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## Taxation and Economic Development in Ohio: A Blueprint for the Future

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# Full Text: 'Taxation And Economic Development In Ohio: A Blueprint For The Future.'

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## ===== SUMMARY =====

[Roy W. Bahl is professor of economics and Policy Research Center director at Georgia State University, Atlanta. Bahl was staff director of the Commission to Study the Ohio Economy and Tax Structure, which prepared the report from which the following excerpt is taken.

For a news story on this report, see State Tax Notes, Dec. 19, 1994, p. 1877.]

## ===== FULL TEXT =====

### What Do We Want From the Ohio Tax System?

There is no one best tax structure for Ohio, and no single "right" way to reform this tax structure. Any reform must be guided by the objectives to be achieved and the tradeoffs that are acceptable. The basic principles adopted by the commission describe the features of a good tax system, but it remains to decide which of these principles should be emphasized.

To make this decision, the commission members individually ranked and weighted each of the principles. The results of this vote are presented in Table 1, and show a strong consensus. The commission recommends a reform that emphasizes economic development and corrects the horizontal equity problems that are so pervasive in the present system.

This is not to say that other objectives, such as vertical equity or revenue elasticity are unimportant. Clearly, the fairness in the distribution of tax burdens between rich and poor people and rich and poor places are important considerations that weigh heavily in the proposed reform, as are the criteria about the future revenue performance of the tax system. But the bigger problems that drive this reform program are the declining Ohio economy and the need to avoid a future of continuous discretionary tax rate changes.

The commission proposes a change in the tax system that will be more favorable to those who invest in Ohio, thereby enhancing the general business climate, and creating a more level playing field for all investors and consumers. Some will see this change in emphasis toward economic development as a backing away from the traditional emphasis on vertical equity. The commission does not see it this way, for the following reasons:

- o If state economic development is enhanced by the tax reform, because investment in Ohio is stimulated, then the entire state population will benefit from increased

jobs and real income.

o If the Ohio economy continues on its present path, the job and real income growth in Ohio will lag behind the rest of the nation and both low- and high-income families will suffer.

o The traditional emphasis in the tax structure has not supported a business climate that has led to an above-average growth.

It would be politic to say that this shift in emphasis can be accomplished without cost or sacrifice. Tax reductions can stimulate investment but must be paid for with increases in other taxes. The commission's view is that the long-run benefits of a stronger economy more than outweigh the short-run costs.

Table 1

Summary of the Priorities of the Commission /a/

	Ranking /b/	Weighting /c/
Elasticity	4.4	6.6
Stability	4.5	6.4
Vertical Equity	4.6	6.3
Horizontal Equity	2.3	8.6
Economic Development	1.5	9.5
Simplification/Administration	4.7	6.3
Spatial Distribution	5.4	6.4
Obsolescence	5.9	5.3

FOOTNOTES TO TABLE

/a/ 13 members voted. Average rankings and weightings are presented here.

/b/ Ranking: 1 (most important).

/c/ Weighting: 10 (most important).

END OF FOOTNOTES

Horizontal equity as a priority of reform will bring winners and losers. Some firms and individuals pay higher taxes in the present system because others receive a preferential treatment. Moreover, differential tax treatment drives some firms to alter their behavior to avoid a higher tax bill. Bringing all businesses under a common tax regime will remove tax incentives for firms to alter their behavior, and an equal treatment of all consumption will make the sales tax more fair to all consumers.

The commission recognizes that tax preferences are not easily given up once they have been granted, and that proposals to enhance fairness are never warmly received. But fairness or horizontal equity requires an equal treatment of similarly situated taxpayers.

The reform direction we propose turns on the commission's belief that certain changes in the tax structure can improve the climate for investment in Ohio. In fact, no research can project exactly how great this effect will be, but the basic thrust of this reform is clearly in the direction of attracting new investment to the state. A different emphasis has driven the Ohio tax structure for many years and it is the view of the commission that it is time for a change.

#### Box 1

##### Revenue Neutrality

The proposed reform is to be revenue-neutral, i.e., to yield the same amount of revenue as the present system would yield. This revenue neutrality is demonstrated throughout with data for 1993, the latest year for which information was available on actual collections.

It should be noted, however, that revenue neutrality for one period does not necessarily mean revenue neutrality in future years. In fact, the proposed system has a greater revenue-income elasticity than the present system, hence it will automatically generate a larger flow of future revenues.

##### A Blueprint for Reforming the Ohio Tax System

How does Ohio get on a faster economic growth path, e.g., one that keeps pace with the national economy? The commission realizes that tax restructuring alone is not the answer, because many factors have influenced those business and personal decisions that have led to slow economic growth. Still, taxes do matter, and the present tax structure is particularly hard on private investment. Unburdening the tax on investment, even in the context of a low taxing state like Ohio, can improve the business climate. The fiscal plan that we propose, therefore, emphasizes economic development.

Some will say that this is a plan that shifts taxes from businesses to people. This is simply incorrect. No matter what structure of taxation is used, people always pay the taxes imposed. Sometimes they pay in the form of higher prices for the goods they purchase, sometimes in the form of lower wages than they otherwise would have received, and sometimes in the form of lower return on their investment. It is true that the distribution of tax burdens may fall differently on families at different income levels depending on whether the final incidence is with consumers, workers, or shareholders, and it is true that some of the tax may be exported to residents of other states. But, ultimately, taxes can be borne only by people. This plan, like any restructuring, rearranges the tax burden among consumers, workers, and capitalists.

There is also an excess burden of taxation. If the tax structure has encouraged investment and consumption decisions that have led to a slower rate of economic growth in Ohio, then an additional burden has been imposed in the form of slower long-run growth and fewer employment

opportunities. People also bear this burden: in the form of less growth in real income than that received by other Americans, fewer job opportunities, and less expansion in public services and infrastructure. If a reform such as the one proposed here were to lead to an increased rate of economic growth in the state, then consumers, workers and capitalists all would benefit.

This is not a tax increase program. An important constraint that the commission imposed on itself is that the reform program would be revenue-neutral (see Box 1). If there is a proposal for the reduction in one tax, there must be a compensating proposal for the increase in another. The focus of this commission is solely on restructuring.

This blueprint for comprehensive reform of the Ohio tax system carries an expectation that tax restructuring will take place over a period of years. This report lays out a new direction for tax policy in Ohio, and discusses a phasing in of the various proposed changes. Some of the changes can and should be enacted immediately, but for several reasons (discussed below), it is necessary to complete the reform on a gradual basis.

### Corporate Franchise Tax

Proposal: Eliminate the net worth tax, and require combined income reporting for all corporations. These reforms should be adopted together, or not at all. Both could be adopted immediately. Revenue cost if fully enacted in 1993 would have been \$200 million, less the revenue gains from combined income reporting.

Currently, the corporate franchise tax is levied on one of two bases: corporate income or the net wealth of corporations. The purpose of this dual base is to ensure that any corporation operating in Ohio makes some contribution to the state for the privilege of operating a business in Ohio, whether or not the corporation shows a profit in any particular year. The existence of the net worth component of the tax also provides stability to the revenue stream.

While the net worth component of the tax does increase the long-term expected level of revenues, it reduces the net rate of return to investment in the state. It is especially burdensome to capital-intensive and start-up companies because newer companies tend to lose money in the early stages of their development. Thus, the net worth element of the existing tax is a disincentive to new business formation and an impediment to the success of these new businesses. The commission proposes repeal of the net worth tax.

This proposal, if accepted, would convert the corporation tax to a net income basis only. The commission recommends no compensating change in the corporation income tax rate, because the Ohio rate is already high.

A major problem with this proposal is the revenue loss and the possibility that many firms who use Ohio services will be freed from any tax liability. In some cases these are companies with positive net income but with the wherewithal to allocate costs and revenues among subsidiaries in such a way as to avoid payment of Ohio taxes. There is reason to believe that such accounting practices are occurring at the expense of the state government in Ohio. Ohio currently has one of the highest

corporate tax rates, yet receives a below-average amount of revenue from this tax. The commission proposes the requirement of combined income reporting, a method of corporate taxation already used in many states (see Box 2, page 000). This will hold firms in the corporate tax net, enable a more fair distribution of the tax burden, and even possibly increase the yield of the corporate income tax.

The commission recommends the adoption of these two proposals as a package. If combined income reporting is not adopted, the net worth tax should be retained. By eliminating the net worth tax and requiring combined reporting, the state will remove an important disincentive to new business formation and success, reduce the expected long-term tax rate on profits, remove a tax that discriminates against capital intensive sectors, ensure that tax burdens are more fairly distributed across all firms operating within the state, and generally encourage economic development.

