Taxation of the Insurance Industry

TAXATION AND ECONOMIC DEVELOPMENT

A Blueprint for Tax Reform in Ohio

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INSURANCE TAXATION

INTRODUCTION

This chapter examines the insurance industry, its contribution to the Ohio economy, and issues in the taxation of the Ohio insurance industry. Insurance is a very important service provided in the economy, and because of its special nature it is often taxed differently than other types of corporations and even other financial service firms.

Table 12-1 compares the insurance industry with others in the state and shows that the insurance industry pays more in premium and capital and surplus taxes than the banking industry pays in net worth taxes. The insurance tax accounts for approximately 26 percent of corporate franchise taxes (included insurance taxes, corporate net income and net worth tax, and financial institutions taxes). In comparison, the manufacturing sector pays approximately the same amount as the insurance industry, while the service sector pays about 5.5 percent of business taxes. The insurance industry employs slightly more people than the banking sector, while contributing about the same amount to state GDP. Thus, the insurance industry is an important part of Ohio's tax structure as well as the state's economy.

TABLE 12-1
Relative Importance of Insurance Industry Relative to Other Industries in Ohio

Industry	Total Taxes paid to Dept. Of Taxation (1992) (Million $)	Percent of Total Corporation Taxes Paid (1992)[a]	Total Number of Employees	Average Wage	Percent of Ohio GDP (1989)
Insurance[b]	277.1	25.80	90,300	$32,064	1.73
Banking[c]	157.9	15.56	87,200	$24,900	1.86
Services	60.2	5.6	1,490,700	$21,770	16.96
Manufacturing	282.6	26.31	1,278,500	$33,943	27.53
Corporations	630.1	58.65	---	---	---

Sources: Ohio Bureau of Employment Services, U.S. Dept of Labor, Bureau of Labor Statistics, *Employment and Earnings* (1993); Ohio Department of Taxation, and U.S., Dept of Commerce, *Survey of Current Business*.

[a]Includes all corporation net income and net worth taxes, financial institution taxes, and insurance premium taxes.
[b]Premium Taxes only
[c]Financial Institution Taxes Only

Performance of Ohio's Insurance Industry

In 1993 the state of Ohio was home to 47 life insurance companies and 165 property-liability companies. This number has changed dramatically over time. Over the last 30 years a number of companies have domesticated in Ohio. The increase in the number of property and liability companies occurred after 1979, while the life industry experienced growth until the middle 1970s and then stabilized.[1] The home office of an insurance company contains most of the company's employment base as well as its operations base. Thus, obtaining and retaining home offices would increase employment and economic development in Ohio.[2] Wheaton (1986) found that states' tax policy can penalize the domestic industry in terms of future growth of the industry. Thus, it is important to make sure that there is a full understanding of the effects of all income tax policies and how they interact to effect employment and growth of the state's insurance industry.

Industry Breakdown

Property and Liability. The Ohio property and liability insurance industry is made up of approximately 800 companies selling insurance for auto, homeowner, commercial, liability, and other coverages. In 1992 approximately 50,000 people were employed in the property-liability insurance industry in Ohio. Of these, 165 were domestic companies, accounting for 57 percent of premiums written in 1992.

Life. The life insurance industry includes 695 companies writing group and individual life insurance. These firms employ approximately 20,000 people in

Ohio. Life insurance is actually two products: one for savings, and one for indemnity in case of death. Since there is a savings component, it is very important that tax policy be structured to be consistent with other savings products. To the extent there is different tax treatment between the savings component of a life insurance product and the savings component of some other financial contract, the state's tax policy could bias or reduce the amount of savings within the state. Of the approximately 695 companies writing business in Ohio, 47 are domestic companies. These companies account for 13 percent of the life business written in Ohio.

Other. In addition to accident and health insurance written by life insurance companies or by traditional property-liability companies, there are a number of other providers of health coverage. There are Blue Cross/Blue Shield providers in Ohio.[3] These companies are now classified as domestic mutual property-liability companies. In 1991 they accounted for $1.885 billion in subscriber premiums, representing 21 percent of the non-life premiums (excluding HMOs) in Ohio. In addition, there are a number of health maintenance organizations (HMOs), with $1.755 billion in premiums in 1991.[4] These companies can elect an exemption from the premium tax in exchange for open enrollment[5] and community rating.[6] However, open enrollment and community rating are potentially very costly and not many HMOs elect this exemption.

There are also a number of fraternal insurance companies. These companies provide coverage to members of certain fraternal organization, such as the Knights of Columbus or the Alliance of Transylvanian Saxons. In Ohio there are 14 domestic fraternals and 63 foreign fraternals. In 1991, these companies accounted for 3.15 percent of total premiums written in the life insurance industry in Ohio.

