

Retooling OHIO

A bulletin for leaders on policy issues critical to Ohio manufacturers

THE POLICY POINT: *A Competitive Ohio Tax System*

Few people would dispute that tax policy has a major impact on a state's business climate and ability to stimulate investment, growth and job creation. But, it can be difficult to reach consensus on exactly how favorable or unfavorable a given state's tax policies are. There is no shortage of reports, statistics and rankings on the subject – however, they do not always yield the same conclusions.

The purpose of this edition of Retooling Ohio is to help inform tax policy discussions among leaders in Ohio. To develop informed views on appropriate tax policy strategy, it is useful to study history and context. To that end, this document provides three things: (1) a brief history of key Ohio tax reforms implemented over the last several years, (2) an overview of recent analyses of Ohio's tax policies compared to other states, and (3) a discussion of major tax policy concerns and priorities.

A Snapshot of Recent Major Tax Reforms in Ohio

In June 2005, the Ohio General Assembly approved a landmark tax reform package (HB 66) that represented a major overhaul of state tax policy. Prior to HB 66, Ohio's tax code was widely regarded to be outdated – and in particular, a disincentive to new investment and unfair in favoring some industries over others.

The reforms approved in 2005 were designed to achieve the following objectives:

- **Reduce overall tax rates** (for businesses and individuals) to make Ohio more competitive for investment and talent
- **Eliminate tax on investment** to spur innovation, growth and job creation

- **Broaden the tax base** to treat similar businesses in a similar fashion and spread the tax burden more equitably among all sectors of the economy
- **Provide more stable, predictable revenues** for essential state programs and services
- **Simplify compliance** with state tax requirements

The underlying economic strategy for the HB 66 reforms was to stimulate robust economic growth by eliminating obstacles to investment and capital formation. Reform advocates sought a system that would increase capital investment, gross state product, personal income and job creation – and that the resulting economic growth would generate increased tax revenues. To realize this vision, HB 66 authorized the following structural changes to the state's tax system, which have been implemented over a five-year period:

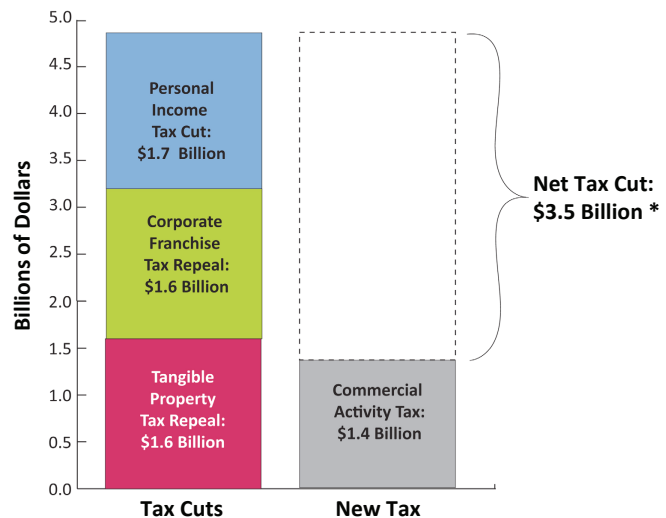
- **Phased out the tangible personal property tax** on most business inventory, manufacturing machinery and equipment, furniture and fixtures, long considered the most anti-competitive element of Ohio's tax system
- **Phased out the high-rate, narrow-based, loophole-ridden corporation franchise tax** on profits and net worth for most companies
- **Phased in a new Commercial Activities Tax (CAT)**, a broad-based, low-rate tax on gross receipts for virtually all types of businesses with annual gross receipts of \$150,000 or more
- **Phased in a reduction in personal income tax rates** for all taxpayers, including owners of S-corporations, typically small businesses, who essentially pay their business tax through their personal income tax

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The only component of the 2005 reforms that has not been fully implemented is the final installment of the 21 percent personal income tax reduction that was being phased in over five years. The final 4.2 percent cut, scheduled to be implemented in tax year 2009, has been temporarily delayed by the Ohio General Assembly until tax year 2011 to help balance the state budget.

According to Ohio Tax Commissioner Richard Levin, HB 66's phased-in reforms resulted in a tax cut of \$3.5 billion for FY 2010. When other HB 66 changes that took immediate effect are factored in (i.e., increases in sales and cigarette taxes, repeal of the business real estate tax rollback), annual tax savings for FY 2010 still total \$2.1 billion.

