Policy Matters Ohio

Executive Summary
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Problems in the MBR tax cut package

Volatility, uncertainty, unsustainability in shift to new sources

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Gov. John Kasich has proposed income-tax cuts that, according to administration estimates, will total more than $2.6 billion over the next three fiscal years. At the same time, the governor proposed increases in other taxes that would pay for much of these cuts. The new taxes still would not pay for $174 million of the reductions. This is money that will have to be diverted from meeting important Ohio needs, ranging from restoring aid to local governments to making college more affordable.

Even apart from that shortfall, however, there is considerable uncertainty whether the proposed increases in the severance tax on oil and gas, tobacco taxes, and the Commercial Activity Tax will generate the growing, sustainable revenue needed to support the permanent income-tax reduction.

This especially true of the severance tax, a revenue source that may or may not meet forecasts and can be volatile. And while the likely revenues from the other two major tax sources, tobacco taxes and the CAT, are better known, they still pose doubts. Revenues from tobacco taxes have been declining for years, apart from when tax increases have led to revenue spikes. The CAT, the state's major business tax, has been "strongly cyclical," as a top official at the Ohio Department of Taxation testified in 2011. The income tax, too, can decline significantly in an economic slump, but it grows with the economy over the long-term, unlike tobacco taxes, and is not dependent on limited resources that will be used up, like the severance tax.

There is good reason to support increases in the taxes Gov. Kasich has proposed, but not for income-tax rate cuts that will go mostly to affluent Ohioans. It would be financially irresponsible for the General Assembly to approve the tax cuts when the revenues used to back them are so uncertain.

Key findings

- Gov. Kasich's proposed income-tax cuts are not all paid for; an unfunded gap of $174 million impacts public services.
- The balance of the $2.6 billion cuts depends on other tax increases.
- Some of the tax hikes are on resources that are not sustainable over time.
- The severance tax boost, in particular, may not produce the growing, sustainable revenue needed to pay for the tax cuts.
- Tobacco and business taxes also pose doubts.

Severance tax

Taxing the growing oil and gas industry is good public policy. Gov. Kasich's severance tax proposal is simple, transparent and administratively efficient, although the rate needs to be higher to cover the needs of impacted communities and fully restore budget cuts of the last state budget (fiscal years 2012-13). Also problematic is the overly generous exclusion from the tax of $8 million in receipts for each well. On the positive side, the distribution plan addresses local needs, includes a long-term investment fund, and allows for adequate funding for industry regulation and oversight.

However, most of the severance tax proceeds would support income tax cuts, a risky swap of revenue sources. Production in the Utica and Marcellus shale formations so far has not lived up to optimistic projections: severance tax collections as forecast may not replace proposed cuts in the amount projected. As of March 15, 2014, 396 horizontal wells had reported production in the Utica and Marcellus, considerably below key forecasts. On the other hand, if the industry grows robustly, the General Revenue Fund could be increasingly based on uncertain and volatile severance tax collections that are not sustainable over the long term.

Ohio's severance tax is now based on volume. Taxing natural resource extraction based on value, as the administration has proposed, is the right approach because it appropriately measures the worth of what is removed. But this approach has its downside: Had Ohio's tax been based on value over the past decade, collections would have gyrated with price. Sustainability is also an issue, because natural resources don't last forever. The only thing we know is that the resource will be depleted and will stop producing tax revenue; we just don't know when.

The Legislative Service Commission and the of the Ohio Department of Taxation have provided very different estimates of revenue from the severance tax, highlighting the difficulty in making such forecasts. The LSC provided projections from high and low production scenarios; in either case, its estimate was far lower – between $201 million and $355 million – than the taxation department's.

The administration's severance-tax proposal will be considered as part of ongoing deliberations on another proposal, HB 375 in the House Ways and Means Committee. Compromises between the governor and the House may be made and new proposals presented. We raise concern here about volatility, uncertainty and sustainability in the context of the governor's proposal, but these issues should be taken into consideration in forthcoming proposals as well.

CAT and tobacco taxes

The Kasich tax proposal calls for increasing the CAT from 0.26 percent to 0.3 percent on Ohio gross receipts. The recession saw CAT taxable gross receipts fall by more than 15 percent on a year-to-year basis for three consecutive quarters. In fiscal years 2009 and 2010, because CAT receipts fell short of estimates, the General Revenue Fund had to subsidize the reimbursement of local governments and school districts for phase-out of the tangible personal property tax. Other factors also will affect future CAT revenues. Of course, the income tax also fluctuates, and collections fell dramatically during the recession. And some of the administration's revenue estimates could reduce the gap between revenues that would be reduced by proposed tax cuts and those gained from tax increases.

The administration proposes raising the cigarette tax by 60 cents over two years, and increasing other tobacco taxes. As noted, revenue from tobacco taxes has been falling. The taxation department estimates of additional tobacco-tax revenue appear to have been conservative, assuming significant declines in cigarette consumption. But there is a problem over the long term: the income tax grows while tobacco taxes shrink. That makes the cigarette tax a bad fit as a revenue replacement.

Together with the uncertainty, volatility and ultimate unsustainability of the severance tax, it is clear that approving income-tax cuts based on these revenue sources would be an irresponsible move on the part of the state legislature.