There are two downsides to this proposal. First, revenues from the corporate tax will be less stable when the net worth component is removed. This is because the net income base, which will now govern the tax, fluctuates more widely over the business cycle. This is an important problem for a state with a cyclical economy, but on the other hand, the corporate franchise tax now accounts for less than 5 percent of total state government revenues. The second problem is that combined income reporting will require additional administrative effort, and will increase the complexity of the tax system.

### Tangible Personal Property Tax

Proposal: Eliminate the tangible personal property tax. This phaseout would take place over a number of years. The fiscal 1992 revenue cost would have been \$1.2 billion. Eliminate the inventory tax immediately. The fiscal 1992 revenue cost would have been \$500 million.

Currently, the state of Ohio collects a tax on the personal property of businesses (other than public utilities). The tax base is 25 percent of the market value of machines, equipment, inventories and other business movable property. The tangible business personal property tax raises a significant amount of revenue for local governments.

The commission recommends that the tangible personal property tax be eliminated from the Ohio tax structure. This is a change that is long overdue. A state such as Ohio that is short on investment and job growth should not single out capital investments for differentially heavy taxation.

It is true that the taxation of depreciable fixed business assets is standard tax practice in the United States. There are 39 states which include tangible business personal property in their tax bases, however, many of these (e.g., Oregon, Wisconsin, Virginia, and Maryland) either exempt manufacturing machinery and equipment or treat it as real property. Of the 11 states that exempt tangible personal business assets from the tax base, Pennsylvania is a neighbor and three other states are in the same economic region (Illinois, Minnesota, and New York). Delaware, Hawaii, Iowa, New Hampshire, New Jersey, New York, North Dakota, and South Dakota are the others. The elimination of the personal property tax could prove to be an important locational advantage to Ohio.

Personal property taxes are levied on inventories in Ohio. Most states that impose the personal property tax do not tax inventories, in fact, only 16 states continue to tax inventories (these include Indiana, Kentucky, and West Virginia). /1/ There are many reasons why inventories should not be taxed. The tax is inequitable, because the presence of a high level of inventories does not necessarily imply a greater ability to pay. In fact, the presence of a large inventory value may be less an indicator of wealth than an indicator that a firm has had a bad year and consequently has less ability to pay. Moreover, some industries naturally require higher levels of inventory than others and are unfairly treated under tax. Clearly, the existence of an inventory tax is a negative factor for any business considering an Ohio location for a distribution center. It acts as an offset to the locational advantages of the state. Thus, the unfairness of the tax and its negative impact for development in Ohio are two strong arguments against the personal property tax on business assets.

The personal property tax presents significant compliance problems for payers, and tax administration problems for the state government. Businesses that self-report personal property must keep detailed records on the price and vintage of all their taxable property. The state tax administration, on the other hand, is faced with a substantial job in discovering business personal property, carrying out a proper audit, and maintaining adequate valuation schedules. The personal property tax also creates administrative problems in that it is the chief reason for the existence of enterprise zones in the state. If these zones are to continue, it will be necessary to monitor their activities more closely, and this assignment will carry a significant administrative cost. Elimination of the personal property tax would eliminate much of the reason for the existence of enterprise zones.

## Box 2

### Combined Income Reporting

The main advantage of required combined income reporting is that it will eliminate the use of accounting and arbitrary allocations of revenues and expenses across state boundaries to avoid payment of Ohio taxes. The arm's length standard and single taxpayer formula apportionment have become ineffective tax enforcement approaches in a world where unitary businesses have at their disposal a variety of options to reduce their state tax liabilities.

Two important decisions need to be made with the adoption of mandatory combined income reporting for all unitary businesses. The first choice concerns the "basis," or how far and wide the combination should go. The recommended basis is domestic or water's edge combination, i.e., to include only U.S.-source income. The state should avoid stopping at a nexus combination basis, which would include only companies with nexus in the state, or corporations domiciled in the state, or some combination thereof. With a nexus combination many of the problems with separate entity reporting will remain.

The second choice concerns the "standards," or how to determine which corporations should file a combined report. The Department of Taxation should be empowered to determine the appropriate standards. The standards used to determine when a group of affiliated companies actually constitute a unitary business vary. The most common standard is based on the "three unities" of common ownership, common management, and common operation or use. Common ownership is

typically interpreted to exist when 50 percent or more of the stock of a corporation is owned by another corporation. Common management is typically interpreted to exist when there are overlapping boards of directors or common managers in key positions. Common operation is interpreted to exist when there are common management functions, financing, accounting, advertising, or purchasing. Other standards used rely on the existence of dependency or contributions between affiliated corporations, similarities in the line of business, or significant intercorporate transactions.

An additional set of administrative issues that will have to be addressed include the statement of rules for the consolidation of intercompany transactions, rules for the merging of different accounting periods, rules for the treatment of partnerships in the affiliated group, rules for foreign-source income, and rules for modifying the apportionment formula to adapt it to the apportionment formula used for financial institutions and insurance companies.

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A final, important reason to consider elimination of this tax is that the base of the tax has shown relatively little growth in recent years. However, its revenues are a mainstay of the support for financing the operations of local governments (70 percent of calendar 1992 collections went to school districts). Elimination of this tax would force a decision to move local governments (and particularly school districts) on to a tax base that is more commensurate with the growth in their expenditure needs. The elimination of the personal property tax would also lighten the administrative and compliance burden associated with the property tax.

There are desirable features to the personal property tax on business that also must be considered in evaluating the pros and cons of its elimination. Its base has grown very slowly in real terms, but this has created considerable stability, an important characteristic for a school district, where fiscal planning is so important. Virtually any other replacement tax would be less stable in its revenue yield over the business cycle. Another desirable feature of the tangible personal property tax is that its burden is partly exported: to the federal government through deductibility from taxable federal income, to consumers of the final product, and to shareholders who reside in other states.

It is the view of the commission that the drawbacks of the tangible personal property tax far outweigh its advantages. The commission recommends that the tax on inventories be eliminated immediately. The revenue cost (for calendar 1992) would be \$500 million. The remaining tangible personal property tax should be eliminated over a period of 5 to 10 years. The phasing in of this reform is required because of a number of reasons, including (a) to avoid a large tax shock associated with so big a change, (b) to give time to determine how the revenue loss to local governments will be replaced, and (c) to give time for the differential assessment ratios for utilities to be stepped down.

### Public Utility Property Tax

Proposal: Eliminate the public utility property tax, and bring all utilities under the corporate income tax. The commission recommends that utility rates be reduced to reflect the tax changes. If this

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program had been fully implemented in 1993, the revenue cost would have been \$950 million, less the corporate tax that would have been collected from the utilities. This program should be phased in over a period of years. As a first step, interexchange companies should be brought immediately into the tangible personal property tax regime for general business. All new investment by other public utilities should be assessed at the 25-percent ratio used for general business, and the assessment ratio on existing property should be stepped down over a 5- to 10-year period.

The public utility property tax introduces a serious horizontal inequity into the Ohio tax system. An assessment ratio of 25 percent is imposed on the personal property of general businesses, but an assessment ratio of 88 percent is imposed on public utility property. /2/ The commission considered both relevant questions: should there be a personal property tax at all, and should there be a differential rate on utility versus other property?

There once was an argument that public utilities should be treated differently by the tax regime: they had received a special franchise to deliver a service that had put them in a monopoly position, and their rate of return was regulated. Those reasons for different tax treatment are fast disappearing as competition comes to the electric, gas, and telecommunications sectors. The commission does recognize that competition is not proceeding at the same pace in all of these sectors, and thus there is some room for differential treatment. On the other hand, this is a blueprint for a 5- to 10-year program and the state must consider the likely case that all three sectors will become highly competitive during that time period.

The first major problem with the present system is that it treats utilities differently from general firms, even though in some cases (interexchange companies) the nature of the differential treatment is unclear. This policy has the effect of making it difficult to attract investment to the highly taxed sectors.

Second, some utilities are taxed differently from competing firms (especially in the telecommunications sector). Cable companies, for example, are treated differently from local exchanges. This creates an unfair situation, especially in the telecommunications sector at a time when heavy investment is being made to strengthen competitive positions.

Third, there are questions about whether such a tax should exist at all, when Ohio is attempting to increase its attractiveness to investors, to bid more capital to the state, and to expand infrastructure. By raising the cost of investment in Ohio, the tax structure makes it more difficult to attract funds to modernize the capital stock in the utilities sector. This is an especially important issue at a time when telecommunications infrastructure has become a key consideration in the location decisions of many firms.

Fourth, the tax is inelastic in its response to income growth, and so would seem to be a weak source of revenue for funding education (which receives 70 percent of the revenues). /3/ The tax base to support education should grow in step with expenditure requirements.