CURRENT STRUCTURE OF OHIO'S INSURANCE TAX

History of Insurance Taxation

Historically, insurance premiums are taxed, rather than notions of income. This has been done for one major reason: simplicity. The calculation of net income for an insurance company is conceptually quite difficult as premiums are collected now, but losses are not realized until a number of periods henceforth. Thus, there is difficulty in determining net income. Reserves set up for future liabilities appear as income to the tax collector. Even if the tax collector understands the special nature of the insurance contract, the tax collector and the insurer must agree on an appropriate interest rate to discount the reserves to calculate net income for the current year. In addition, even if the reserves are discounted, one may question the appropriateness of taxing reserves. This is because the reserves are the finan-

cial capital backing future losses. State solvency regulatory policy requires that the companies keep higher reserves than they might otherwise keep to reduce the risk of insolvency, and thus companies with the required reserves would pay more taxes than those which did not keep the required reserves.

Because of these problems, and the fact that a method of properly discounting the reserves was not available when insurance companies first became taxable, a simple solution of taxing premiums was developed. In fact, this is the predominant method for taxing insurance companies worldwide. However, its use has been strongly criticized, and a responsible state should recognize the implications of the premium tax for the long run viability of the industry.[7]

Structure of the Taxes

Premium tax and franchise tax. Companies writing in Ohio are taxed based on the of 2.5 percent of their gross direct premiums written (premium tax) and 0.6 percent of capital and surplus (franchise tax) if they are an Ohio domesticated (or chartered) company.[8] If the company is a foreign company (or companies chartered outside the state of Ohio) the insurer is taxed 2.5 percent of premiums less return premiums paid for cancellations and considerations received for re-insurance of risks within Ohio.[9] In addition, foreign insurers, if they provide dividends to policyholders can deduct these policyholder dividends if the dividend is in excess of the net cost of insurance.[10] The domestic tax on the minimum basis of 0.6 percent of capital and surplus or two and one-half percent of direct premiums written allows small companies with small capital and surplus (net worth) to be taxed at a relatively low rate. As the company grows and has increasing contributions to capital and surplus, the company pays the premium tax if it is less than the capital and surplus tax.

Box 12-1 shows the schematic for the domestic insurer for determining which tax to pay: the premium tax, which is based on gross premiums, or the capital and surplus tax, which is based on a statutory definition of capital and surplus. Note that this statutory definition includes excess reserves, certain policy holder dividends not paid out, certain reinsurance, and non-admitted assets. From this there is a deduction for ownership of stock in Ohio insurance subsidiaries. For foreign companies, the tax base is direct written premiums net of policy holder dividends.

Based on current law approximately 45 percent of the domestic life industry pays a capital and surplus tax while 65 percent of the property industry pays a capital and surplus tax.

More property-liability companies pay the capital and surplus tax. Further, the property-liability companies paying the capital and surplus tax account for almost 70 percent of domestic premiums. This contrasts sharply

BOX 12-1

Insurer pays the minimum of the two taxes

2.5% Gross Premiums 0.6% of Capital & Surplus

Capital & Surplus =
Excess Reserves
+ Statutory Reserves
+ Policy Holder Dividends
+ Certain Reinsurance
+ Non-admitted Assets
— Common Stock Owned in Ohio Subs

with the experience in the domestic life industry, which accounts for only 6.0 percent of the premiums. Finally, as compared to the industry's median asset size, the property-liability companies are relatively larger than those companies paying capital and surplus taxes in the life industry.

Exemptions and Omissions from the Tax Base

Health premiums by HMOs. Health insurance premiums sold by life and health insurance companies and property-liability companies are treated similarly to other insurance. However, the Blue Cross/Blue Shield companies are subject to different capital and surplus requirements for regulatory solvency purposes than the rest of the industry, and are thus more able to take advantage of the lower tax afforded by the capital and surplus franchise tax.[11]

Some states provide some portion of the health insurance industry with tax advantages.[12] This may reduce the cost of insurance to the consumer as no premium tax is paid. A state may desire to promote the consumption of health insurance by reducing its cost through lower taxation.[13] In Ohio this is partially accomplished through the fact that the Blues can take advantage of their special status and pay the franchise tax rather than the premium tax. However, for horizontal equity purposes state policy should treat all health insurance providers similarly.

As part of Ohio's health care policy, HMOs are potentially exempt from the premium tax. In return, the HMOs agree to have open enrollment and employ community, rather than individual ratings for premium determination. There are a number of issues with regard to this policy. The first con-

cerns horizontal equity. Other types of health insurance providers do pay the premium or franchise tax. This provides an incentive for the potential insured to choose an HMO plan over an insurance plan. A second issue concerns whether HMOs are insurance companies subject to a premium tax. HMOs, if not associated with an insurance company, may actually pay the corporate franchise tax rather than the insurance tax. This may provide the HMOs with a tax benefit.

