the largest at the top. The largest tax breaks show the most growth in value of revenue foregone to the state. In part, this is a function of size. The largest tax break, for goods purchased for use in manufacturing, doesn't have one of the fastest percentage growth rates, but its growth in value is the largest of all. The personal and joint filer deduction and the deduction for nonprofit, public and religious organizations show a similar trend.

The deduction for prescription drugs makes it into the top five, driven by broader health care coverage and the individual mandate. This one ranked number six in terms of the fastest growth rates.

The so-called "small business" income deduction again is near the top of the list in volume of growth – the only item to be in the top five on all three tables.

Table 3							
Ohio's 20 tax expenditures with the largest growth in 2018-19 relative to 2016-17 (dollars in millions)							
Type of tax	Tax expenditure	FY 2016	FY 2017	FY 2018	FY 2019	Change	% change
Sales	Property used primarily in manufacturing	$2,071.0	$2,123.7	$2,210.7	$2,299.9	$315.9	7.5%
Personal Income	Ohio "small business" investor income deduction	$360.1	$559.0	$580.4	$599.7	$261.0	28.4%
Sales	Prescription drugs and selected medical supplies	$450.0	$473.8	$505.9	$540.2	$122.3	13.2%
Personal Income	Personal, spousal, and dependent exemption	$501.4	$517.3	$537.6	$558.2	$77.1	7.6%
Personal Income	Social security and railroad retirement benefits	$280.8	$289.0	$306.9	$320.4	$57.5	10.1%
Sales	Sales to non-profit, public and religious organizations	$572.5	$586.0	$600.1	$614.2	$55.8	4.8%
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Personal Income	Resident credit for income taxed by another state	$169.4	$174.3	$179.4	$184.6	$20.3	5.9%
Commercial Activity	Exclusion of 1st million $$ of taxable gross receipts	$242.3	$247.2	$252.2	$257.3	$20.0	4.1%
Commercial Activity	Job creation credit	$104.4	$108.6	$113.0	$117.3	$17.3	8.1%
Personal Income	Deduction for excess medical expenses	$46.5	$45.1	$48.5	$58.8	$15.7	17.1%
Source: Policy Matters Ohio, based on Ohio Tax Expenditure Report, 2018-19 budget.							

Change in tax expenditures

Over the biennium, new tax breaks are passed and some tax breaks are discontinued. Sometimes tax breaks are reclassified into taxes that are not part of the General Revenue Fund, sometimes the tax they were part of is changed in a way that eliminates the tax break, and sometimes they sunset. Table 4 shows tax breaks that were in the prior tax expenditure report – which was part of the executive budget for FY 2016-17 - but were not in the tax expenditure report that was part of the executive budget submission for 2018-19, as well as tax breaks that appear for the first time in the 2018-19 tax expenditure report.

Table 4			
Tax breaks in the 2016-17 report that were not in the 2018-19 report		Tax breaks that appeared for the first time in the 2018-19 report	
Tax	Tax expenditure	Tax	Tax expenditure
Financial Institutions	Assessments paid to Division of Financial Institutions	Sales	Sales of natural gas by a municipal utility
Public Utility	Credit for certain natural gas companies	Sales	Investment bullion and coins
Sales	Property and services used in constructing qualified convention center	Sales	Motor vehicle rental if payment reimbursed under warranty
Sales	TPP used in energy or waste conversion facilities	Commercial Activity	Qualified Supply Chain receipts
Sales	Sales to facilities financed with public hospital bonds	Commercial Activity	Differential of PAT-CAT tax on dyed diesel for railroads
Financial Institutions	Treatment of certain agricultural credit institutions under the Financial Institutions Tax	Personal Income	Deduction for ABLE Account contributions
Source: Policy Matters Ohio, based on the 2018-19 Tax Expenditure Report of the Ohio Department of Taxation			

Several of the tax breaks that were in the last tax expenditure report but not the most recent one, have been combined with other, large categories of tax exemption (convention centers, waste conversion, public hospitals). Others expired (natural gas credits, assessments paid to the Division of Financial Institutions).

