Spending by another name: The 2009 Ohio Tax Expenditure Report

A Brief From

Policy Matters Ohio

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Executive Summary

As it struggles to approve a biennial budget, the Ohio General Assembly should closely examine the state tax expenditure report. Prepared by the Ohio Department of Taxation and sent to the legislature in February, this report examines credits, deductions and exemptions in the tax code that reduce the amount of revenue the state would otherwise receive.

The taxation department estimated 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." The report estimates foregone revenue, which is not necessarily what the state would get if a tax expenditure was repealed. Among its highlights:

- One exemption for banks, estimated at upwards of $177 million each year, is worth more than their expected total corporate franchise tax;
- Ohioans with incomes over $500,000 received $10 million in Tax Year 2006 under the income-tax exemption for Social Security and railroad retirement benefits. The 687 retailers with sales tax collections of $1 million or more got more in state discounts for such collections than the other 197,487 vendors.
- Business tax incentives that were transferred for use under the commercial activity tax are estimated to be much greater than projections made when the tax was created in 2005, though Policy Matters Ohio is conducting additional research to establish how much this represents real growth. Another CAT credit for companies with large, previous losses will add up to $29 million in FY2011.
- The overall number of tax expenditures has fallen since the 2005 overhaul of Ohio's tax system, but new ones have replaced many of those that were eliminated. Overall, 70 exclusions amounting to $3.7 billion a year are classified as business assistance and economic development.

Policy Matters Ohio has detailed in previous reports how tax expenditures do not receive the scrutiny that expenditures do, and has recommended the limitation of a dozen tax loopholes. These include ending the dealers in intangibles tax, which favors payday lenders and mortgage brokers over banks, and extending the sales tax to lobbying and debt collection services.

The General Assembly's conference committee should look to limit or eliminate unnecessary credits and exemptions. It should reexamine new or expanded tax credits and exemptions approved by the House and the Senate in their versions of the budget bill. If the full General Assembly approves any such measures, it should include sunset provisions so they expire in two years unless renewed. The legislature should set a phase-out date for all existing tax expenditures, and create a committee to make recommendations on which should be renewed.

Spending By Another Name:
The 2009 Ohio Tax Expenditure Report

A committee of senators and representatives from the Ohio General Assembly soon will be poring over the state operating budget, trying to figure out how to balance it. Another document presented by the governor at the same time as he proposed his budget, however, should also get their close attention: Book Two of the budget, the tax expenditure report. This biennial report, produced by the Ohio Department of Taxation, examines credits, deductions and exemptions in the tax code that reduce the amount of revenue the state would otherwise receive.

The taxation department estimated 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 (see table below). "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."[1]

The conference committee should closely review the report, and reduce or eliminate unneeded loopholes in its deliberations. It should reexamine proposed new or expanded tax credits and exemptions. If it does approve any such measures, it should include sunset provisions so they expire in two years unless renewed. And whether or not the General Assembly does so in the budget bill, it should set a phase-out date for all existing tax expenditures, and create a committee to make recommendations on which should be renewed.[2]

Table 1. Summary of Revenue Foregone

FY08	FY09	FY10	FY11
$6,915,800,000	$7,162,500,000	$7,444,200,000	$7,730,700,000

Source: Ohio Department of Taxation

[1] State of Ohio, Executive Budget, Fiscal Years 2010 and 2011, Book Two, Tax Expenditure Report, Prepared by the Department of Taxation and Submitted to the 128th General Assembly by Governor Ted Strickland, February 2009, p. 1. The report is available at http://obm.ohio.gov/SectionPages/Budget/FY1011/ExecutiveBudget.aspx
[2] This report reviews the tax expenditure report. Policy Matters Ohio also has recommended reversing key elements of the 2005 state tax overhaul to generate more revenue and increase the fairness of Ohio's tax system. See Policy Matters Ohio Legislative Briefing, *The 2005 Tax Overhaul, Business and Ohio's Economy*, available at http://www.policymattersohio.org/TaxBriefing2009_0219.htm

This brief covers some of the highlights of this year's tax expenditure report, which include:[3]

