

## IV. History of Recent Tax Policy Changes

### 2005 Tax Changes—House Bill 66

The state has struggled to balance its budget since the recession of 2001. This was a dramatic reversal of the situation in the mid-1990s, when the treasury had a surplus and lawmakers decided to make large tax cuts the order of the day. Legislators cut income tax rates for the final five years of the 1990s, foregoing an opportunity to increase Ohio's Budget Stabilization Fund ("Rainy Day Fund"). They also continued a long-term trend in cutting business taxes by adding various exemptions to the corporate franchise tax. These exemptions contributed to weak revenues as Ohio had difficulty coming out of the 2001 recession. By FY 2004, the corporate franchise tax, which had comprised 16 percent of the GRF tax revenues in the mid-1970s, contributed just over 4 percent to the GRF.<sup>15</sup> In 2001, as state revenues fell, income tax rates automatically returned to their previous statutory level, but corporate tax exemptions were untouched.

Ohio's labor market did not begin to recover until the second half of 2003. The state responded with budget cuts and use of the Rainy Day Fund in the FY 2002-2003 budget. When those actions were not sufficient to make up for revenue shortfalls, the state diverted money from the Tobacco Settlement Fund, froze aid to local governments, used a one-time federal increase in Medicaid money, and employed other non-recurring one-time measures to avoid ending the biennium with a deficit.

Entering the FY 2004-2005 budget cycle (which began June 30, 2003), it was obvious that Ohio's finances would continue to be in shambles unless policymakers dealt with the revenue shortfall. The final 2004-2005 budget included a two-pronged approach: (1) a temporary increase of the sales tax by one percentage point to six percent; and (2) an extension of the sales tax to various untaxed services.

In the next biennium, the Taft Administration proposed a major tax overhaul. Pressure had been building from the business community for years to change Ohio's tax structure, and formal recommendations were made to the legislature through study commissions. The manufacturing sector wanted to remove the local tangible personal property tax (TPPT), which applied to business equipment, furniture and fixtures, and inventory. It should be noted, however, that the overall level of business taxation in Ohio was not higher than that of surrounding states.<sup>16</sup>

In 2005, the legislature followed the administration's lead with the rationale that Ohio would be more competitive with other states if it had lower tax rates and different types of taxes. On the business side, the major targets of the changes were the corporate franchise tax and the tangible personal property tax. They were replaced with the new Commercial Activity Tax, or CAT, resulting in a substantial loss of revenue. (For a full description of these tax changes, consult our report, *Taxing Issues (Redux)*, available at [www.CommunitySolutions.com](http://www.CommunitySolutions.com).) These reductions in taxes are expected to remove over \$2 billion each year from the GRF<sup>17</sup>—exacerbating the impact of the current recession on state revenues and partially undermining the purpose of the federal stimulus package, which was meant to stave off deep cuts in state budgets.

Figure 16 summarizes the seven major changes in the tax code made by H.B. 66. Tax revenues have further declined since the estimate was produced, so the actual amount of loss will be lower, but the proportionate reduction to the GRF is still devastating.

**Figure 16. Tax Policy Changes Cause Major Revenue Loss**

<b>Tax</b>	<b>Major Policy Change</b>	<b>Impact of FY 2010 Revenues</b>
<b>Sales and Use Tax</b>	Increase permanent rate to 5.5% from 5% (The temporary 6% rate was allowed to expire.)	Gain of \$772.0 million
<b>Personal Income Tax</b>	Phase-in 21% rate cut over five years; Families with less than \$10,000 in taxable income pay nothing	Loss of \$2.3 billion
<b>Corporate Franchise Tax</b>	Phase-out over five years for non-financial corporations	Loss of \$1.6 billion
<b>Commercial Activity Tax</b>	Phase-in over five years; used to reimburse schools and local governments for the TPPT reduction	Gain of \$1.6 billion
<b>Tangible Personal Property Tax (Local)</b>	Ended in 2005 for new investments; phased-out for existing equipment, inventory, and furniture	Loss of \$1.6 billion
<b>Cigarette Tax</b>	Increase tax rate to \$1.25 per pack from \$0.55	Gain of 398 million
<b>Industrial and Commercial Real Property Tax (Local)</b> <i>\$365 million gain</i>	Eliminate 10% rollback, thus decreasing state expenditure	Gain of \$365 million
<b>Total State and Local Impact</b>		<b>Loss of \$2.4 billion</b>

Source: OBM Executive Budget for FYs 2010 and 2011, Fig. B-1, p. B-4. Amounts for each state tax are for all state funds.