Table 12-2 shows the size of the HMO population in the state of Ohio. The percentage of individuals in HMOs will likely increase in the future. Thus, the potential exists for a diminishing of the state's premium tax or franchise tax base from traditional health insurance.

In 1991, the loss in premium tax revenue if all HMOs had paid the 2.5 percent premium tax would have been $47.6 million while the loss would have been approximately $2.4 million if all HMO's had paid the franchise tax. The HMO industry would pay if taxed like other insurers, something in between as there are some foreign HMOs operating in Ohio and there are some large Ohio HMOs.

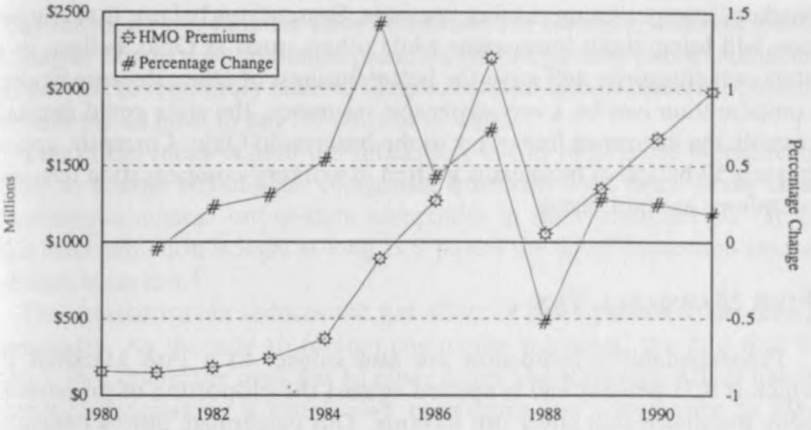
As Figure 12-1 shows, HMO premiums have increased over the last 12 years. As the premiums increase due to individuals and groups leaving traditional insurance policies and switching to HMOs, the loss in terms of tax revenue increases. However, the benefit of having more Ohioans insured may be worth the cost in terms of lost tax revenue and the distortion of the competitive market. If this is true, it makes sense to provide this tax break to all providers of health coverage irrespective of organizational form in exchange for less restrictive underwriting practices.[14]

Annuity Considerations. Annuity considerations are not taxed in Ohio. A number of states, however, do tax these contracts.[15] The majority of states

TABLE 12-2
HMO Enrollment over Time

Year	No. of HMOs	Enrollment	Percent of Ohio Pop
1989	34	1,294,173	11.9
1990	34	1,454,020	13.3
1991	34	1,445,891	13.2
1992	39	1,778,500	16.3

Source: Health Insurance Association of America, *Source Book of Health Insurance Data* (1990-1993).



Source: Ohio Department of Revenue, *Annual Report,* (1992).

FIGURE 12-1. HMO premiums over time.

do not tax annuities, and the federal government also treats annuities differently, exempting qualified pension plans from current income taxation. This is because annuities are thought to be savings vehicles for retirement, and the federal policy is to encourage retirement savings. A state that does not tax current annuity considerations is acting consistently with the federal policy, but unlike the federal government, a state that exempts annuity considerations from current taxation is not able to collect taxes when the annuity is paid.

Some states tax annuities, but exempt considerations paid to qualified plans.[16] So, if an annuity is used to fund a retirement savings program, then it is exempt; otherwise it is subject to the premium tax. To gauge the size of the revenues that could be obtained: if Ohio were to tax all annuity considerations it could expect to receive an additional $41,900,000 in premium tax receipts, which would account for almost 15 percent of current premium tax revenues.[17]

A tax on annuities is a tax on savings and, for horizontal equity reasons, a tax must be put on other savings methods if one is placed on annuity consideration. Savings are arguably not the proper subject of taxation as this is the source of the economy's investment and future consumption opportunities. Thus, a tax on savings, especially if out-of-line with other states would reduce savings and potentially impair economic development.

Workers' Compensation. Workers' compensation premiums are also omitted from the Ohio tax base, because workers' compensation insurance is provided by a state-run monopoly. States have different policies on how the

workers' compensation market operates. Some states believe that competition will bring about lower rates while others, such as Ohio, believe that a state-run enterprise will serve the better business of Ohio. Because workers' compensation can be a very expensive insurance, the state could decide to provide the insurance free of tax to the business in Ohio. Currently, approximately $2 billion of business is written in workers' compensation insurance premiums and not taxed.

