

State Budgeting Matters

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The governor faces many challenges in producing and maintaining a balanced budget that meets Ohio's needs.

This series is an opportunity for our readers to get involved by e-mailing their Ohio budget questions to our Ohio budget expert, Richard G. Sheridan, at rsheridan@CommunitySolutions.com.

Please note that Richard G. Sheridan's opinions are not necessarily those of The Center for Community Solutions.

Creative Budgeting

This article was written before the introduction of the governor's FY 2010 – FY 2011 budget request to the legislature. However, it is written with the recognition that whatever the request contains, it will be subject to contentious review and extensive modification by the legislature. Before a final budget is enacted, it is likely that there will be an increase in revenues, and reductions in spending, beyond whatever is proposed by the governor. The difficulty for legislators will be in deciding which revenues to raise, by how much, and how to make reductions in spending that are thoughtful and serve a valid public purpose. Adverse economic times, such as the state and its citizens are now facing, can provide an opportunity to make policy decisions that would not be possible in better times:

- Instead of taking the kind of “slash and burn” approach to budget-cutting, evidenced in the responses of many state agencies to Governor Strickland's request that they indicate how they would respond to a 25 percent budget cut (See *SBM* Volume 5, Issue 1), there are ways to change public policy that would make cuts of that magnitude far more palatable and provide long-term benefits;
- Instead of considering the continuation of one-time revenue enhancements to shore up a sagging budget, the result of which is to make either tax increases or budget cuts even larger than they would have been, thoughtful changes in the tax code could result in future budget stability; and
- Instead of raising the sales tax just because it is easy to do so, tax increases could, if enacted, be based on making the state's tax code more equitable.

The object of this article is to discuss creative ways of balancing the state budget without resorting to “slash and burn” cutting and which ways will produce long-term beneficial effects. However, it is also recognized that Ohio is facing a serious structural budget deficit and short-term remedies will do nothing but postpone, and probably accelerate the difficulty, the inevitable need to re-examine the state's tax structure for the purpose of providing future budget stability.

Changing Spending Policy

Before Christmas, the Office of Budget and Management (OBM) issued a report, “What Might It Mean If All Agencies Took a 25% Funding Cut?” Predictably, particularly since this was an exercise that none expected to be seriously considered, the responses were dire but unthoughtful. Per pupil school aid would be cut. Institutions would close. Staff would be laid off.¹ Instead of looking at the probability of reductions in spending as mathematically applied reductions

¹ Those interested in a more complete list of the responses are directed to “That Was The Week That Was,” *State Budgeting Matters*, Volume 5, Issue 1, January 9, 2008.



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to be accommodated within the context of existing state programs and policies guiding them, it would be more useful to the state and its citizens if the reductions were viewed, especially by the legislature, as an opportunity to review those existing policies and programs. Which policies should be changed? Which programs should be eliminated? Those are the kinds of questions that reduced circumstances permit when expanding revenues do not.

These are the kinds of questions that the legislature could ask as they struggle with balancing the next (and future) state budget:

- Why should the state provide instructional grants to part-time higher education students?
- Should mandatory adult correction sentencing laws, with a view to reducing prison populations, be re-examined?
- Should selected human services programs be turned over to the counties with fixed block grant state support?
- Should the policy that permits counties to send the state unruly and delinquent children be re-examined?
- Should enrollment at all, or selected, state institutions of higher learning be capped?
- Should the policy of providing state aid for transporting high school students be re-examined?

This list could go on and on. The point is, many such policies in bad economic times could be rightfully re-examined and, if changed, could result in more thoughtful "budget cutting" than was demonstrated in the "25 percent Cut" list produced by agencies at OBM's behest prior to the introduction of the governor's budget request.

Non-Tax Tax Increases

Politicians are always looking for ways to raise taxes that will not appear to be tax increases. They may argue that unless it is an increase in the rate of (sales,

individual income, public utility, or other) a general tax then it is not really a tax increase. For example, is a cigarette rate increase a tax increase? Why no, it is argued, because that tax only applies to the unfortunately-addicted. The same is true of an increase in the alcohol beverage tax. Expanding the sales tax base by getting rid of tax exemptions and credits previously voted is, of course, not to be considered a tax increase. Getting rid of a credit to the personal income tax? Probably not. Raising revenues and raising taxes are somehow considered to be separate and distinguishable acts.

