

**Thinking the  
Unthinkable**  
*Finding Common  
Ground for  
Resolving Ohio's  
Fiscal Crisis*

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## *Thinking the Unthinkable: Executive Summary*

Ohio's governor and General Assembly will confront an enormously challenging budget early next year. This analysis aims at helping move the public discussion in Ohio to a deeper realization of the details of the state's fiscal crisis, and consideration of some of the options for structural reforms.

The sheer magnitude of changes necessary to get into balance is breathtaking. Adopting them, or some combination of equal magnitude, would amount to a pragmatic first step in the face of an unpredictable and evolving economy, laying the groundwork for more fundamental opportunities to strengthen public services and invest in future prosperity.

*Thinking the Unthinkable: Finding Common Ground for Resolving Ohio's Fiscal Crisis* is written with the hope of bringing into focus the spirit of collaboration in common-cause that will be critical to overcoming the customarily contentious interest group politics in Columbus, and heightened state of ideological sparring of our "culture wars." That spirit will in turn require a willingness by all parties to think the unthinkable – in both pursuing new ideas and making concessions from cherished programs and special benefits provided under tax law.

The impact of the Great Recession will not be new to the 2012-2013 biennial budget, but the manner of addressing it will have to be. State spending in the current budget relies heavily on one-time savings and sources of revenue totaling over \$8 billion, or about 20 percent of state General Revenue Fund (GRF) spending. These resources are not expected to be available again.

Constrained by a constitutional prohibition on borrowing for operating purposes, the State of Ohio has little choice but to realign revenue and spending. Based on our analysis of state revenue and spending, and significant uncertainties regarding the economy and several specific areas of state finance, **the range of the structural deficit during the 2012-2013 biennium may be forecast to be from \$6 billion to \$7 billion.**

A variety of strategies, aimed principally at stabilizing state finances in the short-term, will be required to address it. In light of the extensive use of one-time revenues and savings during the current budget, exhaustion of the state's Budget Stabilization Fund, and the evolution of tax and spending policy over the past three decades, **the necessary "balanced approach" in Ohio might be reduced to a three-part strategy, utilizing approximately equal shares of one-third each in new tax revenue, reduced tax expenditures, and reduced programmatic expenditures.**

This represents a viable and fair way of sharing the sacrifices required to stabilize state finances. Throughout, consideration has been given to both the short-term impact on people and businesses, and implications for the future prosperity of the state.

Some principles will be important to follow:

- Policy makers should balance the additional tax burden between individuals and businesses.
- Initiating regular oversight of tax exemptions, credits, deductions, and other breaks collectively known as tax expenditures will better assure the efficacy and fairness of this spending over the long term, and provide greater transparency to the budget process.
- The importance of investing in Ohio's youth can be addressed by sustaining through the next biennium SFY 2011 spending levels for early childhood development, libraries, and instructional, transportation, and student aid subsidies for primary and secondary, and higher education. Ohio's school districts, colleges, and universities should contribute their fair share to deficit reduction through other GRF subsidies.
- Cost cutting in human service programs, especially Medicaid, will be necessary to balance the budget.
- Reframing the Local Government Fund offers a way to both cut costs and assist local governments in achieving economies through collaboration and consolidation of services.

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- Investing new resources to stabilize Ohio's behavioral health programs (mental health, alcohol, and drug addiction services), and commissioning work on the future of that system in light of national health reform, should be a top priority.

### **Taxes**

Several conclusions with regard to income and taxes in Ohio are of central importance in considering options for the next biennium.

While incomes for most Americans have stagnated for three decades, those of Ohioans have generally stagnated at lower levels, reducing the capacity of the middle class in particular to bear additional tax burdens. However, the wealthiest fifth of Ohio taxpayers have enjoyed soaring incomes for over 20 years. The regressive effects of combined state and local taxes in Ohio take a larger share of middle class incomes than the wealthy.

Business taxes, as a proportion of state tax revenue, have been in steady decline for several decades, and the long-range implications of the 2005 tax overhaul in this regard are as yet unclear. However, it is clear that the combined effects of state personal income and business tax changes during the middle of the last decade have contributed significantly to the structural deficit.

There are reasonable approaches to increasing revenue, beginning with revisiting the 2005 tax changes which lowered overall income tax rates from levels put in place with bipartisan support in the early 1990s. Returning to the former upper bracket rate of 7.5 percent for those whose incomes have outpaced the vast majority of Ohioans, would affect just over 2 percent of taxpayers, while raising almost \$900 million over the biennium. Consideration might be given to mitigating the regressive effects of Ohio state and local taxes and boosting incomes for those in low-wage jobs by adopting a refundable state Earned Income Tax Credit, structured like the federal EITC, as proposed by Policy Matters Ohio and others. Twenty-four states plus the District of Columbia have such a credit.