There is a positive side to the public utility property tax in Ohio. It is a stable source of revenue over the business cycle. It is "invisible" in the sense that residential ratepayers do not always recognize

the shifting of a substantial portion of the burden directly to them, and therefore it is seen by many as a tax without significant burden. This perception is best articulated by those who see a clear distinction between taxes on people and taxes on business. Another advantage of personal property taxes on public utilities is that they do not pose the same degree of administrative difficulty as does the tangible personal property tax. Finally, the utility taxes are in place, are understood and accepted, and their impacts have been capitalized into higher consumer prices and less investment.

The view of the commission is that the public utility property tax should be abolished, and that public utilities should be treated as ordinary businesses with respect to the tangible personal property tax and the corporate income tax. This will lead to a tax structure that is more horizontally equitable, more conducive to economic development, and more elastic. However, it is clear that this must be a long-term program of reform, rather than a one-year restructuring. This is partly because of the need to decide how the revenue lost to the local governments will be replaced, partly because of the revenue loss itself, and partly because the pace of competition is proceeding at different rates in different utility sectors.

The commission recommends that interexchange companies be brought to parity with general companies immediately, with respect to the personal property tax. It is also recommended that all new investment by public utilities be subject to the 25-percent personal property tax assessment ratio, and that this take place immediately. Third, the assessment ratio on the remaining public utility property should be stepped down from 88 percent to 25 percent over a 5- to 10- year period, and phased out along with the tangible personal property tax. Finally, these tax reductions should be reflected in rate reductions to users.

### Public Utility Gross Receipts Tax

Proposal: Convert the public utility gross receipts tax to a user charge, holding public utility rates constant except for those individuals and businesses who were previously receiving a tax preference. The net revenue cost is zero.

Public utilities in the state are currently subject to a gross receipts tax (public utilities excise tax) of 4.75 percent (6.75 percent for pipelines). The tax applies to all receipts of the public utilities except those from purely interstate business. There are two major problems with this tax. One is that municipal utilities are not required to pay, creating an unfair competitive position vis--vis investor-owned utilities, and the other is that it leaves Ohio utilities in a noncompetitive position relative to competing out-of- state firms and in-state firms that are not subject to the gross receipts tax.

The commission proposes that the gross receipts tax be replaced with a user charge on utility bills. This user charge would be either an ad valorem levy or a specific charge on the purchase of any utility service from any provider. The taxation of all purchases evens the treatment of municipal and investor-owned utilities since purchases from either provider would be equivalently taxed. The user charge also eliminates any distortions that may arise as a result of the deduction from taxable gross receipts of those receipts from purely interstate business.

It is the intention of the commission that the switch from a gross receipts tax to a user charge not effect the gross price of utilities to consumers of the service. On the one hand, the elimination of the gross receipts tax would reduce costs. Utility prices, in principle, should fall by the full amount of the tax. On the other hand, the imposition of the equal yield user charge would push the gross prices up to their original level (less the amount now paid by those whose purchases have been outside the gross receipts tax). In practice, the Public Utilities Commission of Ohio (PUCO) would need to request a rate hearing from those affected by the switch, and there is the potential for a lag between elimination of the gross receipts tax and consequent net price reductions. The legislation authorizing the swap could, however, specifically request that the reductions take effect immediately as has been proposed by SB 120, which specifies a mandated reduction in prices for telecommunications services.

### Enterprise Zones and Tax Incentives

Proposal: Abolish enterprise zones, and prohibit the use of targeted tax incentives to recruit companies to Ohio. Revenues will increase, but the amounts are uncertain.

Much of the rationale for enterprise zones in Ohio rests on the need for relieving the property tax on inventories. Ohio is among a small number of states that still tax business inventories under the property tax. However, enterprise zones created all over a state are not an efficient mechanism for correcting what fiscal experts know to be poor property tax policy. Moreover, solving the problem through ad hoc agreements drawn between firms and municipalities, townships and counties is very inefficient administratively. Though Ohio's school districts receive more than 70 percent of personal property tax revenues, other local governments are empowered to forgive the property tax on inventory, in most cases, without school district approval. Such a practice is disruptive to the overall system of state and local government finance in Ohio.

A major part of this tax reform plan is the elimination of the personal property tax and, in particular, the elimination of the personal property tax on inventories. Abatement of these personal property taxes is currently the most frequently used tax-incentive. If either the personal property tax on inventories or on all personal property is eliminated, the primary reason for the existence of enterprise zones would be eliminated.

Some might oppose the elimination of enterprise zones on grounds that they provide a significant subsidy to low-income or unemployed workers. This may not be the case. The enterprise zone program has only recently developed two different zone designations to target more job credits to distressed zones. There is considerable debate about whether spatial targeting is at all useful. Evidence suggests that 60 to 100 percent of the benefits of spatial targeting accrues to non-zone residents either through labor force migration into the targeted areas or simply missed targets within the area. Another important conclusion is that Ohio's proliferation of zones makes it unlikely that benefits are reaching the target population. This is because population mobility diffuses benefits among targeted zones and nontargeted areas. /4/ The commission recommends the elimination of enterprise zones.

The commission also recommends ending the practice of giving targeted tax incentives to attract firms to Ohio. This practice is inconsistent with the horizontal equity goals of this reform, i.e., creating a competitive environment and allowing the market to determine which firms will invest and expand in Ohio. But more important, the proposed reforms create a very favorable tax climate for businesses in Ohio by eliminating the more onerous taxes for investors: namely, the personal property tax; the net worth tax; and the tax on inventories. This program of generally lower business taxes advantages new and existing firms to the same extent. Under a targeted incentive program for new companies, the state must make up the revenue loss with a higher tax elsewhere in the system, possibly with heavier taxes on existing businesses.

### Banks and Insurance Companies

Proposal: Eliminate the special taxes on banks, insurance companies, and dealers in intangibles and bring all financial institutions under the corporate income tax with appropriate modifications. The 1993 revenue cost would have been approximately \$66 million.

Banks, insurance companies, and dealers in intangibles are each subject to special taxes that historically evolved from and reflected the distinctive nature of their operations and businesses. The commission recommends that these special taxes be eliminated and that all financial institutions be taxed under the corporate income tax.

This reform will create a more competitive environment and encourage economic development in the state. For example, it will remove artificial distinctions between banks with and without deposits in Ohio because all companies will be subject to the same income tax. It will likewise eliminate the very different tax treatment among insurance companies. Furthermore, by putting all financial institutions on an equal footing, decisions to purchase certain types of savings instruments will not be affected by state tax policy.

Two complications arise from taxing all financial institutions under the general income tax. First, banks and other financial institutions hold a large part of their investment portfolios in tax-exempt federal and state securities and their taxable income (and tax liability) is usually lower than that of the average nonfinancial company. One view is that this is not a problem since tax-exempt securities pay lower interest rates and all taxpayers can invest in these types of securities and receive similar benefits. If the low tax liability is viewed as a problem, two options are available. One is to tax all interest from government securities (including Ohio's) received by all corporations. However, this change would interfere with the public policy underlying the exemption and may cause horizontal inequities if such interest remains exempt in other states, as most states with an income tax exempt public obligations. Another option is to tax banks and other financial institutions at a higher corporate income tax rate. This method, however, adds complexities and interferes with the goal of horizontal equity.

The second complication involves the appropriate corporate income tax apportionment formula for banks and insurance companies. The goal of equal treatment would require all companies to apportion income in a consistent manner. However, most states use a nonstandard three-factor formula or a single-factor formula to apportion banking and insurance businesses. A single-factor

apportionment formula based on deposits or premiums should benefit domestic (Ohio) insurance companies and banks the same way a single sales factor would benefit all nonfinancial Ohio corporations. Moreover, there are reasons why the standard three-factor formula may not be appropriate for both banks and insurers. For example, the Multistate Tax Commission has proposed a nonstandard apportionment formula for banks. If Ohio's apportionment formula is inconsistent with the formula used in other states, Ohio's banking industry will be at a disadvantage. Similarly, a single premiums factor is used in most states where the insurance industry is subject to income taxes. Again, an apportionment method that is inconsistent with other states may put the Ohio insurance industry at a disadvantage.

While reform is clearly needed, the commission recognizes that its recommendation to bring all financial institutions under the corporate income tax must be carefully implemented in order to encourage rather than penalize financial institutions for locating in Ohio. In particular, financial institutions should be permitted the same exemption for tax-exempt interest as other corporations, and the apportionment factor for banks and insurance companies should be consistent with other states and/or the Multistate Tax Commission model.

The effect of this recommendation on retaliatory taxes paid by Ohio firms must be considered. Ohio's insurance premium tax rate is among the highest in the country and, therefore, Ohio's insurance industry is at a competitive disadvantage when it sells in other states. Replacing the premium tax with a broader-based income tax should lower the effective tax, thus lowering the amount of retaliatory taxes paid by Ohio insurers to other states, while also increasing the amount of retaliatory taxes paid by out-of-state insurers to Ohio. This would not only remove the economic penalty to locate in Ohio, but would aid economic development by increasing opportunities for growth in the domestic insurance industry.