- 70 exclusions, accounting for about $3.7 billion a year or nearly half of the foregone revenue, are classified as business assistance and economic development. Another 40 benefit individuals for a total of $3 billion in FY11.[4] The remaining dozen tax breaks are worth nearly $1 billion a year to public and nonprofit organizations.
- One exclusion under the corporate franchise tax – for goodwill, appreciation and abandoned property of financial institutions – accounts for a larger amount than the entire estimated amount the state is expected to collect in taxes from financial institutions both in FY2010 and FY2011, respectively. This exclusion, the 11th largest of the 122 listed in the report, is projected at $177.9 million in FY10 and $186.8 million FY11, while the tax is expected to bring in less than $170 million each year.[5]
- Credits against the commercial activity tax will amount to $481.6 million in FY11, compared to estimated tax collections of $1.63 billion after credits.[6] Close to half of this is the CAT provision that companies only pay a flat $150 amount on their first $1 million of taxable gross receipts. However, altogether, there are 17 exclusions from the CAT. One rationale for the creation of this new tax in 2005 was that the two taxes it replaced, the franchise tax and the tangible personal property tax, were often abated or avoided. Yet the CAT already has nearly half as many credits and exemptions as the franchise tax accumulated over many decades.
- Four credits – economic development incentives -- that were previously taken against the franchise tax but are now taken against the commercial activity tax are projected to grow in size to $139.3 million in FY11, up from $98.6 million in FY08. These include the job creation tax credit ($101.5 million in FY11); the job retention tax credit ($9.3 million); the credit for increased spending on research and development

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[3] This year's report is not directly comparable to the one two years ago, as the department has changed the methodology it uses. ODT presents estimates in this report of "General Revenue Fund revenue foregone," or the benefits to recipients of the credits and exemptions. This is not necessarily the same as the amount that the state would receive in revenue if the exemptions were eliminated, and the department notes in bold-faced type that "the figures in this report do not represent the potential revenue gain from repeal of the tax expenditure." (p. 4) There may be a time lag before the full effect of repealing the tax expenditure shows up in state revenues, or recipients of the tax expenditures conceivably could behave differently because of the change. The department did attempt to estimate the effect of such behavioral changes in some instances. The current report also differs from the previous version in that it limits its estimates to the General Revenue Fund, instead of also reviewing the impact on local government funds.

[4] The report further breaks this down into $888 million in health or education-related assistance to individuals, and $2.11 billion in other fiscal assistance to individuals. See pp. 56-7

[5] Estimates for corporate franchise revenue are from the governor's Executive Budget, Economic Overview and Forecast, p. B-12. For additional discussion of this tax break, see *Limiting Loopholes: A Dozen Tax Breaks Ohio Can Do Without*, Policy Matters Ohio, September 2008, p.6, available at http://www.policymattersohio.org/LimitingLoopholes2008.htm

[6] See Executive Budget, Economic Overview and Forecast, p. B-13 This estimate is probably high, as CAT receipts have come in below expectations this year.

($22.5 million) and R&D loan program credit ($6 million).[7] The aggregate value of these credits is considerably higher than was estimated when the CAT was approved in 2005. Policy Matters Ohio is conducting additional research to establish how much this represents real growth, in part because the original estimates likely didn't take into account some of the job creation tax credits being given.[8] A fifth credit available against the CAT starting in calendar year 2010 allows companies with more than $50 million in unused net operating losses prior to the enactment of the new tax to write them off against their CAT liabilities. This credit is expected to provide $29 million in benefits in FY2011. This benefit is only available to large companies and was originally based on future profits they would earn. Now, they will get credit for past losses though they no longer will be taxed on their profits.

In the current report, the taxation department for the first time estimated how many taxpayers of different income levels are receiving certain credits, and how much they are getting. For instance, in Tax Year 2006, 527,846 Ohioans received the exemption for Social Security and railroad retirement benefits on their state income tax. This data reveals that 36,000 Ohioans with taxable income above $150,000 received the exemption, which was worth $45 million to them altogether. The 6,591 taxpayers with income above $500,000 saved $10 million that year because of the exemption.