Fire Marshall Tax

Property-liability companies are also subject to a Fire Marshall Tax, which is 0.75 percent and is applied against the proportion of property-liability premiums that cover fire hazards. This percentage differs depending on the line of insurance written. For example, fire insurance is categorized as 100 percent fire coverage, auto insurance is categorized as 10 percent fire coverage, and health insurance is categorized as 0 percent fire coverage.[18]

In 1992 the fire marshall tax collected $6.3 million in revenue, which is used to fund the Office of the State Fire Marshall. The fire marshall tax has been volatile over the decade of the 1980s, and the growth in revenues seems to be trending downwards. The most important item to note, however, that it is combined with the premium tax, and thus the real effective rate of taxation on fire related coverage is potentially greater than 2.5 percent. For example, including the premium tax and the fire marshall tax, the effective rate on large domestics and foreign companies can be as high as 3.25 percent.

Retaliatory Taxes

Insurance taxation among the states is unique because of the interrelationship between the taxation policies of the states. Because Congress granted the states complete authority over the regulation and taxation of the insurance industry, subject to relatively minor constraints, states authorize what has been called "retaliatory taxation."[19] The system of retaliatory taxation seems complex, but in its simplest terms says that if another state taxes Ohio's companies at a higher rate than Ohio does, then companies in those high-tax states must pay to Ohio the premium tax plus a tax based on the amount of the difference in the taxes. For example, Alabama taxes Ohio companies operating in that state at 4.00 percent of premiums if they cover Alabama risks. Thus, an Alabama company writing business in Ohio pays the Ohio premium tax at the rate of 2.5 percent of direct premiums, and an additional tax of 1.5 percent, which is the difference between the rate that an Ohio company would pay in Alabama and the rate applicable in Ohio. Similarly, Ohio companies would pay retaliatory taxes to other states if the

Ohio rate is greater than the state's own rate. For example, Ohio companies writing in Illinois pay the Illinois premium tax of 1 percent plus an additional 1.5 percent in retaliatory taxes to Illinois, because Illinois insurers operating in Ohio would have to pay 2.5 percent to Ohio.

One of the ideas behind the retaliation was to reduce the incentive for states to charge out-of-state companies extremely high rates. Many states discriminate against out-of-state companies in their premium tax rates.[20] This discrimination is legal as long as it passes the equal protection clause's rational basis test.[21]

The retaliatory tax reduces the net effect of this freedom to tax foreign companies. As the rate to foreign companies increases, the rate that the state's own domestics must pay to other states also increases.[22] This has the potential for making a state's own companies less competitive in other states' markets. The higher the state's own rate and the bigger the state's companies are in the national market, the more taxes the state's companies pay to other jurisdictions and the less competitive the company is relative to companies in low-tax states. This, in turn, has effects on the local economy. As the percent of revenues being paid to other states increases due to the home state's tax policy, the less viable is the state's own industry and the lower the employment opportunities there will be in the home state's industry. Thus, a change in the premium tax rate can have a significant effect on the home state's industry even though the home state tax revenues do not change much. More of the fiscal effect of this unique tax interrelationship will be shown in the simulation below.

The retaliatory tax was put in place by the states to keep other states from raising taxes from foreign companies. As a state's rate becomes significantly greater than the average rate among the states, the state's own companies start paying more to other jurisdictions. However, there is another side to this coin that can be employed to Ohio's advantage. Since a relatively large percentage of the Ohio insurance market is served by out-of-state companies, Ohio could reduce its rate below the national average and become a recipient of significant retaliatory tax revenues. In addition, as the rate decreases, the domestics receive a benefit from a lower effective rate versus the foreign companies who now must pay a retaliatory tax to Ohio. Thus, removing the explicit, and perhaps unconstitutional domestic tax, replacing it with a low, but equal tax rate on all companies, Ohio can end up with a constitutional tax preference that can stimulate the insurance industry in the state.

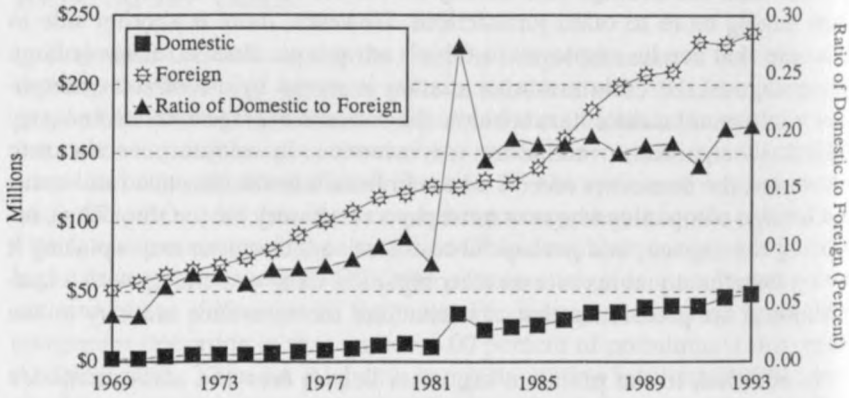
In addition, to the premium tax, other license fees and assessments are also subject to inclusion in the retaliatory tax. This includes assessments for the insolvency funds. The insolvency funds are set up as an *ex-post* insolvency financing mechanism. If a company becomes insolvent, the fund taxes the insurers based on their market share to pay off the Ohio liabilities.