New tax expenditures showing up for the first time in the report this year were either passed in the 2016-17 budget bill after the report was issued (it comes out with the executive budget, which kicks off all budget discussions), or they were passed in legislation leading up to the release of the 2018-19 report in February 2017.[14] For example, Senate Bill 172 of the 131st General Assembly reinstated a break on the sales and use tax for the purchase of investment bullion and coins, repealed after a political scandal. House Bill 483 of the 131st General Assembly created a deduction for contributions to ABLE accounts, which are tax-free savings accounts for individuals with disabilities to be used for qualified disability expenses.

New scrutiny of tax expenditures

More than two-thirds of the states now prepare regular tax expenditure budgets or reports to provide the public and policymakers with up-to-date information on the impact of preferential tax provisions (both tax expenditures and elements of

[14] A number of these tax breaks were discussed in a Policy Matters Ohio report, "Tax Breaks Expand in State Budget," Sept. 16, 2015, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-breaks-expand-in-state-budget

"normal" taxation) in the tax code.[15] As of December 2016, Ohio has joined a smaller group of states with an evaluation process written into statute.

House Bill 9 of the 131st General Assembly established a committee to review all items in the tax expenditure report on a scheduled basis. Each tax break is to be reviewed every eight years and the committee is to recommend whether it should be continued without modification, modified, scheduled for further review at a future date to consider repealing the expenditure, or repealed outright. In addition, the recent budget bill put in place an element of transparency regarding seven business tax incentives on a biennial basis.

Review of Tax Incentives

Tax incentives are a certain type of tax expenditure. Typically, they are intended to change the behavior of someone or something: to encourage a person to weatherize a home, for example, or to encourage a business to locate somewhere that needs jobs and capital. The General Assembly authorizes them and they are typically administered through the state's Development Services Agency. Some have reporting requirements. Others require that the breaks create a certain number of jobs, generate a certain amount of capital investment, or meet some other target. Some contain provisions to recall the award if requirements are not met. There is not currently a comprehensive accounting of state spending for economic development purposes, including tax incentives.

The governor's executive budget included, and the House and Senate supported, a provision to have additional accounting for spending on major business incentives through the tax code. [16] In the future, the executive budget submitted by the governor and enacted by the General Assembly is to include detailed estimates regarding the amount of business incentive tax credits authorized in each year of the biennium, the amount of credits claimed in each year of the biennium, and the amount of credits that will remain outstanding at the end of the biennium.[17]

Table 5 outlines the business tax incentives to be included. This table, taken from House Bill 49, provides an estimate of the specified business incentive credits that may be authorized in each fiscal year of the 2018-19 biennium, an estimate of the credits expected to be claimed in each fiscal year, and an estimate of the value of total credits authorized by the end of the 2018-19 biennium.

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[15] National Conference of State Legislatures, Tax Expenditure Budgets and Reports: Best Practices August 18, 2014 at http://www.ncsl.org/documents/task_forces/tax_expenditure_report.pdf

[16] Am. Sub. H.B. 49, Section 107.036, page 57, at https://www.legislature.ohio.gov/legislation?5&pageSize=10&start=1&sort=LegislationNumber&dir=asc&statusCode&legislationNumber=49&legislationTypes=HB&generalAssemblies=132

[17] The language of the bill reads: "For each business incentive tax credit, the main operating appropriations act shall contain a detailed estimate of the total amount of credits that may be authorized in each year, an estimate of the amount of credits expected to be claimed in each year, and an estimate of the amount of credits expected to remain outstanding at the end of the biennium. The governor shall include such estimates in the state budget submitted to the general assembly pursuant to section 107.03 of the Revised Code."