ODT also found that big retailers account for the bulk of the 0.75 percent discount on the sales and use tax that vendors are granted. In the 2008 fiscal year, 687 vendors with sales tax collections of $1 million or more accounted for more than $28 million of the discounts received. The remaining 197,487 vendors collectively received $22.6 million. Gov. Strickland, who unsuccessfully proposed restructuring the vendor discount two years ago, has attempted to do so again the upcoming budget. He proposed increasing the discount to 1.0 percent, capped at $100 a month. However, neither the House nor the Senate included this provision in the versions of the budget they approved.

[7] The taxation department learned too late for inclusion in the report that the total amount of R&D tax loan credits was only $0.5 million in a recent year, so the estimate for that tax expenditure is probably too high. E-mail from Christopher Hall, February 10, 2009.

[8] Altogether, the ODT now estimates the amount of the four credits at more than $125 million in FY09, compared to the $70 million it estimated earlier. See Enacted House Bill 66 tax law changes, Ohio Department of Taxation, October 2005. The credit for increased spending on research and development grew substantially, as companies were able to utilize more of it against the CAT than they had been against the franchise tax. Job retention tax credit claims also were higher than they used to be. While the amount of job creation tax credits also appears to have grown, Policy Matters Ohio is seeking additional data, as available numbers provide a contradictory picture. All these figures are estimates, based on certain assumptions, and the 2005 estimates were especially rough.

The taxation department performed this valuable analysis on five tax breaks in the current report. This research should be expanded so that Ohioans can learn more clearly who is receiving benefits from other tax breaks as well.[9]

The overall number of tax expenditures cited rose from 130 in FY2006-07 to 146 in the FY2008-09 report and then fell to 122 in the FY2010-2011 report.[10] This was largely because new credits were added with the creation of the commercial activity tax in 2005, while existing credits were eliminated with the phase-out this year of the corporate franchise tax for non-financial companies.[11] Overall, the elimination of the franchise tax and its replacement by the CAT resulted in a net reduction of just 15 tax expenditures, not the 41 listed in the tax expenditure report just prior to 2005 tax overhaul.[12]

By far the largest number of tax expenditures – 54 – apply to the sales and use tax. Altogether, such expenditures amount to $5.0 billion in FY11. The sales tax also accounts for six of the eight largest tax expenditures, led by the exemption for tangible personal property used in manufacturing. There are 30 tax expenditures against the income tax. Table 2 on the next page shows the 20 largest tax expenditures in FY2011, as estimated by the taxation department. These each account for $100 million or more in foregone revenue:

[9] Texas requires this kind of distributional analysis before consideration of any tax bill by the legislature. See Jason Levitas, Nicholas Johnson, and Jeremy Koulish, *Promoting State Budget Accountability Through Tax Expenditure Reporting*, Center on Budget and Policy Priorities, April 2009, p. 29, available at http://www.cbpp.org/files/4-9-09sfp.pdf

[10] One tax expenditure is counted twice in the 2008-09 and 2010-2011 reports because it is listed under both the income tax and the commercial activity tax. Qualifying trusts created before 1972 may choose which of the two taxes to pay.

[11] These tax expenditures technically still exist in Ohio law. A very small number of nonfinancial companies will continue to pay the franchise tax, but department said it expects "the revenue impact associated with the remaining regular corporate franchise tax expenditures will be extremely small," so it has excluded them from the report. See p. 32 of the tax expenditure report.

[12] One other franchise tax exemption, for credit unions, was shown in the 2005 report and eliminated in 2007 by ODT because credit unions wouldn't be subject to the tax even if this exemption were repealed. State of Ohio, Executive Budget, Fiscal Years 2006 and 2007, Book Two, Tax Expenditure Report, Prepared by the Department of Taxation and Submitted to the 126th General Assembly by Governor Bob Taft, February 2005.

Table 2.