These insolvency assessments are also included in the retaliatory tax calculation in a small number of states.[23]

Foreign Versus Domestic Treatment

Figure 12-2 shows that the ratio of domestic to foreign premiums has increased over time. The domestic industry in 1969 represented about four percent of the total industry's tax contributions. The increase in the early 1980s is the direct result of an increase in the capital surplus franchise tax rate. Since the 1991 increase, the percentage has been relatively stable. By 1993 the domestic industry was paying approximately 20 percent of the premium tax. In contrast, in terms of gross premiums written, the domestic industry wrote approximately 54 percent. This is another indication of the distribution of the tax burden towards out-of-state companies.

A number of states provide some tax breaks solely to domestic companies. These tax breaks are generally of two forms: a rate reduction for investment in certain state assets, or an outright distinction between foreign and domestic companies. Ohio's law, in contrast, is unique. For the first type of preference, a company can reduce its premium tax rate if it invests in state securities or had a relatively high percentage of its assets invested within the state. Alabama, Arkansas, Georgia, and Texas, for example, have laws like this. Although there is no explicit foreign versus domestic distinction in the law, for practical purposes, only small domestics are able to take advantage of the rate reduction, as a large nationwide company could not be expected to invest enough assets in one state to obtain a tax reduction.



Source: Ohio Department of Revenue, *Annual Report* (1992).

FIGURE 12-2. Premium tax collections (foreign and domestic).

Other states, like Illinois, tax foreign companies differentially higher because the regulators argue that foreign companies are more difficult to regulate for solvency purposes. Other states that employed the discriminatory tax as a method of protecting their domestic industry from interstate competition have either scrapped the differentiation as a result of the Supreme Court's ruling in *Metropolitan v. Ward* or have attempted, like Illinois, to provide a rational basis.

A breakdown of the effective tax rates by foreign and domestic companies in 1992 shows that the domestics do benefit from the lower capital and surplus tax (especially for the domestic property-liability companies). This is shown in Table 12-3. The largest beneficiaries here are in the property-liability industry. Of the domestic industry a large proportion is made up of Blue Cross/Blue Shield premiums. Because of the Blues' ability to use a smaller capital and surplus tax base for regulatory reasons, they tend to reap relatively large benefits from the use of the capital-surplus tax.

A question that needs to be addressed is whether the benefits of this tax break are greater than the costs. One benefit may be that there are more small companies available to provide insurance. However, since there are economies of scale in the provision of insurance, these small companies are not likely to be able to reap the benefits of scale economies that would allow them to compete effectively with larger companies. Thus, the differential taxation may enable potentially inefficient companies to stay in business.

Other Fees

There are a number of important licensing and examination fees paid by

TABLE 12-3
1991 Ohio Insurance Effective Tax Rate for Foreign and Domestic Companies

		Effective Tax Rate (In Percent)
Life and Health	Domestic	1.28
	Foreign	1.80
Property - Liability	Domestic	0.87
	Foreign	2.11

Source: Authors' calculation from Ohio Department of Insurance *Annual Report* (1992) Note: Tax base for comparison purposes is gross premiums written. HMO premiums and retaliatory taxes paid to other states are excluded.

the industry for regulatory purposes. Agents of a company have a $20 license fee, and regulatory examinations are also charged to the firm. In 1992, these fees amounted to over $19 million. The corresponding regulatory expenditures were $12.6 million. Thus, the licenses and fees more than pay for the regulation of the industry.

Guaranty Fund Assessments

Ohio, like all other states except the State of New York, has a post-insolvency assessment due from all companies doing business in Ohio during the year of an insolvency. This assessment is based on the insurer's market share during the year a failed company goes insolvent. Recently, these assessments were minimal, but due to insolvencies outside of the state of Ohio during the mid to late 1980s there were large assessments made against the surviving companies doing business in Ohio. However, these assessments are creditable for the life insurance guaranty fund assessment against the premium tax at a rate of 20 percent a year for five years.[24] There is no corresponding credit for property-liability insolvencies.