Operating on the principle that there are some tax increases that politicians are willing to vote for, maintaining they have not violated any "pledges" they may have made to voters to get re-elected, here are

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some examples of "non-tax tax increases" that could raise substantial amounts of money.

The Property Tax Rollback.

Back in the 1970s, when the legislature agreed to institute the state's first individual and corporate income tax, a trade-off was promised. Residential property taxes would be reduced by 10 percent and the state would pay local governments, mostly schools, for the loss of revenue that results. However, somewhere along the way legislators expanded their promise. They included commercial and industrial property in the rollback costing the state hundreds of millions of dollars annually in state General Revenue Fund (GRF) money used to repay local governments for the resultant loss of property tax revenues. A decade later they expanded and raised the rate to 12.5 percent for residential property. There are numerous variations by which additional state revenue could be raised by re-examining the justification for the continuation of the property tax rollback, including capping it at a specific dollar amount.

The Estate Tax. For some unknown reason, in 1989, the state decided to increase the amount that surviv-

ing spouses can inherit without paying any state inheritance tax from \$500,000 to \$1 million. A reconsideration of that decision could raise hundreds of millions of dollars.

Senior Citizens. There are a number of state tax benefits that apply to senior citizens just because they are elderly—not because they need it. The recent expansion of the homestead property tax exemption to every senior citizen is one example of this. The federal government looked at this issue and made some Social Security payments subject to the federal income tax. Because one is old and wealthy does not mean one is entitled not to pay a fair share of taxes. In Ohio, one of the tax breaks enjoyed by elderly persons is a \$50 senior citizen credit to the personal income tax. If this were means tested, Ohio could raise tens of millions of dollars in additional GRF tax revenues each year. Furthermore, since 1983, all states have had the right to tax Social Security benefits but only a few states, not including Ohio, have chosen to do so. As to pensions and other retirement income, various tax exemptions also exclude these regardless of the overall income of the taxpayer.

Other Means Testing. Nationally, the notion of means-testing has taken hold in a number of interesting areas. What about means-testing the sales tax exemption on food? The intent of the tax exemption was to assist low-income families from the regressive tax burden of the sales tax. But who else benefits? Those who go through the grocery lines purchasing lobster, snails, and caviar. A way to deal with this is to tax all food but offer an income tax credit for low-income residents as several states do; a refundable credit would deal with the problem of persons with no income. Other options including phasing-out personal income tax credits at high-income levels, or doing the same thing with the standard deduction.

Privatization and Asset Disposal. A number of states have decided to turn over a whole series of activities to private operation. These include state parks, snow removal, lab testing of environmental samples, inspections of state facilities such as prisons, and the administration of the Medicaid system. Privatization

could be extended to research, public service, and outreach at individual state universities and colleges. The test that should be applied to candidates for privatization is “any service for which performance requirements can be identified and measured precisely.”

Municipally-Owned Utilities. Ohio does not apply the public utility tax to municipally-owned utilities. That places residents fortunate enough to live in areas serviced by such utilities in the enviable position of paying less for their utility services than their neighbors whose bill includes the cost of the state public utility tax. Getting rid of this exemption could raise hundreds of millions of dollars a year. And, while the state is thinking about it, they might also consider the fact that Ohio is one of the few states that treats utilities differently from other corporations. Placing them under the Commercial Activity Tax structure and repealing the public utility tax would also raise hundreds of additional dollars annually.