Top 20 Tax Expenditures, FY2011, by Foregone General Revenue Fund Revenue				
Rank	**Type of tax against which exemption is taken**	**Tax expenditure description**	**Foregone FY2011 Revenue (millions of dollars)**	**Originally Enacted**
1	Sales and use	Property used primarily in manufacturing tangible personal property	1,724.30	1935
2	Sales and use	Sales of prescription drugs and selected medical items	696.9	1961
3	Individual income	Personal, spousal, and dependent deduction	519.8	1972
4	Sales and use	Building and construction materials and services used in certain structures	435.5	1959
5	Individual income	Social Security and railroad retirement benefits	362	1972
6	Sales and use	Sales to churches and certain other non-profit organizations	347.5	1935
7	Sales and use	Sales of tangible personal property and services to electricity providers	331.8	2000
8	Sales and use	Packaging and packaging equipment	230.4	1961
9	Individual income	Joint filer credit	225.2	1973
10	Commercial activity	Exclusion of first $1 million of taxable gross reciepts	222.8	2005
11	Corporate franchise	Goodwill, appreciation, and abandoned property of financial institutions	186.8	1933
12	Sales and use	Transportation of persons and property	177.4	1935
13	Sales and use	Tangible personal property used or consumed in agriculture and mining	153	1935
14	Individual income	$20 personal exemption credit	152.5	1983
15	Individual income	Resident credit for income taxed by another state	141.1	1972
16	Individual income	Retirement income credit	135.1	1983
17	Sales and use	Sales to the state, its political subdivisons and certain other states	129.3	1935
18	Sales and use	Value of motor vehicle trade-ins	120.2	1981
19	Sales and use	Tangible personal property used directly in providing public utility services	117.6	1935
20	Commercial activity*	Job creation credit	101.5	1993

*This credit also is available against the individual income tax. It became available against the CAT instead of the corporate franchise tax in Fiscal Year 2009.

Source: Ohio Department of Taxation, Policy Matters Ohio

The report shows four new credits added by the last General Assembly. Two were on the sales tax, one on flight simulators and the other on services and materials used to maintain and repair aircraft (this was subsequently expanded). Two were on the income tax, covering organ donation and military retirement income. The legislature repealed a provision that had allowed consumers to buy up to $300 a month in cigarettes from states with lower taxes and not have to pay the difference. Four tax expenditures were revised: The historic structure rehabilitation credit and the child adoption credit on the income tax, and the sales-tax exemptions on motor vehicles sold in Ohio to nonresidents and for tangible personal property used in electronic publishing. Not all of the tax expenditures identified in the report are substantial: 31 are worth less than $1 million a year.

In light of the state's budget problems, tax cuts that will reduce state and local business taxes by $1 billion or more a year, and research indicating the ineffectiveness of business tax incentives,[13] the conference committee also should reexamine expanded and new tax credits that were approved by both the House and the Senate. These include expansion of the job creation and job retention tax credits and creation of new incentives for film production and "new markets." If any new or expanded credits are approved, they should include sunset provisions so they will expire unless reauthorized by the next General Assembly. A number of states do a regular review of tax expenditures.[14]

Policy Matters Ohio has detailed in two previous reports how tax expenditures permanently ensconced in the tax code do not receive the regular scrutiny that expenditures do, even though they also come out of the state's pocketbook and affect its ability to finance its activities.[15] For example, the largest tax expenditure, the sales and use tax exemption for machinery, equipment, supplies and fuel used in manufacturing, has not been closely reexamined since it was overhauled in 1990. It is worth more than $1.7 billion a year, according to the tax expenditure report. This prevents multiple taxation of the same goods and is employed in some form by most states that have sales and use taxes. However, the sheer size of this expenditure means it should be scrutinized more often.

The curtailment of some tax expenditures – such as the sales tax exemption on prescription drugs and medical supplies -- is neither likely nor desirable. However, others should be scrapped. In a

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[13] See, for instance, Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*. Economic Policy Institute (Washington, D.C.), 2004; Yoonsoo Lee, *Geographic Redistribution of U.S. Manufacturing and the Role of State Development Policy*, Federal Reserve Bank of Cleveland, Working Paper 04-15, December 2004, p. 5, and Richard G.Sheridan, Richard G., David A. Ellis and Richard Marountas, *Taxing Issues, Implications of Tax Expenditures on Ohio's Revenue System*, Federation for Community Planning, October 2002, p. 8.