HB 66's Phased-In Business Tax Reform Savings: \$3.5 Billion (FY 2010)



Source: Ohio Tax Commissioner Richard Levin, presentation to Ohio Tax Conference, Jan. 28, 2010

Note: This chart shows the impact of phased-in business and personal income tax reforms provided under HB 66. When additional HB 66 changes that took immediate effect are also considered (increased sales tax and cigarette tax, repealed business real estate tax rollback), annual savings from HB 66 savings are \$2.1 billion in FY2010.

Delaying Final Phase of Income Tax Best of Limited Options Available

As fallout from the nation's economic recession took its toll on state tax revenues, the already challenging job of balancing Ohio's state budget became even more difficult. From 2007 well into 2009, spending cuts helped keep the budget in balance. In September 2009, however, an Ohio Supreme Court ruling effectively prevented the state from using video lottery revenue in the FY 2010-11 biennial state budget – a ruling that created an \$850 million hole.

That hole was plugged, and the budget was balanced, by policymakers' decision to temporarily delay implementation of the final 4.2 percent of the 21 percent reduction in personal income tax that HB 66 had been phasing in over five

years. In the absence of any serious or viable alternative, the OMA – together with many other major statewide business organizations and most major daily newspaper editorial writers who had joined us in supporting HB 66 back in 2005 – reluctantly supported HB 318, the budget corrections bill, which delayed the final installment of the income tax reduction.

The OMA's position was simple: Balancing the state budget – as Ohio law requires – by temporarily postponing the last scheduled part of the of HB 66's phased-in income tax reduction was the best of the limited and difficult policy options available. Our support for HB 318 was qualified, however, and contained a clear directive to Ohio's elected leaders to turn their focus going forward to cost-down activities that improve efficiency without compromising value.

Clearing the Air Surrounding Ohio's Tax Policy Climate

So, where does Ohio stack up compared to other states in the region and nationally?

A frequent source of criticism of Ohio's tax code is the Washington D.C.-based tax research group called the **Tax Foundation**, which attracts much attention each year with the release of its annual State Business Tax Climate Index (SBTCI). The SBTCI includes five component indices for corporate tax, individual income tax, sales tax, unemployment tax and property tax.

The group's 2010 report contends that Ohio's "high tax burden" and "unfriendly tax environment for business" are driving away investment, stunting growth and hampering job creation. According to the Tax Foundation, Ohio has the 7th-highest state and local tax burden in the country and one of the worst business tax climates in the nation, ranking 47th out of 50 states on the 2010 Index.

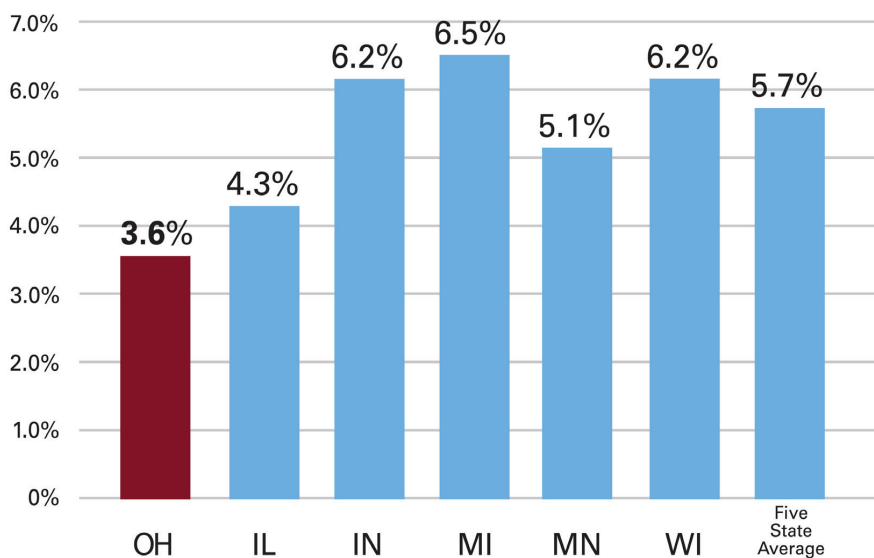
Other parties have taken issue with the Tax Foundation findings. **The Education Tax Policy Institute (ETPI)**, for example, has concluded that the Tax Foundation's business tax climate index "provides a poor indication of Ohio's true tax situation." ETPI cites a number of shortcomings in the Tax Foundation methodology. For example, it focuses on tax structure rather than on measuring actual tax levels – so a state with a more attractive tax structure (in the Tax Foundation's eyes) but higher actual taxes may rank more favorably than a state with a less attractive structure but lower actual taxes.