Some other examples of non-tax revenue options include:

- Increase inheritance tax rates.
- Repeal special tax treatment for dealers in intangibles.
- Expand the sales tax base to include coin-operated games, cable television, magazine subscriptions, and for-hire freight transportation.
- Eliminate the joint filer credit for high-income persons.
- Tax income earned by trusts.
- Increase liquor profits.
- Refinance state debt at lower interest rates.
- Institute a tax amnesty program.
- Enhance the enforcement of existing tax laws.
- Institute new user charges for selected services currently provided using 100 percent GRF funds.
- Impose a surcharge on existing fees.
- Convert selected grant programs (e.g., the instructional grant program for higher income families) to loan programs.
- Accelerate the payment of real property taxes (currently the state collects these 12 months in ar-

rears) and reduce state payments to local governments (notably school districts) by the amount of the increased collections.

It may well be that the legislature will “bite the bullet” and actually raise taxes to provide the kind of long-term stability needed to enable the state to fulfill its constitutional responsibility to provide for the education, health, and welfare of its citizens, as well as enhancing economic development in the state. In that case, the issue will be selecting a tax to increase.

Selecting a Tax to Increase

The reality of tax politics in Ohio is that if there is to be a tax increase, it will have to be proposed by the governor.

No matter how austere the proposed spending plan is, legislators will not take the initiative and enact a tax increase instead of budget cuts or other alternative revenue-raising approaches proposed by the governor. That is simply a historical political fact.

Even if the governor were to propose a tax increase, gaining the necessary legislative support for it, especially from the Republican-controlled Senate, will be a difficult, though surmountable, task and could threaten the re-election chances of those voting in favor of it. This next legislative session is likely to provoke unprecedented rancor during budget deliberations. Nonetheless, it must be said that a tax increase is absolutely necessary, not just to balance the upcoming budget but to restore financial stability in future biennia. The question really is when such a tax increase will occur and what its components should be.

To obtain additional revenues in the amounts needed to deal with the state’s budgetary imbalances, consideration has to be given to raising the rate or changing the base of either, or both, the state sales tax or the income tax. Other tax changes are possible, including the kinds of non-tax alternatives previously described, but for the “big bucks” the state, having dedicated corporate taxes to local government aid, must look to these two remaining big GRF revenue producers. In choosing among these alternatives,

policy makers will be most concerned about what are here being called (1) academic considerations; (2) economic impact considerations; and (3) political considerations.

Academic Considerations. In academic circles, taxes are evaluated in terms of their simplicity, neutrality, and equity.

Simplicity generally comes into play only when taxing something that has not been previously taxed is under consideration. Then, the concern is whether the object being taxed, and the way the tax is to be set up, is unduly complex to warrant its imposition. Is it really worth the bother? A similar consideration arises when it is determined that the costs of administration and enforcement outweigh the yield from the tax.

Neutrality is also important. In theory, a tax should not single out certain activities for special treatment; all economic activities should be treated neutrally to meet the criterion.

In terms of *equity*, two kinds of consideration come into play. One is relative regressivity. A regressive tax places a greater burden on persons with less ability to pay, whereas a progressive tax is levied so that persons with greater ability to pay, pay more.

Sales Tax. The Ohio sales tax is regressive. It can be made more progressive. By not applying it to food, which consumes a greater portion of the income of persons at the lower end of the economic scale, that removes some of the regressiveness. In addition, Michigan exempts clothing, adding even more progressivity to the tax. Some states allow a sliding percentage credit against the personal income tax to serve as a surrogate estimate of sales tax paid; it caps out at a certain level. This, too, improves progressivity.

Another way of increasing progressivity is to expand the base of the sales tax to apply it to the kinds of goods and services that higher income persons pay. It could also be levied at a higher rate for luxury items, such as automobiles above a certain value or boats.

The sales tax is also non-neutral. Some economic activity completely escapes taxation, while others are taxed. This is especially true with respect to exemptions such as one granted to tax payments for specific businesses, such as brewers who brew more than a given volume of beer.

Personal or Individual Income Tax. The personal or individual income tax in Ohio is progressive because it is graduated, applying a higher percentage at higher levels of income through gradations. But, the tax has become less progressive than it used to be for several reasons. One, is that it is tied to the federal income tax and for persons who itemize deductions, mostly at higher income levels, changes in federal tax law allow exemptions that reduce the federal adjusted gross income—the point at which the state income tax is applied. Also, over the years, more persons have moved up to the top bracket at which point the percentage levied on their income peaks.