The phase-out of two existing business taxes in favor of the new CAT also resulted in large revenue losses. CAT revenues have declined significantly, and no revenue from a general business tax will come back to the GRF in FY 2010-2011.<sup>18</sup> The tax overhaul also continued a long-term shift in responsibility for state and local tax payments from businesses to individuals. In the mid-1970s, business paid 40 percent of all state and local taxes. This share is now only 27 percent.<sup>19</sup>

Two taxes that fall more heavily on low-income individuals—sales and cigarette<sup>20</sup>—were increased. But state income tax rates were cut by 21 percent, reducing the rate on the highest tax bracket 5.925 percent, the lowest since the early 1980s.<sup>21</sup> With rates lowered by an equal percentage across the board, upper-income taxpayers reaped the highest gains from the income tax

cuts both in dollars and as a percentage of their income.

Figure 17 shows how the 21 percent tax reduction has affected tax calculations for households at various income levels. The table reflects tax liability before the application of credits and does not take into account family size or filing status. A family with \$300,000 in taxable income would see over the five-year phase-in period a tax reduction of \$3,991, or 1.3 percent of its Ohio taxable income. (This measurement will overstate tax liabilities because taxable income will be less than total income.) A family with \$80,000 in income would receive a tax reduction of \$718, or less than one percent of its taxable income. A family with \$20,000 of taxable income would receive a tax reduction of \$93, or slightly less than one half of one percent of its taxable income.<sup>22</sup>

**Phase Out of TPPT on Local Governments:**

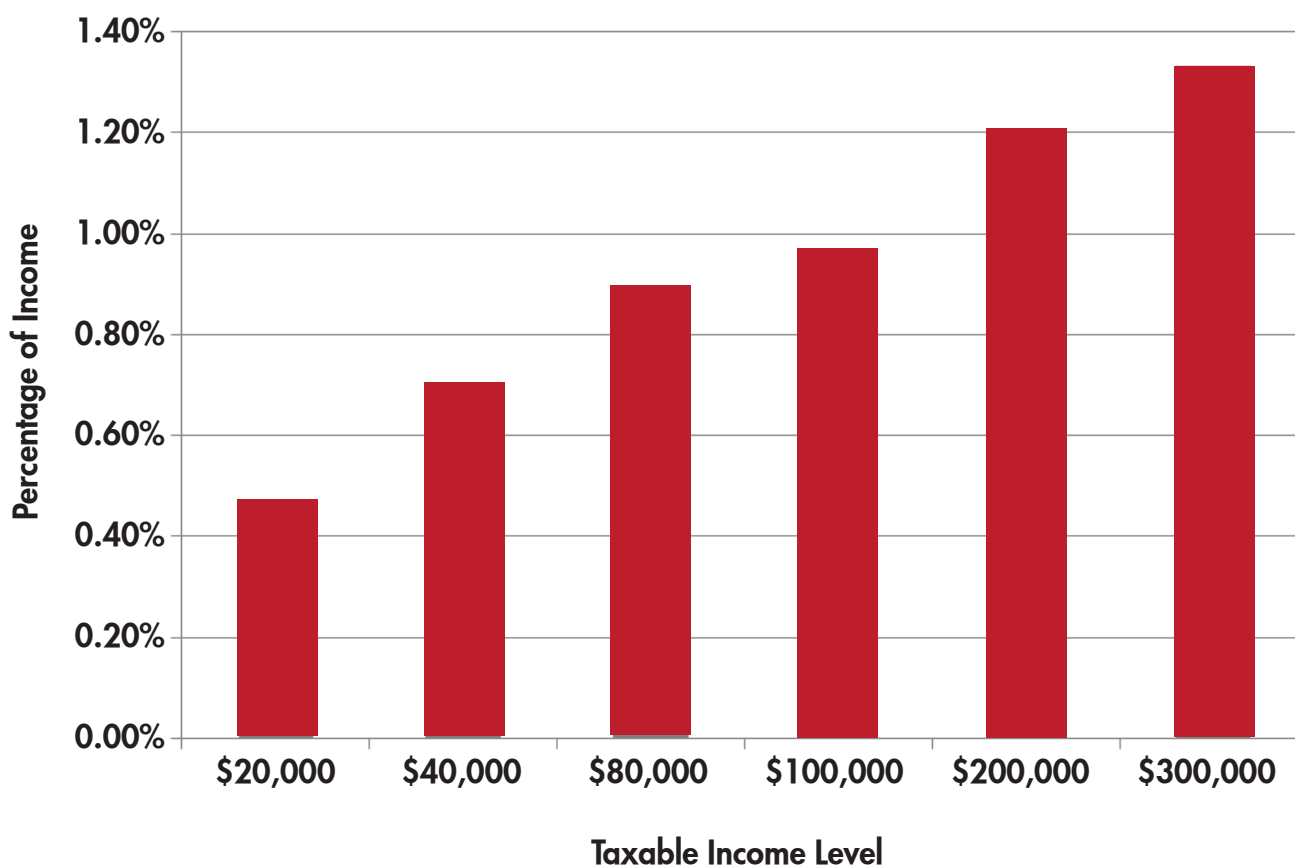
Local governments and school districts will not lose revenues from the TPPT because they will receive money from the CAT through tax year 2011. If insufficient CAT revenues have been collected, the state will reimburse local governments through the GRF. Full compensation to local governments will be phased out in fiscal years 2012 through 2019. Although H.B. 66 phased out full compensation to school districts, the subsequent FY 2008-2009 budget bill (H.B. 119) secured full compensation to school districts in the aggregate beyond 2018 through the state school fund. In House Bill 1, local governments secured a provision directing 30 percent of CAT revenue toward reimbursement in perpetuity, but the governor vetoed it. The issue of reimbursements for the phase out of the TPPT remains a difficult and contentious issue.