Such is the case with Ohio. While Ohio's state tax burden on business is quite low after tax reform, the Tax Foundation's generally unfavorable ranking is due largely to its dislike of a gross-receipts-based tax structure such as Ohio implemented with the Commercial Activity Tax. Also, according to ETPI, the Tax Foundation index is "based wholly on subjective judgments" about the relative role of different tax factors.

The fact is, many other reports and data paint a considerably more favorable view of Ohio's business tax climate than the view advanced by the Tax Foundation. Consider the following examples:

- A January 2009 **Ernst & Young study of total state and local business taxes** found that Ohio ranked:
 - **20th best nationally** for business taxes as a share of total state and local taxes (FY 2008),
 - **18th best nationally** for business taxes as a share of private sector Gross State Product (FY 2008), and
 - **23rd most favorably nationally** for ratio of business taxes to government expenditures benefitting businesses (FY 2006).
- According to analysis conducted by Ernst & Young for the Ohio Business Development Coalition, Ohio has the **lowest effective tax rates on new capital investments in the Midwest.**

Effective Tax Rates on New Capital Investments



Ernst & Young analysis. The effective state and local tax rates (taxes divided by before-tax income) on new capital investments are calculated for four selected manufacturing industries (food processing, pharmaceuticals, electronic components, and motor vehicles) and three service industries (information services, computer services and research and development). The representative firms are multi-state companies selling primarily in regional national and international markets. The included state and local taxes are those imposed directly on a company's new capital investments (machinery, plant and equipment): corporate income and net worth taxes, property taxes, the sales tax imposed on the purchases of capital equipment and structures and the Commercial Activity Tax. The tax parameters for each state are based on the tax features scheduled to be in effect by 2010, the year that Ohio's tax changes are fully effective.

Is Tax Reform Working in Ohio?

It's reasonable to ask, "Are the HB 66 tax reforms working as intended?" The economic recession of the past two to three years makes it difficult – if not impossible – to assess the true impact of the reforms on Ohio's economy. The recession has almost certainly stunted some of the growth reform advocates expected to see. On the job creation side, for example, Ohio has seen a net loss of jobs since HB 66 was approved.

On the investment side, however, the picture is much more positive. In 2009, Ohio won *Site Selection* magazine's "Governor's Cup" for an unprecedented fourth consecutive year. The Governor's Cup is awarded annually to the state having the most major business expansions in the nation. Qualifying projects, which include new developments and expansions of existing companies, must involve at least \$1 million in investment, 20,000 square feet of new work space and 50 new jobs. In 2009, Ohio led the nation with 381 projects meeting these criteria.

Considering that HB 66 has been phased in over five years, and keeping in mind the impact of the lingering national and state recession, Ohio manufacturers believe it's too early to draw definitive conclusions about the impact of the HB 66 reforms. They need to be allowed to come fully into force before we can accurately measure their true impact on the state's economy.

- The **Small Business & Entrepreneurship (SBE) Council's Business Tax Index** ranks states from best to worst regarding the cost of their tax systems on entrepreneurship and small business. In SBE's 2008 index, Ohio's state tax system ranked as the **14th best nationally**.
- In the **Anderson Economic Group's third annual State Business Tax Burden Rankings** (2008), Ohio tied for the **third-lowest business tax burden** as measured by business taxes as a share of profits.
- In March 2010, the **Federation of Tax Administrators** released an analysis of new data from the U.S. Census Bureau showing that **Ohio's state tax burden in FY 2009 was 16th lowest in the nation on a per capita basis and 18th lowest when measured as a percentage of Ohioans' personal income**.
- According to the Ohio Department of Taxation, Ohio is **one of just 6 states** that do not tax corporate profits and **one of just 10 states** that do not tax business personal property.

This composite of data, which provides multiple perspectives on Ohio's overall tax climate, provides a more thorough view of the competitiveness of Ohio's revamped tax system than any single study can offer.

Notable Progress Made – And More Improvements to Consider

From manufacturers' perspective, the business tax climate in Ohio today is certainly more conducive to investment, growth and job creation than it was five years ago.

The tax cuts and reforms launched in 2005 have helped Ohio businesses boost productivity, reduce operating costs and maximize profits, while also rewarding

entrepreneurialism. And the broad-based, low-rate Commercial Activities Tax has created an equitable and level playing field.