In other words, more people in Ohio have federally adjusted gross income of \$100,000 and more than they had previously. Also, the recent tax reductions have resulted in a greater dollar benefit to those at the top brackets.

It can also be argued that by allowing business partnerships, and so-called “S” corporations, to pay individual income taxes, rather than both individual and business taxes, the state’s income tax is not neutral with respect to persons whose income is derived from, for example, law and accounting firms which are typically partnerships.

Economic Impact Considerations. The legislature is always concerned about the economic impact of tax law changes. And rightly so.

However, it is assumed, without requiring proof or justification, that a given tax break granted to businesses will always result in state economic improvements. If a business argues that they are being harmed by the existence of a business across the

state’s borders which pays less sales, corporate, or other taxes, the state generally accepts the argument without considering countervailing arguments—and they are seldom even offered.

When it comes to raising taxes, the same arguments are usually raised.

In considering a tax increase, it will be argued that, regardless of its nature, it will jeopardize the state’s economic development. This is despite the fact that there are many, many academic studies, including those that interview businesses, that conclude that taxes play a relatively minor, if any, effect on business location or expansion decisions. There is also some evidence that corporate decision-makers, who make those decisions, are more concerned about how estate

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and individual income taxes apply to them personally, than they care about business taxes affecting their business, when it

comes to location and expansion decisions. Academic studies aside, the issue of economic impact is important to state policy makers.

When it comes to economic impact, both the sales tax and the individual income tax, and its rates and bases, are subjected to an assessment in the state policy arena. Whatever is recommended will be tested in terms of economic impact regardless of the fact that there is little or no objective measures to apply to determine whether, what kind, and the extent of any such impact on Ohio’s economy.

Political Considerations. Several political considerations affect the selection of which tax to increase. Perhaps foremost, is the misguided belief of the general public, expressed repeatedly in polls, that the sales tax is fairer than the income tax and therefore is preferred if a tax is to be increased. When the public hears tax discussions they tend to automatically think of rate increases and so it can be assumed that the preference applies to a sales tax rate increase. Po-

litionally, it is known that the public does not always perceive a base increase as a tax increase—at least politicians work hard at making a convincing case to that effect. This, too, influences the outcome of a tax debate.

Another political consideration is that there is a growing awareness that the rich have been, and are, continuing to get richer and the poor, poorer, and a belief that part of the reason is that the federal and state tax structures are unfair. This augurs well for increasing the rates at the upper levels of the personal income tax, adding new brackets, and expanding the base of the sales tax to include more luxury services.

But the federal government is also a player in the tax debate.

President Obama is going to have his hands full dealing with the federal government's unsustainable budget deficits, as well as his plans for major spending increases. There is likely to be a new federal tax debate and it may well center on the question of the fairness of the income tax, among other things. It must not be forgotten that Ohio has tied its state income tax to the federal income tax. Whatever happens to the federal tax will affect state tax collections. Interestingly, Ohio would today be in a far better fiscal position if, like most other states, it had accepted, rather than rejected, the "wind-fall" that resulted in 1986, when federal income taxes were increased. Should there be another federal income tax increase, the political consideration will be the same as it was in 1986—should the state accept a tax increase that was "unvoted"? State legislators do not have to be counted when a federal law change affects Ohio's personal income taxes, and that bothers those who would prefer to use the issue in future campaigning.

An overriding political consideration, which may very well override all of the other considerations already described, is what the public will think two years from now when the battle for control of the legislature and the governorship will be waged.

On the one hand, there is an important campaign issue if the state is allowed to continue its slide into educational mediocrity because of inadequate financial support, and the continued deterioration of other state programs and activities that could be blamed on those who fail to consider a tax increase. On the other hand, there are still painful memories of the downfall of some legislators who supported the "Celeste 90 percent tax increase," as it was incorrectly dubbed.