[14] See *Exempt from Scrutiny: Tax Breaks in Ohio*, February 2007, p.12, available at http://www.policymattersohio.org/ExemptFromScrutiny2007.htm

[15] See *Exempt from Scrutiny: Tax Breaks in Ohio*, February 2007, and *Limiting Loopholes: A Dozen Tax Breaks Ohio Can Do Without*, September 2008. The taxation department noted in the current tax expenditure report: "Unless there is a pre-existing termination date, the expenditures may remain in effect indefinitely with little or no scrutiny by policy makers." Tax expenditure report, p. 1

report last year, Policy Matters Ohio identified a dozen tax loopholes that should be eliminated or limited. These include such tax breaks as:

- The dealers in intangibles tax, an obsolete tax whose elimination has been recommended by two state-commissioned studies on the tax system. This tax allows payday lenders and mortgage brokers to pay a lower tax rate than banks do under the franchise tax.
- The 2006 loosening of the residency test, which allows many affluent individuals to avoid paying the Ohio income tax;
- Three state-financed programs that allow even the wealthiest Ohio homeowners to reduce their property taxes;[16]
- Special-interest breaks for industries and companies, such as the sales-tax exemption on new warehouse machinery and equipment for retailers that ship most of their product out of state.[17]

Beyond a review of tax expenditures for the FY2010-11 budget, the General Assembly should set a date for the phase-out of all tax expenditures identified in the latest report and create a committee to make recommendations on which ones should be renewed.

The tax expenditure report is not a comprehensive list of tax breaks. It does not cover services such as lobbying and debt collection that could be covered under the sales tax, or the amount of tax that nonprofit organizations such as hospitals avoid because they are not subject to the commercial activity tax. Those elements of the tax code that are considered to be an inherent part of the tax base are not listed.[18] In one instance, a refundable tax credit to defray losses of lenders under a state venture capital program, the department said it had no data to make an estimate.[19]

Many of the estimates are approximations, based on ODT analysis of available statistics and reasonable assumptions. In some cases, including the largest tax expenditure, the department has used the same figure for all four years when clearly the amount will not remain identical during that whole period. Christopher Hall of the department's Tax Analysis Division explains that the department did so rather than assume a particular economic growth rate in a volatile economy. The department reduces its estimates if it finds overlapping tax expenditures, in which another tax expenditure is available to the taxpayer for the same item or activity.[20]

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[16] For details on one of these programs, see "Targeting Homestead Exemption Would Save Ohio $118 Million a Year," Policy Matters Ohio, June 2007, available at http://www.policymattersohio.org/pdf/HomesteadExemptionRelease2007_0606.pdf

[17] See *Limiting Loopholes* for details on these tax breaks.

[18] See pp. 2-3 of the report for an explanation of how tax expenditures are defined. The four basic criteria are: That the item reduces, or has the potential to reduce, one of the state's General Revenue Fund taxes; that it would have been part of the defined tax base; that it is not subject to an alternative tax, and that it is subject to change by state legislative action. The taxation department includes the commercial activity tax though it does not contribute directly to the GRF, as the GRF is responsible for covering any shortfalls should CAT revenues be insufficient, and if any CAT tax expenditure were repealed, the GRF would benefit.

[19] See 2009 tax expenditure report, p. 32. An expansion of this credit is being considered in the state budget bill.

[20] See 2009 tax expenditure report, p. 3

Despite its limitations, the tax expenditure report is an important document that is included in the governor's budget by statute.[21] Legislators should use it as they formulate the next budget.

[21] Ohio Revised Code, Section 107.03(F). Policy Matters Ohio made a number of recommendations on how the report could be improved in *Exempt from Scrutiny*, pp. 13-4.

Policy Matters Ohio is a non-profit, non-partisan research institute dedicated to researching an economy that works for all in Ohio. Policy Matters seeks to broaden debate about economic policy by providing research on issues that matter to Ohio's working people and their families. Areas of inquiry for Policy Matters include work, wages, and benefits; education; economic development; energy policy; and tax policy. Generous funding comes from the Joyce, Gund, Cleveland, Public Welfare, KnowledgeWorks, New World, Annie E. Casey, Sisters of Charity and W.K. Kellogg Foundations, the Economic Policy Institute, and Greater Cleveland Community Shares. To those who want a more fair and prosperous economy... Policy Matters.

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