While Ohio's tax system has improved in recent years, there is plenty of room for additional improvement as well as a continuing need for vigilance to protect recent gains.

Tax policy priorities for the short term begin with **preserving the integrity of the 2005 reforms**. Ohio must adopt a zero-tolerance response to any efforts to (a) carve out exemptions or credits to avoid paying the CAT or (b) earmark any portion of CAT revenues for specific government services.

Efforts to avoid paying the CAT, whether via exemptions or credits, undermine the broad-base, low-rate philosophy that is key to the CAT's success. The more exemptions there are, the narrower the tax base will become. Increased stress on tax revenues will create pressure on policymakers to increase the tax rate to recover the lost dollars. As with exemptions and credits, earmarking any category of CAT receipts unfairly creates winners and losers and ties the hands

of the General Assembly to engage in the normal give and take of the state budgeting process where competing interests are evaluated and spending priorities are established.

To date, efforts to weaken the CAT have been largely unsuccessful. Exemptions have been sought by the motor fuel industry and grocery industry, with the grocers' challenge being rejected by the Ohio Supreme Court. Such efforts will certainly continue in both legislative and judicial arenas. Thwarting these efforts must be a priority.

Additional tax policy priorities include the following:

- **Improve Ohio's tax appeals process** that, due to budget cuts and severe staffing cutbacks, has helped create such a backlog of cases at the Ohio Board of Tax Appeals that it now routinely takes two years to advance from the date of filing an appeal to the date of the first hearing. As the backlog of cases grows, collection of tax revenues slows because a taxpayer filing an appeal often is not required to submit payment until the case is resolved. Furthermore, this situation

Unemployment Compensation Amplifies Impact of Tax Burden

State policymakers evaluating the overall impact of Ohio's business tax burden should not overlook the impact of Ohio's mandatory employer-paid unemployment "tax." While technically an insurance premium, this is a government-imposed cost that all businesses are required to incur – and it increasingly is subject to rate increases.

For nearly a decade Ohio's unemployment compensation fund has paid out more than it has collected; by the end of 2010, it will be \$3 billion in

debt to the federal government. While the federal government has funded significant extensions in unemployment benefits, **the underlying structure of the state fund eventually will need to be addressed.**

The OMA has been working with state lawmakers in recent months to prevent unfunded new expansions of the unemployment premium. Without action by state leaders, the federal government will effectively force additional tax increases on employers, further illustrating the critical need to hold state business taxes in line.

has resulted in a downgrade in the Council on State Taxation rating of Ohio's appeals process and could lead to further downgrades in the future if the situation is not remedied.

- **Improve energy cost**

competitiveness by (a) enabling multi-site industrial consumers to pool electricity consumption levels in order to qualify for self assessment of kWh tax and (b) lowering the self-assessment threshold to allow a broader group of industrial and commercial consumers to qualify.

- **Promote heightened public scrutiny of the trend of funding government programs with fee revenue**

instead of general fund revenue to ensure transparency regarding the true cost of government and the rate of its growth. Protection of our environment and natural resources is of value to all Ohioans, but those state functions are now funded largely by fees or taxes paid by businesses. Additionally, the growing popularity of so called "public-private partnerships" frequently comes with new hidden taxes on businesses, shrouding the true cost of necessary public projects.

- **Improve efficiency and certainty in Ohio's business tax incentive process.**

For Ohio to strengthen its ability to attract new investments and business expansions, the state's economic development process needs to be streamlined and assurances provided that incentives granted in writing will be delivered and not withdrawn due to state budget challenges. Additionally, Ohio should consider repealing the state's duplicative "look-back" audit and "accountability" program approved in 2009, which requires the Ohio Attorney General to pursue recovery from companies awarded government incentives but that have not achieved their growth targets – regardless of prevailing economic conditions. A

"look-back" audit function already exists under the authority of the Ohio Department of Development, so a secondary audit for this purpose is redundant and unnecessary.

- **Eliminate Ohio's estate tax.** The estate tax serves as a disincentive to invest in existing businesses and as an impediment to the capital formation that is so vital to Ohio's economy. It has a potentially onerous impact on thousands of small- and medium-size family businesses; it burdens those individuals who create economic opportunities for their communities and want to be able to continue to do so; and it encourages tax avoidance strategies, diverting capital that could be used to acquire new technology or to create new jobs. The estate tax should be repealed.