Legislators, especially Democrats, would have less fear of accusations of being "taxers and spenders" if they stick to proposals that "tax the rich," such as new income tax brackets at the

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upper levels and sales taxes applied to country club memberships, or even higher rates on luxury (or low mileage) autos and boats. Republicans, on the other hand, will, no doubt, try to encourage a sales tax rate increase coupled with tax reductions to benefit those they perceive as their primary constituencies.

Politically, everyone, of course, would prefer not to cut budgets and not to raise taxes. That could be more easily done if a constitutional amendment were offered to allow referenda on tax increases. Absent, such a provision talk usually centers on enactment of a temporary one or two year increase in the sales tax and, perhaps, an initiative campaign mounted for its continuance. Presumably, a change in the personal income tax could be suggested in the same way by using a surcharge on existing rates, which can go into effect immediately, and then subject it to an initiative for continuation.

As a final point, there is also a practical consideration involved.

A sales tax rate increase can go into effect virtually immediately and begin raising revenues as soon as it is adopted. A sales tax base expansion is pretty immediate as well.

A change in the income tax structure voted in 2009 will not go into effect and raise revenues until 2010.

That is because the tax year is one year behind the collection years. That is the main reason that in 1980, and 1981, legislators applied temporary surcharges on income as a way of raising monies immediately. They did not change any brackets or rates on brackets for fear that such actions could not withstand a constitutional challenge.

Taxing Issues Redux

In the middle of January, The Center for Community Solutions (Community Solutions) released a new report, *Taxing Issues Redux*. The report concluded that Ohio has a structural budget problem that is far greater and longer-term than can be dealt with by simply using budget cuts, one-time revenue enhancements, and a continuation of patchwork budget-fixing.

The report also finds that the causes of the state's problems are not only a result of the bad national and state economic conditions. It is also the result of actions taken by the state in 2005, to reduce the rate of the state's individual income tax by 21 percent, eliminate the corporate income tax and tangible personal property tax for general businesses and telecommunications companies, and enact a new commercial activity tax, the overall result of which was to reduce taxes on certain businesses by an average of 50 percent. Further complicating the state's budget structure, were decisions made this biennium to pay local governments for an expansion of the homestead property tax exemption to seniors, regardless of how high their incomes are, and to sell-off the state's rights to the continued receipt of tobacco settlement income.

The report concludes that Ohio has a major structural budget deficit that will not be erased once the economy improves. For that reason, it is important that long-term structural remedies be considered to deal with the structural deficit as the next budget is prepared. Readers are invited to read the entire report, which includes the identification of options available to state lawmakers in resolving revenue challenges. It is available from Community Solutions in hard copy, and can be downloaded from www.CommunitySolutions.com.

Conclusions

As difficult a task as balancing this next budget will be, the legislature can view this as an opportunity to accomplish tax and spending reconstruction that will provide for greater stability in the future. This approach, as opposed to the more traditional approach to shoring up revenues with "temporary" or "one-time" receipts, gimmicks, and "slash and burn" spending, would provide a novel change to Ohio's budget-making process.

How likely is it that the legislature will undertake the kind of thoughtful analysis needed in these difficult times?

The kinds of alternatives offered in these pages, along with numerous others not here identified, require political courage to be enacted. If they are advanced they will face stiff opposition. What would have to happen in the next biennium to give politicians the courage to choose these alternatives above substantial budget cuts or one-time, non-recurring budget gimmicks or temporary tax increases? The public would have to "feel the hurt" of budget cuts. There is little or no evidence that the general public disapproves of government cutting back on services or using budget gimmicks to "balance" the state budget. Even the existence of homeless persons on urban streets seeking food and shelter, higher tuition rates, and the loss of extracurricular school programming (except for sports) fails to move public attitudes.

It appears certain to this writer that sometime after the FY 2010 – FY 2011 budget deliberations get underway there will be a tax debate of some kind. How it plays out will be a function of the outcome of weighing the various academic, economic impact, and political considerations outline here.

As Bette Davis famously said, "Get ready for a bumpy ride."

Do You Have Questions about Ohio's Budget?

E-mail your questions to budget expert Richard Sheridan at rsheridan@CommunitySolutions.com.

Answers to your questions could be the topic of future issues!