## Sales Taxation

Proposal: Extend the sales tax to services, immediately to a narrow category to raise about \$150 million in revenue and later to a broader category, including professional services, to gain about \$600 million.

Proposal: Give voters a choice on a ballot initiative, between the inclusion of food in the sales tax base (with a food credit for low-income taxpayers), and a 1-percent increase in the sales tax rate. The extension to food, net of the credit, would produce about \$400 million in new revenue, and the 1-percent increase in the rate would produce about \$800 million.

The commission proposes that a significant proportion of the tax restructuring be financed by sales taxation. Three adjustments in the sales tax might be considered:

- o an expansion of the sales tax base to cover additional service consumption;
- o an expansion of the sales tax base to cover food consumption, accompanied by a food tax credit for low-

income families; and

o an increase of 1 percent in the sales tax rate.

The commission proposes that Ohio voters be given a choice between the rate increase and the food/credit options.

Services. The commission's proposal to add a significant number of service categories to the retail sales tax would improve the tax system in many ways: it would make the sales tax more fair by including more categories of consumption, it could improve the elasticity of the tax system depending on what is brought into tax, and it would yield significant revenue.

As noted above and in the background research papers, /5/ Ohio's sales tax base excludes a significant portion of the consumption of services. This is not unusual policy, though Ohio's coverage of services under the sales tax is relatively narrow. Most states do not tax a significant number of services, either because they are considered business inputs, they involve consumption of socially desirable goods, they are administratively difficult to reach, or simply because "that's the way it always has been." But these services do constitute consumption and in many cases fairness demands that they be taxed.

Most importantly, the inclusion of services would improve the horizontal equity of the tax system by removing tax preferences from those who consume a significant number of services. A cursory glance at the list of exempt services in Box 3 (p. 000) should convince even skeptics about the fairness of this proposal: why should one family pay a 5-percent sales tax on its purchase of a household good while another pays no sales tax on its consumption of cable TV or income tax preparation services? Another way to view the fairness issue is that the additional revenues raised from taxing services could be used to lower the sales tax rate on all consumption.

The revenue responsiveness of the sales tax to income growth might also be effected by the inclusion of services in the tax base. Depending on the extent to which services are included, the income elasticity of the sales tax could increase above its present 0.97 level. The consumption of medical services, for example, is growing faster than total personal income. The share of services (less housing) in total consumption in the United States grew from 30 percent in 1976 to 43 percent in 1993, suggesting that the inclusion of all services in the sales tax base would have increased the elasticity of the sales tax significantly. There are a number of other choices for inclusion, however, that are not growing as fast and would not significantly increase the income elasticity of the sales tax.

The questions to be answered are what services should be included in the sales tax base, and how should this base expansion be phased in? Certainly there are choices. The commission identified 72 types of services that are not now subject to sales taxation in Ohio but are subject to sales taxation in other states (Box 3). It also identified the order of magnitude of revenues that could be expected from this base expansion (Table 2). Clearly, there is much room for base expansion.

[BOX 3 OMITTED]

Table 2  
Significant Ohio Service Exemptions  
(in millions of dollars)

	Fiscal 1994	
1. Health Care	\$1,172.7	
2. Legal Services	157.0	
3. Engineering, Architecture and Surveying		60.2
4. Management Services	59.8	
5. Accounting and Bookkeeping	52.3	
6. Cable TV	45.0	
7. Beauty Salons and Barber Shops		16.1
8. Coin-Operated Amusements		10.0
9. Auto Parking	9.9	
10. Laundry and Dry Cleaning		9.3
11. Advertising and Public Relations		7.6
12. Public Golf Courses	7.4	
13. Funeral Services	7.4	
14. Motion Picture Theaters		4.5
Total	\$1,619.2	

Source: State of Ohio Executive Budget for the Biennium, July 1, 1993 to June 30, 1995, Book Two: Report on Tax Expenditures, prepared by the Ohio Department of Taxation, as reported in Fox, William, 1994, Ohio's Sales Tax: Current Condition and Policy Options, Staff Report Number 2 of the Commission to Study the Ohio Economy and Tax Structure, November, Atlanta, Ga: Policy Research Center, Georgia State University.

The commission recommends that the sales tax base be expanded to include services. Immediately, a "narrow" category of consumer-type services and some professional services can be brought into the sales tax, and can yield about \$150 million (Table 2). Narrow base expansion includes cable television, hair salon services, coin-operated amusements, parking, laundry and dry cleaning, golf course fees, funeral services, and motion picture admissions. A second round of base broadening, carried out as the tax reductions are phased in, could raise this total to about \$600 million (measured in terms of 1993 revenues). The "broad expansion" would cover selected professional (including medical) services, business services and construction services. This still will constitute only about 37 percent of the total service consumption that is presently outside the sales tax base.

Rather than recommend the exact services to be brought in at each step, the commission proposes consideration of the following criteria in selecting services to be excluded from the tax base:

1. medical services, where taxation would impose significant hardship or compromise state social policy;

2. services that would be extremely difficult to administer because there are difficulties in determining the situs of the activity, e.g., advertising; and

3. services that are direct inputs to business production and therefore would involve double taxation, and place Ohio producers at a comparative disadvantage.

Eliminating the services that meet these conditions, however, still leaves the state considerable room to expand the sales tax base.

Apart from these decision rules, the issue is not which services are best to tax, but how far the state is willing to go to make the system more horizontally equitable. Many professional services can be taxed without creating undue hardship or discouraging Ohio business, but most states have not had the political courage to bring these "hard to tax" sectors into the sales tax base. The commission proposes that taxing a broad range of consumer services, however unpopular, is better for economic development in Ohio than continued heavy taxation of business investment.

As fair and as reasonable as this proposal sounds, there will be vocal opposition to any proposal to remove tax preferences. There also will be questions about how to handle the distribution of the sales tax revenues among counties, since the taxation of services raises some difficult nexus issues. These issues have been resolved in other states, however, and the commission believes they can be resolved in Ohio. The taxation of services will place administrative burdens on the state Department of Taxation, but other states have handled these burdens and the commission has confidence in the ability of the Ohio administration to handle this expansion in responsibilities.

The growing share of service consumption, and the commensurate erosion of the consumption base that is presently taxed, is fact. Expansion of the sales tax base to cover the untaxed base is the only way to avoid ever-increasing sales tax rates.

Food. Food is exempt from sales taxation in Ohio and in many other states. Twenty-six of the 46 states with retail sales taxes exempt food for consumption at home. /6/ The trend generally has been for more states to exempt these items. /7/

The commission understands that the taxation of food is an emotionally charged issue, and that there are strong arguments to support those who insist on the exemption of food from the sales tax: food is a necessity that should not be taxed; lower-income people spend a greater proportion of their income on food and therefore to bring it into the tax base is to make the tax system more regressive. Since a tax on food also touches every voter, there is widespread political opposition.

But it would be wrong not to recognize that there are good, defensible reasons to include food in the sales tax base:

o most food expenditures are made by higher-income families, hence the exemption of food in the name of

assistance to the low-income may not be well-founded;

- o more than food is typically consumed at food stores, hence there are administrative difficulties with the exemption;

- o the differential treatment of food-at-home versus food-in-restaurants leads to many administrative ambiguities that compromise the original intent of this dichotomy;

- o the food exemption leads to a lower revenue level, which often is made up by a higher sales tax rate that burdens the same low-income families that exemption was supposed to help; and

- o the inclusion of food in the tax base improves the cyclical stability of the sales tax.

The commission believes that the case for taxing food is compelling enough that it ought to be offered to voters as an alternative to an increased sales tax rate, but recommends the inclusion of food in the sales tax base only if accompanied by a refundable income tax credit. This plan would have yielded about \$400 million in additional tax revenue in 1993. All families with incomes below \$20,000 would receive a \$160 credit to compensate them for sales taxes paid for food. Families with an income above \$20,000 would not receive the credit. While this is an efficient way to target the tax relief on the overburdened families, it would require filing a return in order to receive the cash transfer.

**Sales Tax Rate.** An obvious policy option for Ohio is to raise the sales tax rate. A 1-percent increase in the state sales tax rate would have generated about \$800 million in 1993. The additional revenue could be used either to lower other tax rates or to eliminate other taxes. There are important advantages to this approach to raising additional revenues. No one likes a tax increase but the sales tax has proven to be less objectionable than income and property taxes; the administrative machinery is already in place, and compliance costs associated with a 1-percent higher rate are low; and a 1-percent increase in the rate is revenue productive.