The decades-long decline in the proportion of taxes paid by business, from over 40 percent in the 1970s to about 25 percent today, has been covered by relative increases in taxes paid by individuals. This imbalance might be addressed in part by adjusting the rate of the CAT, which currently is set too low to reimburse schools and local governments for the full amount of tangible property tax revenue lost from the latter tax's repeal in 2005. An increase of 0.08 percent would yield enough to cover the estimated cost of GRF subsidies to schools and local governments for loss of revenue from the tangible personal property tax (repealed in 2005), and return approximately \$400 million over the biennium to the GRF.

The sales tax also offers an alternative for raising revenue during the next biennium. Temporary sales tax increases have been adopted under governors and General Assemblies of both parties during recessionary periods. An increase of one-half of one percent would raise about \$ 1.3 billion over the biennium.

Policy makers could also consider at least temporarily retaining part of the income component of the corporate franchise tax. It would be reasonable to expect that retaining one-fifth of the former rate would yield about \$250 million per year through a temporary tax during the next biennium; depending on the performance of the CAT in an expanding economy, rates could be subsequently rolled back or eliminated in future biennia.

### **Tax Expenditures**

Ending various unproductive tax expenditures is another essential tool for straightening out Ohio's finances. State government loses over \$7 billion per year to deductions, credits, and exemptions for an enormous va-

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riety of special purposes. Considering the state's dire financial condition, it is reasonable to target this category of spending for an equal one-third share of the amount needed to close the structural deficit. Often, supporters of these exemptions justify them on the grounds of economic development and job creation. Equally often, the rationales are long on theory and short on measurable evidence. This spending receives nothing even approaching the routine periodic scrutiny given to programmatic expenditures in the biennial budget process. Long-term, the state would benefit by developing tools to evaluate and monitor these expenditures, much like the November, 2009, recommendations of the Ohio Society of CPAs regarding programmatic expenditures.

In addition to identifying tax expenditure reductions for the next biennium, the governor and General Assembly might consider including line items for tax expenditures in biennial budget legislation, and adopting a schedule for sunseting the tax code provisions governing them on a rotating basis over two or three biennia. This would assure that they receive the routine legislative scrutiny that is applied to programmatic expenditures every two years, and that the burden of demonstrating their efficacy is placed on equal footing with education, public safety, civil defense, human services, parks, natural resources, and other programmatic spending.

### **Programmatic Expenditures**

If one-third of the biennial structural deficit is to be closed by reductions in programmatic expenditures, funding for human services will bear a significant share of reductions. In part, this is due to their share of total spending, representing 46.3 percent of GRF outlays, and 44.1 percent of total state spending. The impact of including human services in state budget cuts would leave the vast majority of the safety net intact.

Several alternative approaches to achieving spending cuts of \$1 billion-plus per year might be combined in various ways to cover one-third of the structural deficit:

- Reduce Medicaid in ways that would not affect eligibility.
- Reduce State-Fund-Only Human Service Line Items.
- Reduce Non-Formula and Non-Federal Match Subsidies for Primary and Secondary Education.
- Reduce Non-Formula, Non-Student Aid, and Non-Federal Match Subsidies for Higher Education.
- Reduce General Government GRF Appropriations (except debt service).
- Means Test Subsidies for Property Tax Relief, reducing roll backs on more expensive properties.
- Restructure and reduce payments through the Local Government Fund.
- Phase in 10 percent reduction in prison population over the biennium.

While addressing the immediate effects of an uncertain economy and structural deficit, concurrent initiatives to address long-term problems should be pursued. Blue ribbon panels on (1) the dysfunctional mix of state and local taxes, (2) Ohio's faltering behavioral health system, and (3) Ohio's under-invested public health system, could set the stage for fundamental reforms in the future. Any ensuing tax reforms will have to include provisions for retiring the multi-billion dollar Unemployment Insurance Trust Fund debt and replenishing the state's Budget Stabilization (or "Rainy Day") Fund.

Ohio's elected leaders, like their peers around the country, have many practical alternatives for stabilizing the operation and finance of a state government that is in serious trouble. If successful in enacting a fair and balanced package, they could lay the groundwork for more strategic initiatives that can carry the Buckeye State into a new era of rising hopes and prosperity.

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