Report to the Ohio Budget Planning and Management Commission

Executive Summary

The State of Ohio is staring at a huge budget problem next year, as the economic downturn has slashed tax receipts and increased the demand for services. However, Ohio's fiscal fault line is opening up also because of conscious state policy: The tax overhaul of 2005, the biggest in a generation. That year, the Ohio General Assembly approved a 21 percent reduction in the state income tax, the largest source of state tax receipts. It also eliminated two major business taxes, the state's tax on corporate profits and the local property tax on machinery, equipment, inventory, furniture and fixtures. The legislature replaced these two taxes with a new tax on Ohio gross receipts, the Commercial Activity Tax (CAT). Together with other changes to the tax system, these tax reductions are costing the state $2.1 billion in annual net revenue, according to the Ohio Department of Taxation.

The premise of the tax overhaul was that it would spark Ohio's economy. This was an unlikely claim to begin with, since taxes are not a key determinant of state economic performance. A good illustration: South Dakota, a state with no income tax and the lowest overall state and local taxes in the country as a share of personal income, had the second-lowest unemployment rate in the country in June. North Dakota, a state with an income tax and the fifth-highest overall tax levels, had the lowest rate.

Sure enough, the tax cuts have not proven to be the magic potion for Ohio's economy. Key measures of economic performance show the opposite: Ohio's economy has produced relatively fewer jobs, fewer manufacturing jobs, less overall output and lower personal income growth than the country as a whole since the tax overhaul was approved in June 2005. Ohio's share of the nation's jobs has shrunk since then from 4.06 percent to 3.87 percent. The tax changes are not responsible for Ohio's relative decline, but neither did they improve the state's standing.

More than 40 per cent of the income-tax cuts, when fully implemented next year, will go to the five percent of families with income of $135,000 or more a year, according to the Institute on Taxation and Economic Policy. Meanwhile, the bottom three-fifths of Ohio families by income will receive just 13 percent of the total tax cut. This reinforced a system in which low- and middle-income families already pay more of their income in state and local taxes than affluent families do. Yet in 2006, the richest one percent of Ohio families took in slightly more pretax income than the bottom half of the population.

In addition, as the Ohio Business Roundtable noted in a 2008 court filing: "The new business tax system substantially lowered the overall tax burden on business." Annual business tax savings are well north of $1 billion a year. This reduction came after a long-term decline in business taxes that reduced the business share of Ohio state and local taxes to about 30 percent from nearly 40 percent in the late 1970s.

Every two years, as part of the biennial budget, the Ohio Department of Taxation produces a report itemizing credits, deductions and exemptions in the tax code that reduce the amount of revenue the state would otherwise receive. The taxation department estimated in

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Policy Matters Ohio
3631 Perkins Avenue Suite 4C–East, Cleveland, OH 44114 • 216/361-9801 • Fax: 216/361-9810
300 East Broad Street, Suite 490, Columbus, OH 43215 • 614/221-4505• Fax: 614/224-8132

POLICY MATTERS OHIO
3631 PERKINS AVENUE SUITE 4C–EAST, CLEVELAND, OH 44114 • 216/361-9801 • FAX: 216/361-9810
300 EAST BROAD STREET, SUITE 490, COLUMBUS, OH 43215 • 614/221-4505 • FAX: 614/224-8132

its report last year that in both Fiscal Years 2010 and 2011, 122 such exemptions and credits amounted to more than $7 billion in foregone revenue to the state's General Revenue Fund. "Tax expenditures result in a loss of tax revenue to state government, thereby reducing the funds available for other government programs," ODT noted in the report. "In essence, a tax expenditure has the same fiscal impact as a direct government expenditure." However, many tax expenditures have continued for decades without review.

Such exemptions range from the small to the gigantic: A sales-tax exemption for pollution control equipment, most of which is mandated and utilities must purchase. A corporate-franchise tax exemption for goodwill, appreciation and abandoned property of financial institutions that is considerably larger than the entire amount of such tax collected annually. Property-tax exemptions reimbursed by the state that the last two Republican governors unsuccessfully sought to means-test, so that they would not be available to wealthy homeowners. A sales-tax exemption for machinery, equipment and supplies used in manufacturing worth $1.7 billion a year that has not been reexamined since it was overhauled 20 years ago. A sales-tax cap for wealthy buyers of shares in jet aircraft. A loophole that means no sales tax is charged on lobbyists' services.

Other states such as Arizona and Washington have regular reviews of their tax expenditures. States such as Oklahoma, Colorado, Iowa and Kansas have reduced tax credits, in particular. The Ohio Manufacturers' Association recently noted how the state sales tax "has become riddled with exemptions, carve-outs and credits," and called for a comprehensive examination of the tax.

State support for early childhood education, mental health programs, libraries and numerous other services have come under the knife as revenues have fallen. Yet tax expenditures – which have every bit as much impact on the state budget -- did not receive the same treatment. They should be pared. Beyond a review of specific tax expenditures, which would make sense even in good times, the budget commission should set goals for substantial reductions in tax expenditures and begin planning how they can be implemented. It should ask the taxation department and the Legislative Service Commission to detail their understanding of why each of these expenditures was originally approved and whether that purpose is being met now. The budget commission also should help convene a summit of state and federal legislators to rally support for a long-standing effort to level the playing field so that online and mail-order retailers collect the sales tax just as traditional retailers do.

The 2005 tax cuts did not improve Ohio's economic performance as promised, increased the share of taxes paid by middle- and low-income taxpayers, and deprived the state of needed resources for public services. Based on that, we recommend that we revitalize the income tax, in particular for high earners, and restore revenue from business taxes to levels that existed prior to the 2005 tax changes. This would still leave the business share well below where it was 30 years ago. Ohio's tax system should be overhauled to produce the revenue we need for public services and investments that support our economic success and maintain our quality of life.