There are also drawbacks to a rate increase that must be reckoned with. A higher rate will magnify all the flaws presently in the system, e.g., the sales tax on business inputs, the regressivity of the present system. Border problems could arise as a result of the increase because of the increased incentive to shop in other states. Another problem is that the sales tax is not deductible from the federal income tax, hence its burden is higher on itemizers than would be the case for an equal tax increase from income or real property taxes. Finally, a 6-percent rate would not leave Ohio as an outlier, but it would move Ohio into the higher-taxing group of states.

## Individual Income Tax

Proposal: Convert the present individual income tax to a flat- rate tax on federal tax liability. At a rate of 27.5 percent, this restructuring would have increased revenues by \$850 million in 1993.

The commission found three problems with the current system of individual income taxation. First, it is unduly complicated, with nine rate brackets and four credits. This leaves open many possibilities for arbitrary manipulation, e.g., "change the rates," "change the bracket width," "add a new credit," and so on. In such a complicated system, the impacts of discretionary adjustments are not always clear to those who make the proposals or to taxpayers. Second, the present system of individual income taxation brings lower-income taxpayers into the net at a low level of income. Third, to finance the blueprint for tax reform proposed here, it is necessary to raise an additional \$850 million from the individual income tax, and it is not clear how this can be done fairly under the present system (e.g., which bracket rate should be increased, should a new marginal rate be added, etc.). For these reasons, the commission recommends a major change in the individual income tax, to a flat-rate tax based on federal tax liability. The proposed flat tax would be simple, progressive, and elastic.

**Coupling to Federal Tax Liability.** This is perhaps the simplest form of state income taxation. Taxpayers report their federal tax liability and then multiply by a single Ohio tax rate. A tax rate of 23.2 percent applied to federal tax liability (in 1993) would be revenue-neutral with the present system for Ohio, and a rate of 27.5 percent applied to federal tax liability would raise approximately \$850 million in additional revenue. /8/ Two states, Rhode Island and Vermont, currently use such a tax base.

This reform option would tie Ohio's individual income tax to the federal taxable income base and the federal marginal rate structure. Federal taxable income is a base that is quite different from Ohio's current tax base in many ways. Ohio's current income tax structure allows few deductions and additions to federal adjusted gross income to obtain Ohio adjusted gross income. Also, Ohio's current structure allows personal exemptions of only \$650 per dependent and taxpayer(s). The result of these additions and subtractions is that Ohio brings taxpayers into the tax net at relatively low levels of income, even though certain Ohio credits mitigate this somewhat.

Under the proposed federal tax liability option, deductions from federal-adjusted gross income (FAGI) would be expanded. This reform option would allow a personal exemption of \$2,350 per person (for 1993), and the greater of a standard deduction amount or an amount for itemized deductions. Itemized deductions are allowed for: medical expenses (above 7.5 percent of FAGI), home mortgage interest, state and local taxes (income and property), excessive casualty and theft losses, and some employment expenses. These deductions are adjusted annually for inflation.

Under this proposal, Ohio would implicitly be tied to the federal income tax rate structure. Currently, the federal tax rates are 15, 28, 31, 36, and 39.6 percent. The tax brackets are defined by filing status and are indexed annually for inflation.

**Evaluation.** This proposed change in the individual income tax would have several important effects. First, using federal tax liability as the tax base would significantly simplify the state individual income tax calculation. Taxpayers would simply multiply their federal tax liability by an Ohio tax rate to obtain Ohio tax liability.

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Box 4

Individual Income Tax Calculation: Present and Proposed  
Calculation of the Ohio tax due under the present system, for a  
hypothetical taxpayer, family of four, would be as follows:

Federal adjusted gross income:	\$30,000
less: Ohio adjustments	\$0
equals: Ohio adjusted gross income	\$30,000
less: Personal exemptions (650x4)	\$2,600
equals: Ohio taxable income	\$27,400

Apply Ohio tax rate schedule:

equals: Ohio tax before credits	\$776
less: Ohio credits	
(Example: joint-filer and exemption credits):	\$195
equals: Ohio tax liability after credits	\$581

Under the proposed system, the tax due would be calculated in two  
steps:

Federal tax liability:	\$2,156
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Apply Ohio rate (23.2 percent) to obtain:

Ohio Tax liability:	\$500
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Second, because this reform option will lead to substantially increased deductions from income for most Ohio taxpayers, adoption of this base would cause many low-income families to be dropped from the rolls. Currently, for most filers, total Ohio adjustments equal their personal exemption amount of \$650 per dependent plus taxpayer(s). For a family of four, total Ohio deductions are \$2,600, but under this reform option, total deductions for a family of four taking the standard deduction would equal \$15,600, hence families of four with incomes below \$15,600 would no longer pay Ohio income tax. It is estimated that about 300,000 returns (out of 4.8 million) could have been eliminated had this reform been adopted in 1993. This would increase the vertical equity in the system, and could ease administrative burdens for the Department of Taxation.

Third, the horizontal equity of the tax would be improved due to the reduction in special income deductions (retirement income), and the elimination of the marriage penalty. The use of federal tax liability as the base of the Ohio income tax would disallow Ohio's current deductions for Social Security/railroad retirement income. The simplified structure would also disallow the retirement income and senior citizen credit. However, the net benefit to retirees of the increased standard

deduction and personal exemption amounts would outweigh the loss of the Social Security deduction and credits for most all retirees and senior citizens.

Fourth, the effective marginal tax rates would change from the current nine rates between 0.743 and 7.5 percent to five effective marginal rates ranging from 3.48 to 9.19 percent for the revenue-neutral option and 4.13 to 10.89 percent for the revenue-enhancing option. /9/ This means that the proposed new system is more progressive than the current structure since the top effective tax rate rises from 4.3 to 6.03 percent. /10/ Taxpayers with incomes over \$100,000 pay approximately 33 percent of the total tax liability. Currently, those taxpayers pay approximately 30.7 percent of total liability. This change would put the highest individual income tax rate slightly above the highest corporate tax rate, which puts partnerships and sole proprietorships at a disadvantage relative to corporations. However, this relative disadvantage occurs for individuals with very high levels of income, over \$200,000.

A comparison of the present system to an equal yield federal liability system shows that the top rate rises only to 5.2 percent. However, it should be emphasized that the true effects will vary by individual filer. For those individuals with very high itemized deductions, Ohio liability may be reduced substantially over their current liability.

Some will see the increased marginal rates at the top end as a problem with the proposed reform, i.e., that the result will be to make Ohio's environment less friendly to high-income workers and investors. In fact, the marginal income tax rate will be high, but not significantly higher than it would have been had this reform been financed with an add-on to the current marginal rate schedule. The alternatives, to hold on to the high rates of tax on business investment or to ask the sales tax to carry more of the load, seemed less acceptable.

Fifth, this reform would reduce the discretion of the legislature to adjust the income tax structure. If they remained true to the system of coupling to federal tax liability without further adjustments, they would have only one policy option to increase or reduce revenues -- to change the tax rate. This is both good and bad, depending on one's point of view. It is bad because the state is affected by any policy actions that the federal government takes (rate changes, standard deduction increases, etc.) and can adjust to "undesirable federal changes" by altering its single tax rate. It is good because it precludes the introduction of self-interest measures such as special deductions or credits, discretionary inflation adjustments, etc.

Sixth, the elasticity of this option is approximately 1.15, which is lower than that of Ohio's current income tax. Due to the indexation of the federal income tax, the rate elasticity of this option is lower than that of Ohio's current structure, while the base elasticity is slightly larger. This option would therefore yield a revenue source which is less volatile, and would grow faster than the growth in the economy. However, part of the very high built-in growth of the current Ohio income tax would be eliminated.

Lastly, the availability of itemized deductions would encourage, to a lesser degree, the same types of behavior currently subsidized by the federal government. /11/ These types of behavior include the purchase of a home, a substantial gift to a qualified charity, and relief for the burden of catastrophic

health care. Deductions clearly introduce inequities, but these inequities have been found to be justified for social reasons.

## Property Tax

Proposal: The commission recommends the appointment of a working group to review the system of state-local government finance of Ohio. The charge to this study should include a review of the real property tax with an eye toward comprehensive reform.

Proposal for study: Consider a restructuring of the present real property tax that would replace the present system with a tax base of full market value, eliminate the tax reduction factor, (i.e., HB 920), freeze the dollar amounts of the property tax rollbacks, and impose an absolute millage cap. Such a program could be phased in over a five-year period, and could be revenue-neutral. Consideration also should be given to allowing local jurisdictions to impose differential property tax rates on land and buildings.

The commission recognizes the importance of reforming the real property tax. Reform is necessary because the tax is terribly complicated and because it may not be an adequate basis for financing the services that Ohio's local governments must deliver in the future. But the commission did not feel that it had the time or resources to fully develop a proposal for reforming the real property tax, nor did it have the charge to study the effects of tax reform on individual local governments. It is not possible to properly evaluate alternative structures of the real property tax in isolation from analysis of the overall state assistance program for local governments, other sources of local government revenue, and school finance. Accordingly, we strongly urge that property taxation be at the center of the terms of reference for a study group on state and local government finances in Ohio.