Table 5

The state will be liable for $1.5 billion in seven business tax incentives by the end of the biennium (dollars in millions)

Tax credit		Estimate of total value of tax credits authorized		Estimate of total value of tax credits issued/claimed		Expected outstanding credits
Tax	Tax expenditure	FY 2018	FY 2019	FY 2018	FY2019	End of Biennium
Commercial Activity	Job creation tax credit (*)	$100	$100	$105	$100	$885
Commercial Activity	Job retention tax credit	$ 0	$ 0	$55	$55	$290
Personal Income	Historic Preservation Tax Credit	$60	$60	$120	$90	$190
Personal Income**	Motion Picture Tax Credit	$40	$40	$50	$50	$35
Commercial Activity	New Markets Tax Credit	$10	$10	$9.8	$10	$38.2
Commercial Activity	R&D loan tax credit	$4.5	$4.5	$4.5	$4	$30
Commercial Activity	InvestOhio Tax Credit	$12	$12	$18	$15	$42
TOTAL		$227	$227	$362.3	$324	$1,510.2

Source: Policy Matters Ohio based on House Bill 49

This biennial review of business tax incentives could be the starting point for a long-needed unified economic development budget that spells out state spending for economic development, both through line-item spending and the tax code, and allows for a better accounting of such spending.

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The Tax Expenditure Review Committee

In December 2016, House Bill 9 of the 131st General Assembly created the "Tax Expenditure Review Committee," a permanent legislative committee tasked with reviewing all existing tax expenditures. This section of the report is drawn from the Ohio Legislative Service Commission's summary of House Bill 9 as enrolled.[18]

House Bill 9 defines tax expenditures as they are defined in the tax expenditure report and outlines the nature and duties of the committee. The committee must establish a schedule and protocol for reviewing the 129 tax expenditures. The legislation gives the committee discretion to decide how to proceed and suggests that it may (not "shall") provide for review of tax expenditures:

- in the order in which they were enacted or modified (The language of the bill suggests starting with the "least recent," or oldest)
- by the individuals or industries benefiting from the expenditures;
- by the objectives of each expenditure, or
- by the policy rationale of each expenditure.

The law requires the committee to review each tax break once every eight years and recommend whether it should be continued, modified, repealed, or scheduled for further review later. The committee may also recommend "accountability standards" for future reviews of a tax expenditure. The law includes a list of factors that may be used in reviewing tax expenditures. Since the word "may" and not "shall" is used, these recommendations can be incorporated or disregarded, and other factors can be used.

The committee *must* hold at least one meeting for each tax break, during which members of the public may present evidence or testimony related to that provision. The chairperson *may* call a special meeting to accept evidence or testimony on a particular tax expenditure at the request of a member of the public.

The committee must issue a report of its determinations by July 1 of every even-numbered year, deliver a copy of the report to the leadership of both parties of each house of the General Assembly, and arrange for the report to be made available online. The report must be provided to the governor as well, who includes it as an appendix to the executive budget.

The committee is not charged with reviewing tax expenditures proposed in pending legislation. However, the act requires any introduced bill that proposes to enact or modify a tax expenditure to include a statement explaining its objectives and the sponsor's intent.

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[18] This section is taken from the text of the legislation and the analysis, which can be found at https://www.legislature.ohio.gov/legislation/legislation-documents?id=GA131-HB-9

Composition of the committee

The committee is made up of six voting members: three representatives and three senators, appointed by the speaker and Senate president in consultation with the minority party counterparts. No more than two representatives or senators may be members of the same political party and all "should," according to the act, be members of their chamber's committee that primarily deals with tax legislation. Terms coincide with the term of each General Assembly. The seventh, nonvoting member of the committee is the tax commissioner or the commissioner's designee. The committee chair is elected from among the legislative members and serves a two-year term. Two consecutive chairs may not be members of the same chamber.

The committee must meet at least once during the first year of each fiscal biennium. Its meetings are open to the public to the extent required under the existing Open Meetings Law, and the committee must allow any person to present testimony or evidence related to a tax expenditure.

It was to hold its first meeting by June 19, 2017, but did not do so. Members of the committee were named subsequently, months after they were supposed to be,[19] but as of this writing the committee had not yet met.