Tax Administration

The administration of this tax, unlike most other taxes in Ohio, is under the jurisdiction of the Ohio Department of Insurance. For the domestic companies the Department of Insurance calculates the tax payable based upon the companies' statutory filing of informational returns with the state.[25] For the foreign companies, the companies themselves file a tax return with the Department of Taxation. As the domestic company tax calculation is rather simple, it seems efficient for the Department of Insurance to calculate all domestic company taxes and send out bills.

COMPARISON WITH OTHER STATES

Ohio's Insurance Revenues

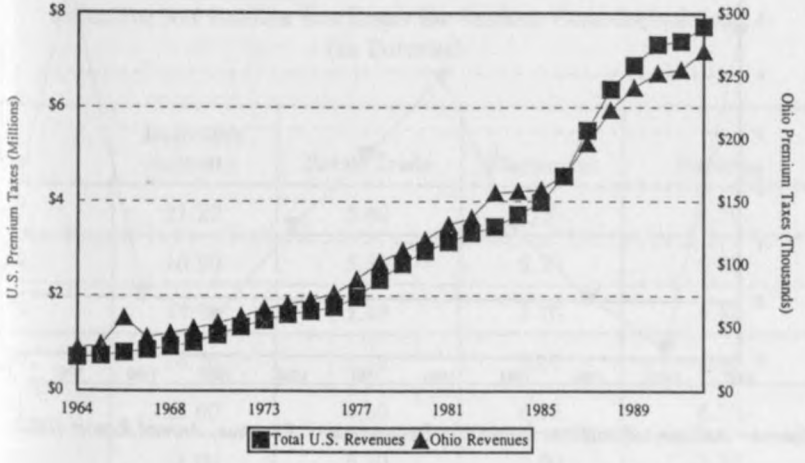
Ohio revenues from the premium tax have followed the national trend in premium taxes. Figure 12-3 shows that the national trend is increasing premium tax revenues for the nation. In addition, the percentage change over time is roughly the same for both the state of Ohio and the other states. This implies the Ohio insurance tax revenue stream follows that of the rest of the country. This is to be expected, since the states have very similar tax policies towards insurance.

The growth in Ohio's premium tax revenues seemed to be less responsive to changes in the insurance industry in comparison to the nationwide growth in premium tax revenues from the 1960s until the middle 1980s. From 1986 until the present, the growth rates are very close and likely reflect the increasing efficiency of the insurance market. The cycle in tax revenue growth shown in Figure 12-4 is likely due to the cyclicality of the insurance market.[26] The well-known cycles in the property-liability industry are the subject of tremendous academic and industry debate as to their cause. However, no matter the cause of cycles, they have an impact on revenue growth for the state, making revenue forecasts dependent on the insurance cycle.

The elasticities shown in Figure 12-5 are the percentage changes in premium tax as over the percentage changes in per capita income during the time period. The premium tax income elasticity shows the stability of the tax revenues in changes brought about by recessions and expansions. Taxes are relatively stable if the income elasticity is constant or rising during a recession, and is constant or decreasing in an expansion. One can observe peaks during recessions, and decreases or relatively constant elasticities during expansions. In total, however, the insurance industry's premium taxes provide a relatively stable source of income to the state, even accounting for the insurance profit cycle.

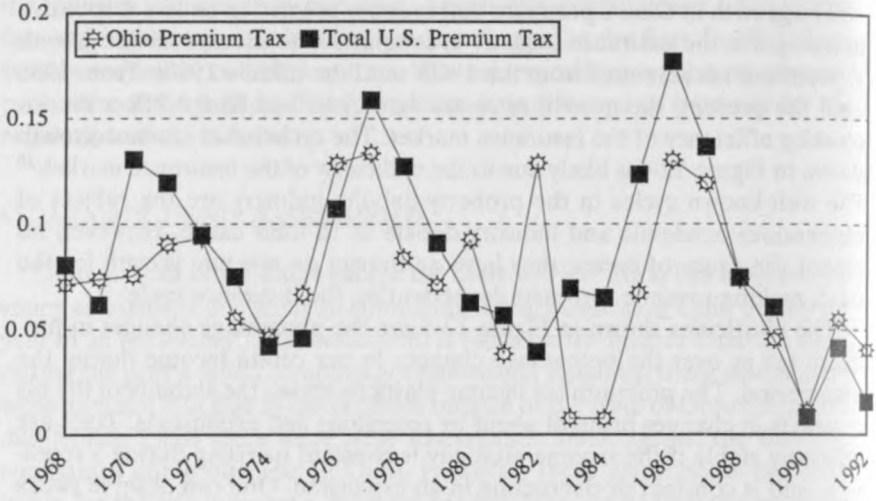
Comparison of Tax Burden with Other States