While the commission is not prepared to make a formal recommendation for reform of the real property tax, we have a view on the appropriate general direction for reform. The goal of reform should be to simplify the tax, reduce the number of millage elections, and make it possible for school districts to do more efficient fiscal planning. Such changes would have to be implemented over a period of time, perhaps five years, and should be revenue- neutral.

The Ohio property tax has long needed a complete reform. The problem in Ohio, unlike other states, is not with the level of property taxation. The problem is complexity. In fact, the Ohio property tax is so complicated that few taxpayers understand how it works or how their liability is determined. Moreover, its revenue growth is held inelastic by "reduction factors," it is assessed at a fraction of full market value, and it includes a credit program that is a combination of property tax relief and a grant to local governments. Both features, in fact, are poorly designed.

The commission has identified five key areas of concern:

- o Consideration should be given to increasing the assessment rate to 100 percent of full market value. This would require a reduction in millage rates to offset the increase in assessed value.

o Consideration should also be given to elimination of the tax reduction factors. This could be accomplished by freezing the factors at their current values. New millage rates, including replacement rates, would not be subject to a reduction factor. Thus within five years, most millage rates would be freed from reduction. For any permanent or long-term millage rate, the reduction factors would be eliminated over a five-year phase-in period. During this period the tax reduction factors could be reduced by 20 percent each year, with mandated reduction in the voted millage used to keep the effective millage levy constant.

o The elimination of the 10-percent and the 2.5-percent rollbacks should be considered. The funds used to finance the rollbacks would be frozen and used to offset the loss in local government revenues.

o In addition to the current 10-mill limit, a maximum property tax rate (or cap) might be considered. This could take the form of a limit on the maximum millage levy.

o The commission recommends that consideration be given to allowing local jurisdictions the option of imposing a differential tax rate on land versus improvements. Under such a scheme, the property tax rate on land would be higher than the rate on structures, giving landowners maximum incentive to develop their properties to highest use. Such a system is used in Pennsylvania, and in several countries around the world.

Adoption of the five suggestions would have several advantages. First, it would simplify the real property tax, which is now incomprehensible to most Ohio taxpayers. Second, it would eliminate the two rollbacks, which form a poorly designed property tax relief and local government aid program. Third, it would reduce the need for local jurisdictions to seek voter approval of millage levies on such a frequent basis as is now the case. As a consequence, it would allow for a more rational budgeting process on the part of local governments. Finally, by moving the tax base to full market value, the assessment process could be made more understandable.

There are many details that would have to be addressed in designing a plan with these features. For example, the state funds that are currently used to finance the rollbacks could either be used to hold each local government harmless, or be converted into a formula-based local government grant program. Likewise, going to 100- percent assessment means that the 10-mill limit will no longer be equivalent to a 0.35-percent limit, but will equal the constitutional limit of 1 percent. Thus, a decision

would have to be made whether to keep the legislatively imposed 10-mill limit or lower it to 3.5 mills. Despite the difficult design problems, the commission believes that a comprehensive reform program could be fully developed and implemented over a five-year period so that property taxes do not increase and local governments are held harmless in terms of total revenues.

Removing the tax reduction factor need not result in an increase in property taxes. Over the past 20 years voters, have approved millage increases that have increased property tax revenue by about the same amount as would have occurred if the full growth in the property tax base had been taxed. The commission believes, however, that any increases in millage rates should be approved by the voters.

The example in Table 3 illustrates how a program to move to 100- percent assessment, eliminate the tax reduction factor, and freeze the rollbacks could be implemented without any increase in property taxes or loss of revenue to local governments. The first part of the table shows the calculation of real property taxes under the current structure, while the second part shows the calculation under these illustrative changes once they are fully phased in. It is assumed that the maximum inside millage is changed to 3.5 mills. The value of property and the amount of taxes levied are the actual values for the state, and the tax reduction factor and millage rates represent the average values for Ohio.

Table 3  
Impact of the Illustrative Reform Program  
(dollar amounts in millions)

	Current		Recommendation	
	Class 1	Class 2	Class 1	Class 2
Property Value	\$211,689	\$81,306	\$211,089	\$81,300
Assessed Value	\$74,091	\$28,457	\$211,689	\$81,300
Inside Millage	10 mills	10 mills	3.5 mills	3.5 mills
Outside Millage	62.6 mills	62.6 mills	12.1 mills	13.8 mills
Total Millage	72.6 mills	72.6 mills	15.6 mills	17.3 mills
1-Tax Reduction				
Factor	0.653	0.719	0	0
Effective Tax Rate	50.9 mills	55.0 mills	15.6 mills	17.3 mills
Property Taxes				
Charged	\$3,771	\$1,564	\$3,300	\$1,408
Rollback	\$471	\$156	0	0
Taxes Paid	\$3,300	\$1,408	\$3,300	\$1,408
Grants to Local				
Government		0	627	

Two points should be noted:

- o Taxes on Class 1 taxpayers under the current system are a smaller percent of property value than for Class 2 because of differences in the tax reduction factors and the 2.5-percent rollback that applies only to Class 1

property. Eliminating the tax reduction factor and the rollbacks, and imposing the same millage rates on both classes of taxpayer, would result in a slight increase in the effective tax rate for Class 1 property and a reduction in the effective tax rate for Class 2 property. In order for the property taxes paid by each of the two classes of taxpayers to be the same before and after the implementation of such a program, the millage rate would have to be slightly lower for Class 1 property. Table 3 uses different tax rates for the two classes.

- o Total taxes paid to local governments could remain the same after implementation. The rollbacks are eliminated and in their place is a local government grant program that distributes the same amount of revenue as before the reform.

Property taxes would not increase as a result of such a program. Nevertheless, consideration might be given to capping the property tax rate. Although similar to the 10-mill limitation, such a cap would provide absolute assurance that property tax rates could not exceed some maximum.

There are many details that would have to be worked out before the decision could be made about the desirability of a cap. Whether the cap could be exceeded by a vote of the residents is an issue for study. The value of the cap would have to be selected and a process for allocating parts of that property tax limit to each of the various local governments would have to be determined, as with the allocation of the 10-mill limit. Since the cap would require some local jurisdictions to reduce their total millage levy, alternative sources of funds would have to be found for these local governments.

## The Estate Tax

Proposal: The commission recommends that the Department of Taxation undertake a review of its records to reexamine the question of whether estate taxes have induced out-migration of the wealthy.

The state of Ohio has one significant policy option regarding the estate tax, specifically whether it should eliminate the extra tax on estates that is imposed in Ohio and five other states. Eliminating the tax would remove any incentive for households with estates in the range below \$4 million to make a tax-based decision to move. The Department of Taxation has estimated that such a change would cost the state a significant amount of revenue (approximately \$100 million per year).

However, this revenue could be recovered if enough activity, which had presumably moved out of the state as a result of the estate tax, could be induced to stay in Ohio. There is no direct empirical evidence about the impact of estate taxes as a factor driving Ohioans out of state on retirement.

However, there is information available from the Department of Taxation's individual income tax files which might shed light on this issue.

### Who Benefits and Who Pays?

This reform was structured to shift the emphasis in the Ohio tax system toward one that provides more encouragement to new investors and to those existing firms who would expand their business in Ohio. The blueprint developed by the commission does exactly that, by removing existing taxes on investment in machinery, equipment, inventory, and from capital expenditures in general.

The beneficiaries of this program, to the extent it promotes economic development, are citizens of Ohio and owners of Ohio's businesses: workers who receive a higher real wage, the jobless who find work, capitalists who realize a higher return on their investment, and citizens who receive better-funded public services. It seems proper, therefore, that the burden of payment for this program be spread among these beneficiaries. The blueprint calls for a combination of increased taxes on business income, individual income, and consumption to pay for this program.

These reductions in business taxes would amount to approximately \$2.4 billion, or 12 percent of the total revenues under consideration here. This amount would be financed in some combination of the following ways:

- o increase the sales tax rate by 1 percent to yield about \$800 million;
- o extend the sales tax base to a broad range of services, to yield about \$600 million;
- o extend the sales tax base to include food with a refundable low-income credit against the income tax, to yield \$400 million;
- o restructure the individual income tax to yield \$850 million;
- o bring all companies into the corporate net income tax, introduce combined income reporting, and eliminate tax incentive programs to increase revenues by an estimated \$200 million; and
- o replace the gross receipts tax on utilities with a user charge on utility bills. This will be revenue-neutral, though those who have not been served by utilities subject to the gross receipts tax in the past will see an increase.