- **Guard against trends to wholly exempt certain forms of energy generation from taxation.** Bipartisan legislation is pending in the Ohio General Assembly that would exempt wind and solar generation from Ohio's tangible personal property tax. Energy production is one of the few industries that remain subject to the tangible personal property tax. If policymakers choose to exempt any form of renewable energy generation from the tangible personal property tax, they also should insist that these industries be subject to the Commercial Activity Tax, like virtually all other business activity in our state, or to some other comparable business tax. Additionally, to the extent that the tax code is used to address energy policy, it is important to ensure that the state's tax policy priorities align with its energy policy priorities.

- **Streamline and simplify the sales tax.** Over time Ohio's state sales tax, much like the former corporate franchise tax, has become riddled with exemptions, carve-outs and credits. While some carve-outs have

more merit than others (because Ohio needs to be competitive with other states' sales tax schemes), the resulting diminished sales tax base puts pressure on the remaining taxpayers – in other words, the tax rate must rise to make up for the exempted taxpayers. The time is right for a comprehensive examination of the state sales tax by lawmakers.

An Imperative to Address Ohio's Structural Budget Deficit

Any discussion of the effectiveness of state tax policy must also acknowledge the critical need to take a close, hard look at state government spending practices. While the sluggish economy certainly has contributed to a decline in state tax revenues, compounding already limited budget-balancing options available to policymakers, the fact is Ohio faces a huge structural budget deficit in which state spending is dramatically out of balance with state revenue collection.

Ohio's most recent biennial state budget process was particularly sobering as a constitutionally required balanced budget was achieved only through a combination of painful cuts, depletion of the state's Rainy Day Fund, one-time federal stimulus dollars, delay of income tax rate reductions and the deferral of certain expenses to the next biennium. Most projections for the FY 2012-13 state biennial budget point to an expected deficit of \$6 billion to \$8 billion – a situation that will create enormous pressure to raise taxes, perhaps by rolling back some of the cuts achieved through HB 66.

A structural deficit of such magnitude will not be closed easily. Confronting this reality without derailing the progress brought about by the HB 66 reforms will require an honest, hard look at the spending side and – just as importantly – united, bipartisan support to reign

in unwarranted expansion of local government entities and services. Or, as a March 2010 editorial in the *Akron Beacon Journal* observed, “Such budget realities underscore the need for state and local governments to think more creatively about how they provide services.”

Tackling the state budget’s structural deficit problem will require a commitment from state leaders to seriously explore opportunities for consolidation of school districts, taxing districts, libraries and other local government entities. The 2010 Restoring Prosperity Report from the Brookings Institution and the Greater Ohio Policy Center noted that Ohio has more than 600 school districts and 3,800 cities, villages and townships, resulting in enormous – and costly – duplication of infrastructure, staffing and services. According to the report, Ohio has the ninth-highest local tax burden in the nation (compared to the 34th-highest state tax burden).

Manufacturers urge Ohio’s elected leaders to commit to cost-down activities that increase efficiency without compromising value, while also protecting the state’s most vulnerable citizens and maintaining the necessary investment in job creation. While there are many areas on the spending side that are important to manufacturers – e.g., education, infrastructure, workforce development – state leaders should strive to resolve Ohio’s continuing budget challenges without sacrificing an economically competitive tax structure.

General Principles for Effective Tax Policy

For Ohio to be successful in a global economy, the state’s tax structure must encourage investment and growth, and it must be competitive nationally and internationally. A globally competitive tax structure embodies the following characteristics:

- Certainty
- Equity/fairness
- Simplicity
- Transparency

Economy of collection and convenience of payment also are important considerations.

As a general rule, manufacturers support efforts to broaden the tax base, which enables lower rates. To preserve the integrity of the broad tax base and ensure fairness, credits and exemptions should be reduced and discouraged. Where needed, government incentives are better structured as grants than as tax credits. And, in general, earmarking and dedicating tax revenue should be discouraged.

Finally, good tax policy generates necessary revenues to support the essential functions of government. Good budgeting and spending restraint, at all levels of government, are vital to ensure a competitive tax environment.

*The mission of The Ohio
Manufacturers' Association is to
protect and grow Ohio manufacturing.
Through the OMA, manufacturers
and manufacturing stakeholders
work directly with the members of
the Ohio General Assembly, state
regulatory agencies, the judiciary
community and statewide media with
the sole focus of improving business
conditions for manufacturers in Ohio.*



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