[19] Siegel, Jim, "Billions in State Tax Breaks Going Unexamined, Despite New Law," *The Columbus Dispatch*, July 19, 2017, at http://www.dispatch.com/news/20170719/billions-in-state-tax-breaks-going-unexamined-despite-new-law

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Recommendations for the committee

The National Conference of State Legislatures (NCSL) suggests that rigorous evaluations should determine costs and benefits of each tax expenditure, and allow policymakers to ask critical questions, including: a) Is the purpose, cost and benefit of each tax expenditure clear? b) Are there clear metrics to determine the tax expenditure's effectiveness? c) If no readily available data exists to measure a tax expenditure, how should it be evaluated? d) To what extent did the tax expenditure affect choices made by taxpayers? e) Did the expenditure achieve its purpose? f) Who was affected by the tax expenditure? g) Did the benefits of the tax expenditure outweigh the effects of the tax increases or spending cuts needed to offset it?[20] Ohio's new law allows the legislature to lay a good foundation. But many preliminary decisions must be made to ensure a sound process.

Setting a schedule

Ohio's tax expenditure review committee faces a big job, with 129 tax breaks and a yearly budget of more than $9 billion. No less than a quarter of the tax expenditures – in value and in number – should be evaluated in each of the four biennia of the eight-year cycle. The committee is already behind: it should have begun meeting months ago. It will have to work hard for the rest of the biennium to stay on schedule.

Choosing a place to start

We suggest first analyzing the expenditures with the fewest beneficiaries. This can help identify genuine special interest breaks that have become an entitlement, continuing without scrutiny year after year. These should be cut back or eliminated unless there are compelling reasons to continue them.

Staffing

The act requires staff of the Legislative Service Commission to assist as directed by the committee. State agencies must provide the committee with any information it requires to perform its duties. Ohio legislators need to fund the Legislative Service Commission to assign staff with the necessary experience to do the review. House Bill 9 included no dedicated funding to hire the expertise needed – auditors, economists and tax policy experts. Unfortunately, such funding was also not included in the budget bill for 2018-19.

The law directs legislative staff to assist the committee but does not specify that the staff should provide evaluations. Other states, such as Florida, Indiana, Maryland, and Washington, have laid out specific responsibilities for legislative staff to study the results of incentives. These have resulted in rigorous evaluations.[21] The Ohio committee should ensure similar high-quality evaluations. A new Legislative Budget

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[20] National Conference of State Legislators, Tax Expenditure Budgets & Reports: Best Practices, January 2017 http://www.ncsl.org/documents/statefed/NCSL_Tax_Expenditures_Best_Practices.pdf

[21] How states are improving business tax incentives for jobs and growth, the Pew Charitable Trust, May 3, 2017 at http://www.pewtrusts.org/en/research-and-analysis/reports/2017/05/how-states-are-improving-tax-incentives-for-jobs-and-growth

Office, being studied as a result of the recently enacted budget bill, could provide the structure through which funding may be channeled to hire the staff needed for the review. In the meantime, the LSC could house the staff.

Criteria for evaluation

The statute outlines criteria that may be used in evaluating tax breaks. Those criteria are outlined below; our recommendations are marked by a check-mark.