While this program will seem like a tax shock to many, the tax reductions are equivalent to less than 15 percent of revenues. The revenue shifts implied are summarized in Table 4, using 1993 amounts as a basis for computation.

Table 4  
A Blueprint for Tax Restructuring:  
Estimated Amounts of Increase and Reduction Implied

	Estimates Based on Fiscal 1993 Collections <sup>a</sup> (in millions)
-----	
Revenue Reductions	
Eliminate Tangible Personal Property Tax	-1,200
Eliminate Net Worth Tax	-200
Eliminate Public Utility Property Tax	-950
Eliminate Gross Receipts Tax on Utility Companies	-650
Introduce User Tax on Utility Consumers	+650
Move Financial Institutions and Insurance Companies to the Corporate Income Tax	-60
Amount Required for Revenue Neutrality	2,410
Revenue Enhancing Options	
Expand Sales Tax Base	
Include Services, broad base	+600
Include Services, narrow base	+150
Include Food, with a refundable income tax credit	+400
Raise Sales Tax Rate by 1 percent	+800
Convert the Present Individual Income Tax to a Flat Rate (27.5 percent) Tax on a base of federal tax liability	+850
Abolish Enterprise Zones	u
Prohibit Special Tax Incentives To Attract Industry	u
Require Combined Income Reporting	u
Increase Minimum Tax on Corporations to \$250	10
-----	

FOOTNOTE TO TABLE

<sup>a</sup>/ Data for personal property taxes are for fiscal 1992.

Estimates marked (u) mean that revenue impact could not be estimated,, but the expectation is that it will be positive.

END OF FOOTNOTE

## Impacts on the Tax Structure

This blueprint emerged from the consensus of the commission that its recommendations for tax restructuring should reflect a new emphasis on economic development and on horizontal equity. Ohio should have a tax structure that attracts investment, and one that offers the same treatment to all companies. The commission believes this blueprint for long-run reform will produce such a structure. The central elements in the program are a reduction in the taxation of capital investments, and the creation of a more competitive environment by subjecting all firms to the same tax treatment.

**Economic Development.** It is proposed that the net worth tax, the public utility property tax, and the tangible property tax all be eliminated. This action would substantially lessen the amount of tax imposed on business machinery, equipment, inventory and capital investment in general, and increase the after-tax rate of return to those who would invest in Ohio. The "price" of both capital investment and equity financing will be lowered, and there should be reduced energy costs to residential and nonresidential users.

**Horizontal Equity.** The horizontal equity of the tax system would be improved by eliminating the differential assessment ratios for public utilities and for general business property. It also would be improved by bringing all types of companies under the general business tax, and eliminating special treatment that presently is given to certain public utilities and financial institutions. Enterprise zones and special tax incentives would be eliminated, removing special treatment now received only by beneficiaries of those programs. In addition, the switch from the public utility gross receipts tax to a user charge brings all in-state and out-of-state public utilities to the same competitive basis.

**Vertical Equity.** The distribution of tax burdens across income classes will change with this reform, but the overall progressivity will not be worsened. The blueprint contains a package of reforms that will benefit middle- and upper-income families in some cases, and will benefit lower-income families in other cases. Moreover, an analysis of the short-run tax burden effects of the entire program, such as is presented in Table 5, does not take into account the benefits that will accrue in the longer run, i.e., the increase in job formation and real income growth in the state.

Nevertheless, one can point out that the short-run impacts on tax burden if this program were to be adopted in its entirety would not compromise the vertical equity of the Ohio tax system. In fact, the proposed individual income tax reform would remove about 300,000 low-income workers from the income tax rolls and would increase the marginal effective tax rate on higher income families. The shift from taxes that are deductible for federal income tax purposes to taxes that are not deductible also introduces a progressive element because itemizers (who can take advantage of these deductions) are higher- income families. The elimination of the public utility property tax will benefit some utility consumers and therefore will have a progressive element. The expansion of the sales tax

to include food, with a refundable credit, would protect lower-income families from the increased tax.

Other changes would move in the opposite direction. This is necessary, and desirable, because one of the objectives of the reform is to increase the return to investors, who tend to be higher income. The reduction of the net worth tax is meant to increase the profitability of corporations, and to provide more rewards to those who invest in Ohio. The same is true of the reduction in the tangible personal property tax and the public utility property tax.

Table 5  
Tax Burden Shifts and the Blueprint for Reform:  
Illustrative Short-Run Impacts

	Tax Burden Reductions	Tax Burden Increases
-----		
Individual Income		
Tax Restructuring	Approximately 300,000 low-income workers would be dropped from the roll	Middle- and upper-income families
Increased Sales Tax Rate	--	All consumers
Expand Sales Tax to Services	--	Consumers of services
Expand Sales Tax to Food With Refundable Income Tax Credit	Low-income families receive a rebate for food consumption	Middle- and upper-income consumers of food
Eliminate Net Worth Tax; Introduce Combined Income Reporting	Capitalintensive firms; firms with net losses; small, start-up firms/1/	Firms that avoid income tax through transfer pricing/1/
Eliminate Tangible Personal Property Tax	Capital intensive firms, and firms with heavy inventory requirements/1/	--
Eliminate Public Utility Property Tax	All public utilities covered by this	

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tax;/1/ utility  
consumers

Eliminate Gross	--	Municipal utility
Receipts Tax on		company con-
Utilities and		sumers; those who
Replace With User		purchase from out-
Charge on		of-state companies
Consumers		

-----

FOOTNOTE TO TABLE

/1/The tax increases and reductions will be borne in some proportion by owners of the company,, workers,, and consumers of the products produced.

END OF FOOTNOTE

The overall effect of these changes on vertical equity is difficult to exactly measure. This is partly because the exact composition of the reform package is not yet known, e.g., would Ohio voters choose a sales tax rate increase or a food tax with an income tax credit, would the increase in revenues from the business sector be large enough so that the sales tax increases could be less, etc. Even with this uncertainty, it does not seem likely that the progressivity of the Ohio tax system would be significantly worsened by this reform.

Elasticity. The elasticity of the system, i.e., its built-in growth, would be increased by this package of reforms. This happens for two reasons. First, the sales and gross receipts taxes are themselves restructured in ways that lead to a greater elasticity, i.e., a greater revenue response to income increase. The sales tax become more elastic because of the addition of services to the tax base, and the gross receipts tax becomes more elastic because all utility purchases will be included in the base. The individual income tax, on the other hand, will be somewhat less elastic than at present because it will be tied to the indexed federal tax structure.

The second reason for the increased elasticity is the shift in emphasis from the personal property taxes that have lower elasticities to more buoyant sales and income taxes. The net effect of this restructuring is that Ohio tax revenues will grow at a faster rate than under the current system, even given the same rate of increase in the Ohio economy.

Stability. Revenues under the proposed reformed tax structure will be less stable over the business cycle than under the present system. The elimination of the net worth tax and the personal property taxes drops some taxes that grow very slowly but without much fluctuation. Revenues from sales and income taxes, especially corporate net income taxes, are more variable over the business cycle. The option of taxing food, if it were chosen, would add some stability to the revenue flow.

Simplification. The blueprint for reform would lead to a simplification of the Ohio tax system. This would bring three important benefits. First, the tax structure would be less complex and more understandable by citizens. Second, it would impose less compliance costs on those who pay. Third, it would reduce the administrative effort required by the state tax administration.

- o The elimination of the net worth tax and all personal property taxes will reduce administration and compliance costs by a significant amount.

- o The real property tax reform will simplify the tax to a simple millage rate levied against full market value. The reduction factors and the rollbacks would be eliminated and the tax could be understood by taxpayers.

- o The individual income tax reform also introduces a major simplification. Taxpayers will simply calculate federal liability and multiply by a single percentage rate to obtain state income tax liability.

- o As many as 300,000 taxpayers would be dropped from the individual income tax rolls.

Against these simplifications, some complexities have been proposed. The extension of sales taxes to the services sector will impose some additional administrative costs on the Department of Taxation, since some services are delivered in complex ways. The same is true of the income tax credit for food consumption, which would also place an additional burden on the tax administration, and would require filing by many low-income families. Additional credit filers would tend to offset one of the strong administrative features of the proposed individual income tax -- the elimination of many low-income families from the tax roll. Finally, there is considerable complexity associated with the requirement of combined income reporting for all corporations. The commission felt these simplification sacrifices to the overall goals were unavoidable.

Obsolescence. The reform program eliminates some obsolescence from the tax system with three proposed changes. It recognizes competition in the public utility sector by moving utilities under the corporate income tax and by eliminating the differential treatment under the personal property tax. The extension of the sales tax to services recognizes modern consumption behavior. The adoption, implicitly, of a standard deduction and higher exemption for the individual income tax, recognizes the need for a higher tax threshold for low-income workers.