While the FY 2006-2007 budget was touted as the lowest growth in spending in 40 years, House Bill 66 did not include a comprehensive plan to reduce state spending. Rather, the state saved money from a fall in Medicaid expenditures following the implementation of the federal Medicare Part D program, the prescription drug benefit for senior citizens. In addition, Medicaid eligibility for low-income parents was lowered and enrollment in the Disability Medical Assistance program for non-Medicaid eligible adults was frozen.

**2007 Tax Changes—Homestead Property Tax Exemption Expansion**

The budget bill for Fiscal Years 2007-2008 (H.B. 119, Governor Strickland's first budget) included a major expansion of the Homestead program, making it available to all seniors aged 65 and older and totally and permanently disabled individ-

**Figure 17. Income Tax Reductions Provide Biggest Boost to Wealthiest Households**



Source: Community Solutions' calculations based on ODT income tax tables.

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uals regardless of income. It exempts from property taxation the first \$25,000 of home market value. Previously, taxpayers participating in this program had to have an annual income under approximately \$27,000, which disqualified most seniors. The Department of Taxation estimated that the expansion increased eligibility to 775,000 homeowners from approximately 220,000. The Homestead exemption also now provides a flat amount; previously it was based on income. This expenditure provides approximately \$400 to each qualified homeowner per year. The state makes up the revenue lost to schools, local governments, and specific local services (such as mental health) by making payments to local taxing authorities.

The \$257 million cost of the expansion is not accounted for in the GRF budget. Instead the state will use money from interest on School Facilities Commission funds.<sup>23</sup> As these funds are depleted, however, the cost of the expansion may shift onto GRF resources that are already stretched too thin.

### **2010 Tax Changes – House Bill 1**

The legislature added additional tax breaks in House Bill 1 despite a lack of resources to cover basic state operations. These actions include a tax credit for movies made in the state and an expansion of the technology investment tax credit. These two credits will cost the state up to \$60 million in foregone revenue. The film tax credit in particular is of questionable value. The film industry generally does not create permanent jobs and imports much of its highly paid labor from out of state. The pressure for states to compete for film production has become extremely intense, leading to a bidding war.<sup>24</sup>