- The number and classes of persons that benefit from the tax expenditure;
  - ✓ Type of beneficiary (non-profit, person or business)
  - ✓ Distribution of benefits by income level (in the case of businesses, this might be done by size of business beneficiaries).
- State and local fiscal effects, including in the past and in the eight years before its next review;
  - ✓ Review of all costs, with a focus on local costs, including how the tax break affects the local government fund, public library fund, and other revenue sharing.
  - ✓ Are local property taxes also abated in connection with state tax breaks, and have appropriate steps been taken to ensure that schools and other taxing jurisdictions have a voice in them?
  - ✓ What measures have been taken or should be added to minimize the use of the incentive to facilitate business relocation within Ohio?
  - ✓ The dispersal of a slow-growing population over a wider geographical area, as is happening in most of Ohio's major metropolitan areas, is unsustainable. The committee should look into a requirement that tax incentives and expenditures be based on a thorough cost/benefit analysis that considers infrastructure and services in place or that may be required to support the new establishment during the term of the subsidy.
- Public policy objectives, for which the committee may consider legislative history, sponsor intent, and effects on economic development, "high-wage jobs," and "community stabilization";
  - ✓ Do ongoing tax expenditures successfully change business behavior, as opposed to rewarding what companies would have done anyway?
  - ✓ If the outcome is high wage jobs and community stabilization, have those benefits gone primarily to residents within the host community?
  - ✓ Are employees at companies receiving incentives paid enough that they and their family members do not need public benefits such as Medicaid and food aid? In short, are the jobs created good jobs? What requirements should be added to ensure job quality?
- The success of the tax expenditure in meeting its public policy objectives;
  - ✓ The extent to which without this tax expenditure, particular investments and job creation would not have taken place.
  - ✓ The extent to which any benefits remain within the locality or the state.
  - ✓ The extent to which there was unanticipated benefit or harm.
- Whether the objectives could be accomplished without the tax expenditure or with less fiscal cost;
  - ✓ Whether direct state spending on education and other long-term investments would reap a larger reward for Ohioans and our economy.

- Whether the objectives could have been accomplished by appropriations instead of tax expenditures;
- The extent to which the tax expenditure provides unintended benefits other than those intended or creates an unfair competitive advantage for its recipient with respect to other businesses in the state;
- The extent to which ending the tax expenditure could hurt entities benefitting from it;
- The extent to which ending the tax expenditure could hurt or help the state's employment and economy;
- The feasibility of modifying a tax expenditure in case recipients do not comply with its terms.
  - ✓ While the bill did not call for sunset dates, the committee should consider them so that, like other expenditures, tax exemptions, credits and deductions do not continue without legislative authorization.
  - ✓ When there are reporting requirements and claw-back provisions, performance should be reviewed, and new performance requirements considered and recommended where necessary.
  - ✓ Reporting requirements to facilitate future evaluation must be specified.

Beyond the criteria

Studying the design of incentives, including who benefits and the mechanism for calculating and claiming benefits, can lead to program improvements.

The Tax Expenditure Review Committee's work is important because it makes recommendations to the legislature and Governor on what tax breaks should be eliminated, changed or reduced. Some are clearly candidates for limitation or repeal.

Ohio should eliminate the business income deduction, described in the tax expenditure report as the "small business investor deduction." The number of new jobs at Ohio businesses hiring for the first time has not increased since this deduction was implemented, yet it is draining over $1 billion a year in revenue that could be invested in education and other needed public services.[22] A bipartisan majority of the Kansas legislature repealed a similar tax break there earlier this year.

The committee also should limit the amount retailers can receive for collecting the sales tax, known as the vendor discount. Most states with a sales tax either have no discount at all or cap the amount, ensuring big retailers do not reap a windfall. Tax Commissioner Joe Testa has noted in testimony that Ohio's 0.75 percent discount "essentially functions as a profit center" for big-volume retailers.[23] According to data from the 2009 tax expenditure report, more than half of the $50.7 million received in such discounts in 2008 went to 687 retailers that collected at least $1 million in tax,

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[22] See "The $1 billion tax break burning a hole in Ohio's budget," Policy Matters Ohio, May 22, 2017, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/the-1-billion-tax-break-burning-a-hole-in-ohios-budget and "Budget Bite: Scrap the 'passthrough' tax break, Feb. 22, 2017, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/budget-policy/budget-bite-scrap-the-passthrough-tax-break

[23] Testa, Joe, Testimony to the House Finance Committee, Feb. 12, 2015, p. 11

while 197,487 retailers got the rest.[24] Both Governors Strickland and Kasich unsuccessfully attempted to limit this discount.