Poor Places. A goal of the commission was the protection of the fiscal condition of poor places. While the commission was not given a mandate to work on the fiscal problems of individual local governments, or even to consider a restructuring of the general system of state-local fiscal relations, it did recognize the need to scrutinize each of its reform proposals to determine whether they would have a particularly undesirable effect on poor places. The conclusion of the commission is that this reform would likely benefit poor places, some in the short run but perhaps all in the long run.

The main reason why the budgets of poorer central cities in Ohio have done as well as they have in recent years is the availability of the local income tax, which is levied on residents, employees, and businesses in the city. Despite the obvious gains to merging this with the state income tax (administration and compliance costs), the commission has made no recommendation for change.

The commission's recommendations will benefit poor places in two ways. The elimination of 300,000 low-income workers from the state income tax roll will benefit those locations where the working poor are clustered, and the expansion of the sales tax base to services and food will benefit counties that levy the local option sales tax (though the option of an increased sales tax rate will benefit only the state).

Finally there is the issue of abolishing the personal property tax, a mainstay of the revenue structure of local school districts. The commission recognizes this change would result in a devastating loss for some school districts, and recommends that all local governments be held harmless for these losses until a more appropriate basis for long-term financing can be worked out. The personal property tax is not a suitable way to finance local schools, and the shift to a more elastic source with a more fair distribution of revenues will be a long-run benefit to education financing in Ohio.

#### Phasing in the Reform

This blueprint for tax reform was designed as a package. The pieces fit together to move the Ohio tax structure to a new emphasis on economic development without compromising equity, fairness, and adequacy of revenue yield. Individual components of the proposal make less sense when viewed out of context. The commission recognizes, however, that this reform cannot be implemented immediately as a single comprehensive package. There are several reasons for this, as noted in the paragraphs below.

**Effect on Local Governments.** The proposed reform raises major issues in state-local government fiscal relations that need to be worked out. The proposal to eliminate personal property taxes would weigh heavily on some local governments, and the proposal to expand the sales tax base would benefit others disproportionately. Similarly, the property tax simplification has potentially important effects on some local governments. The commission was not asked to study the distribution effects of such reforms. It would be poor public policy, however, to ignore these effects or to offer patchwork solutions without careful study.

The commission recommends that the state appoint a study group to develop a long-run program for state-local fiscal relations, and for local government taxation. This group would be charged with identifying a program that is consistent with the state's goals for local government finance and is consistent with the blueprint for taxation developed here. In the interim, the commission recommends that all local governments be held harmless from any revenue loss that results from this reform program. Local governments can remain unharmed through a temporary, compensating state assistance program financed from increased state taxes resulting from this program.

**State Government Expenditure Strategy.** The state government must settle on a long-run expenditure program before it can decide on the growth rate it wants from its tax system. The reform program

proposed here is revenue-neutral but provides for a greater elasticity than the present system. The state government may want to adjust this structure depending on estimates of long-term expenditure needs.

Competition in the Public Utility Sector. The motivation for the switch away from the gross receipts tax and personal property tax with a differentially higher tax rate is growing competition. Once utility "monopolies" become competitive, inappropriate tax policy can have important allocative effects and may leave a public utility at a disadvantage relative to its competitors. However, a fair question is whether all of the industries currently subject to the gross receipts tax and higher personal property taxes are now "competitive," and if not, how do they rank on the competition scale. This is a question that has no definitive answer.

There are two ways of addressing the issue. On the one hand, it is certainly the case that the large bulk of the business done in these industries is still done by the public utilities. There are very few (if any) options for getting power into a house without running through the power lines of the local electric company. Likewise, in the natural gas industry. However, there is competition in the purchase of the raw power or the raw natural gas. The amount of purchases from the alternative sources is still very small, but they do exist. If one wants to define a monopoly in terms of some measure of concentration of sales in a particular industry, then the utilities still look very much like a monopoly.

However, if one takes the view that a monopoly no longer exists when the "monopolist" must make its pricing and production decision with an eye toward an alternative provider of the same service, then the monopoly no longer exists. This is "virtual competition." This situation exists to some degree in the electric and natural gas industries and it certainly exists in the telecommunications industry. It seems clear that the market in electric and natural gas will develop to the point that pricing and service decisions will become very sensitive to the alternative sources of service that are available.

In short, there is no easy answer to the question about the degree of competition in these industries. However, there is clearly encroachment on these markets, particularly in the telecommunications sector. A reasonable tax policy approach is to phase in the tax reform for public utilities over a period of years.

Tax Administration. Some time must be given to the Ohio Department of Taxation to organize itself to implement the new system, and to work out the inevitable transition problems. A new form of income tax is to be administered, for example, and this will require everything from new forms and instructions to a new taxpayer information service. Both the introduction of combined income reporting for all corporations, and the expansion of sales taxes to services will require substantial administrative adjustments, and the switch to a user basis on public utility charges will require changes in collection procedures.

### Phase One Reform

The commission recommends that the state move to adopt a Phase One reform, as a first step in implementing this blueprint for tax reform. The Phase One reform would include the following:

1. elimination of the personal property tax on inventories;
2. elimination of the net worth tax;
3. the requirement of combined income reporting for all corporations;
4. reduction of the assessment ratio for new investment by public utilities to 25 percent;
5. reduction of the assessment ratio on personal property to 25 percent for interexchange companies;
6. replacement of the gross receipts tax on utilities with an equal yield user charge on consumers;
7. inclusion of all financial institutions and insurance companies in the corporate tax. Abolish the special taxes on banks, insurance companies, and dealers in intangibles; and
8. a five-year step-down of the assessment ratio for public utility property from 88 to 25 percent. These reductions will be returned to ratepayers in the form of rate relief.

We have not made exact projections of the amounts of revenue involved in 1995. But using 1993 estimates as a basis, we can estimate that this package would have cost about \$800 million (exclusive of the gross receipts tax, which will be an even swap with the user charge). There are two options for raising this additional amount.

One is to introduce the individual income tax reform, with the appropriate rate. The other is to introduce a sales tax increase, with a combination of base-broadening and increased rate.

Other measures that should be undertaken in Phase One include:

1. a study group on local government finance should be appointed to review the system of state-local fiscal relations, and local taxation;
2. no new tax abatements should be allowed, either in the form of targeted tax incentives or enterprise zones. Existing enterprise zones should be phased out; and
3. the minimum tax on corporations should be increased to \$250.

During the Phase Two reform, the balance of the tax plan could be implemented. The personal property tax on utilities would be stepped down and eventually phased out, along with the noninventory portion of the tangible personal property tax. The state Department of Taxation, the legislature, the PUCO, and the utilities should work together to make these changes over a period of time to meet the commission's recommendations.

The revenue reductions in phase two would be paid for with increased sales/income taxes and increased business taxes as companies are phased into the corporate net income tax.

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## FOOTNOTES

/1/ Of these 16 states, 7 allow either for partial exemption, or for total exemption at the option of individual local governments.

/2/ The assessment ratio is 100 percent for electricity production equipment, and for certain other classes of equipment.

/3/ Though it is not our mandate to study the system of intergovernmental fiscal transfers, the commission questions the fairness of using the value of public utility property as a method of distributing resources for school finance. While there may be good reasons to allow local governments to enhance their fiscal capacity if they are home to these facilities, this tax base would not seem related to the education expenditure needs of a school district.

/4/ Michael Wasylenko, *The Role of Fiscal Incentives in Economic Development: How Ohio Stands Relative to Its Competitor States*. Staff Report Number 11 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, Ga: Policy Research Center, Georgia State University) page 54.

/5/ William Fox, *Ohio's Sales Tax: Current Condition and Policy Options*. Staff Report Number 2 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, Ga: Policy Research Center, Georgia State University).

/6/ See ACIR (1993), Table 29.

/7/ In 1992 Maryland broadened its taxation of food to include ready-to-eat food in grocery stores, certain snack foods, and sales by college and hospital cafeterias.

/8/ These estimates were derived from IRS, Statistics of Income (SOI), 1991 and 1992 data. Since Ohio does not currently allow itemized deductions, the SOI data were used to estimate the tax liability base for this option. For a more complete discussion of the method see "Memorandum on the Individual Income Tax Estimates," by Sally Wallace, December 21, 1994.

/9/ These estimates incorporate the federal income tax reforms of 1993. The federal rate structure includes two phaseouts: one for personal exemptions and one for itemized deductions. For taxpayers

"caught" in the phaseout income range, the federal marginal tax rate is actually higher than the statutory rate. Ohio's marginal rate would therefore be higher as well.

/10/ A comparison of the present system to an equal yield federal liability system shows that the top rate rises only to 5.2 percent.

/11/ Under the reform, the Ohio marginal tax rate remains below the federal marginal tax rate. Therefore, the value of each deduction to the Ohio liability is less.

END OF FOOTNOTES