Most states tax the insurance industry with just a premium tax. Another



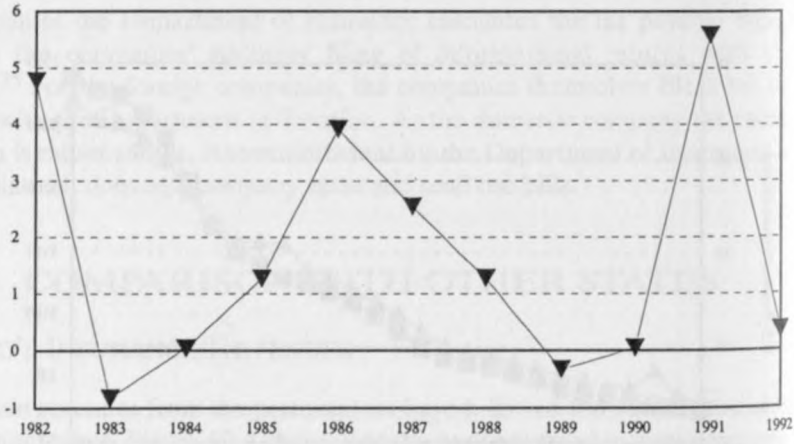
Source: Insurance Information, *Property-Casualty Factbook* (various years).

FIGURE 12-3. United States and Ohio premium taxes.



Source: Insurance Information Institute, *Property-Casualty Factbook* (various years.)

FIGURE 12-4. Total United States and Ohio premium tax revenues (% changes).



Source: Authors calculations from Ohio Department of Revenue, *Annual Report (1992)*

FIGURE 12-5. Premium tax income elasticity.

group of states uses a combination of a premium tax and an income tax, with a credit for other taxes paid. For example, if a state had both an income tax and a premium tax, it could offer a credit for the income tax paid on the income tax for premium taxes paid. Alternatively, it could offer a credit on the premium tax for income taxes paid. However, as illustrated in Table 12-4, the premium tax is likely to be much greater than the income tax.

There are a number of ways to compare the taxation of the insurance industry between states. First, one could look at the other state's tax rates. This is shown in Appendix Table 12A-1 for the life industry, Table 12A-2 for the property-liability insurance industry, Table 12A-3 for the health insurance industry, and Table 12A-4 for the annuity industry. Ohio's nominal rate is among the higher rates for both the life and health industries and the property-liability industry as Ohio's tax rate for an important part of the industry is 2.5 percent. This is relatively high as there are only a handful of states with higher rates.[27] Examining the tax rate tells only part of the story, especially in a state like Ohio where a significant portion of the industry pays the lesser capital and surplus tax. Thus, examining the effective tax rate provides a different information about the distribution of the tax.

Effective tax rate. There are a number of ways of measuring the tax burden on the Ohio insurance industry. The first is to compare the effective rate for Ohio versus other sates' effective rates. Table 12-5 shows the effective

TABLE 12-4
Effective Net Income Tax Rates for Various Ohio Industries
(In Percent)

Year	Insurance Industry	Retail Trade	Electronics	Banking
1987	21.20	5.80	5.30	6.10
1988	16.90	5.30	5.20	6.00
1989	14.30	5.40	5.10	6.10
1990	16.70	5.10	5.00	6.50
1991	15.60	4.60	6.90	6.10
1992	17.00	6.20	5.00	5.20

Source: Price-Waterhouse and Levin and Driscoll, *Comparative Analysis of the Taxation of the Insurance Industry in Ohio, 1987-1992.* (1994)

rates based on 1991 data for major insurance states and states near Ohio that could conceivably compete with Ohio.

In 1991 the national effective rate was 1.78 percent, while the Ohio effective rate was 1.59.[28] The effective rate for Ohio seems low. This is because the domestic industry has the opportunity of paying the lower of the fran-

TABLE 12-5
Effective Tax Rates for Important Insurance States and Ohio Neighbors

State	Effective Tax Rate (In Percent)	Number of Domestic Companies in 1991
California	2.656	220
Connecticut	1.887	70
Florida	1.142	139
Illinois	0.896	366
Iowa	1.501	228
Indiana	1.160	174
Kentucky	4.046	58
Massachusetts	1.707	68
Michigan	1.193	92
New York	1.336	316
Ohio	**1.588**	**209**
Pennsylvania	1.300	264
Texas	1.931	492
Wisconsin	0.958	222
U.S.	1.728	6002

Source: ACIR (1993). Note the figures do not include the retaliatory tax. In 1991 if the retaliatory tax had been included the effective rate would have been approximately 1.87.

chise tax or the premium tax, and this reduces the effective tax rate of the Ohio insurance industry. If everyone paid the actual tax rate of 2.5 percent then the effective rate would be close to 2.5 percent. Other states in the region, such as Michigan, Wisconsin, Ohio, Pennsylvania, Indiana, and Illinois, have lower effective rates while Kentucky seems to be the only state within the region to have a higher effective tax rate. Illinois, an important insurance state with a very low effective rate, does not tax its domestic industry with a premium tax. Similarly, Michigan's low effective rate is attributed to its low tax rate. However, it should be noted that there is an additional tax not accounted for in these firms. This tax is the retaliatory tax which is discussed further below. This retaliatory tax is paid by the domestic companies to other states. Estimates of the retaliatory tax for the Ohio insurance industry place it at over $50-60 million per year.