Ohio should limit the tax break for suppliers to qualified distribution centers (QDCs) that buy at least $500 million a year of goods, and ship at least half of them outside Ohio. They are able to avoid paying the commercial activity tax on what they send outside the state. Suppliers to one such distribution center are paying no CAT tax at all, because Cardinal Health, the operator, reports that none of the products delivered there are being shipped into Ohio. As Budget Director Tim Keen testified earlier this year, this provision has been used as a tax planning device by suppliers to distribution centers to reduce their CAT tax liability to zero.[25] One way they may cut their taxes to nothing would be to rely on a different distribution center outside Ohio for shipments into Ohio, reducing or even eliminating shipments into Ohio and also the tax that would be charged on them. Governor Kasich sought to limit this break in the recently enacted state budget, but legislators did not approve his proposal.

These are just a few of the tax breaks that deserve repeal or limitation. Policy Matters has identified a number of others previously and will produce additional suggestions as the committee gets going.[26]

Economic analysis

The Pew Charitable Trusts, which studies state evaluation of business tax incentives, observes: "High-quality evaluations do not simply judge an incentive program to be a success if it created some jobs or attracted some businesses. Instead, they compare the results of the incentives to the results of potential alternatives."[27] Econometric analysis can provide such analysis, as long as the assumptions are well understood by staff and committee members. If the Ohio evaluations include such measures, committee members must understand and approve the economic assumptions that underlie the calculations of the model. The state does not use dynamic modeling in its budget-making process, and Budget Director Tim Keen, testifying in a 2015 budget hearing, noted 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 an analysis depend heavily on the assumptions used, and the effects are likely to be both small and uncertain.[28]

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[24] Ohio Department of Taxation, Tax Expenditure Report for Fiscal Years 2010 and 2011, February 2009, p. 51, at http://www.tax.ohio.gov/portals/0/communications/publications/fy2010-2011_ter_1.pdf

[25] See "Tax breaks should be reined in," Policy Matters Ohio, May 4, 2017, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-breaks-should-be-reined-in

[26] Schiller, Zach, "Testimony to the 2020 Tax Policy Committee on Tax Expenditures," March 22, 2016, at http://www.policymattersohio.org/wp-content/uploads/2016/03/031116-Draft-Tax-Expenditures-Testimony.pdf

[27] How states are improving business tax incentives for jobs and growth, the Pew Charitable Trust, May 3, 2017 at http://www.pewtrusts.org/en/research-and-analysis/reports/2017/05/how-states-are-improving-tax-incentives-for-jobs-and-growth

[28] Keen, Timothy S., Director, Office of Budget & Management, during testimony to the House Finance Committee, Feb. 3, 2015

Ensuring public participation

Ohio should publicize the existence of the committee hearings. The public has a right to hear the discussions of spending through the tax code, just as they have the right to hear and read about budget discussions. The state should also hold legislative hearings on committee recommendations. Policy improvements are more likely when states have a formal process to ensure lawmakers consider the results – for example, by holding legislative hearings on evaluations. The new law requires the committee report to be included as an appendix in the governor's budget. The governor should respond to the results, including by proposing changes in tax expenditures in the executive budget.

Summary

Ohio's General Assembly has taken a good step in undertaking a review of the enormous tax expenditures in the state code, and together with the Governor, providing more transparency on business tax breaks designed to incentivize certain behaviors. Critical steps to get off to a good start include meeting (they are already months off schedule); getting staff established for a review; deciding where to start and setting a goal for the initial review; and formalizing both how public input will be received and how broader legislative review will be promoted.

The committee should also consider building upon the business tax-break transparency measure in the current budget to move toward complete, accessible disclosure of all of the state's support for economic development efforts. Some tax breaks should be limited or repealed, such as the business-income deduction. But all can benefit from a substantive review.

Ohio spends more than nine billion dollars in tax expenditures, more than is allocated to school districts through formula funding and the tangible personal property tax reimbursement. This part of the budget needs and deserves the same scrutiny as the rest of the state's operations. It can be trimmed substantially, so the state has more resources to make investments in education and other needed services. The Tax Expenditure Review Committee exists to recommend those changes.

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