Another way is to look at the per capita burden. This is shown in Table 12-6 for a number of years. Table 12-6 contains a great deal of information, but what it shows is that Ohio is under taxing the insurance industry on a per capita basis relative to the national average, but that over time Ohio's per capita tax burden has been increasing. Among its neighbors, Ohio is bettered only by Illinois and Michigan, which is a direct function of these states' tax policies: Illinois does not tax its domestics and Michigan has a low rate. In 1989 Ohio ranked 42nd but, by 1992 Ohio's rank had increased to 39th. At the same time the United States average rank fell from 23 to 27. Thus, Ohio's burden as measured on a per capita basis, while less than the national average, is increasing relative to the nation as a whole. Again, however, the retaliatory tax is not included. In 1991, if the Ohio industry's payments to other states were included, the per capita burden would increase by just over $4. This would increase Ohio's rank by about 10.

Another way to determine a relative tax burden is to look at a standardized tax base across states and a standardized tax rate across states. Using the tax base and the tax rate one can determine a standardized "capacity." By comparing actual revenues received by the state for a particular tax to the capacity determined by the standardized tax base and standardized tax rate, one can then determine whether a state is over- or under-taxing its capacity.

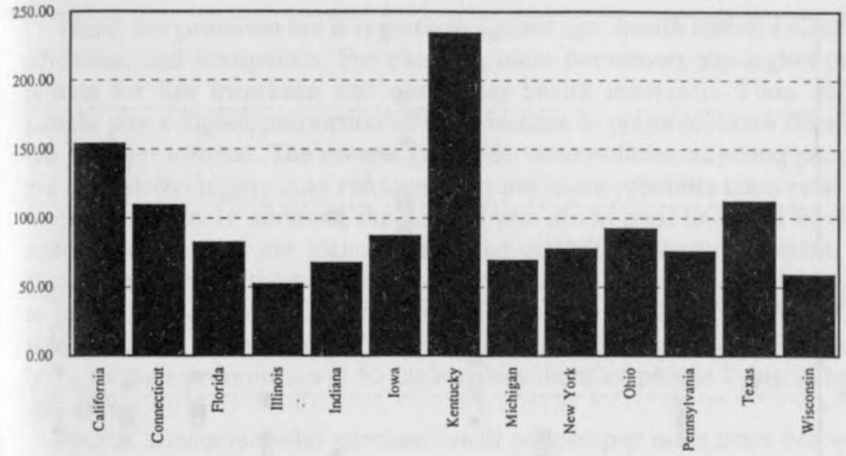
This methodology is what the Advisory Commission on Intergovernmental Relations (ACIR) uses in its study of state tax structures. For the insurance industry the standardized tax base is gross written premiums and the standardized rate is 1.73 percent (representing the United States average tax rate). Figure 12-6 shows that in 1991 Ohio under-utilized its capacity relative to the national average. However, with the exception of California, Connecticut, Kentucky and Texas, the remaining states are also under-utilizing their capacities. In fact, other than Kentucky, Ohio has the highest capacity utilization relative to its neighbors.

The figure should be interpreted with care, however, because like the effective tax rate, the ACIR's methodology does not say anything about the

TABLE 12-6
Insurance Tax and Per Capita Insurance Tax Revenues by State, 1989–1992

State	1989			1990			1991			1992		
	Total (in $000s)	Per Capita	Rank	Total (in $000s)	Per Capita	Rank	Total (in $000s)	Per Capita	Rank	Total (in $000s)	Per Capita	Rank
U.S.	7,340,691	29.57	23	7,369,604	29.63	28	7,721,145	30.69	24	7,875,621	30.88	27
California	1,314,750	45.24	5	1,170,831	39.34	9	1,287,740	42.39	9	1,173,297	38.01	13
Connecticut	175,898	54.31	1	170,163	51.77	2	174,122	52.91	3	160,843	49.02	7
Florida	250,144	19.74	47	322,915	24.87	40	319,567	24.07	41	311,977	23.13	42
Illinois	255,057	21.88	43	166,758	14.59	51	192,876	16.71	51	197,720	17.00	51
Indiana	103,436	18.49	49	107,516	19.39	47	121,809	21.71	44	122,788	21.69	44
Iowa	84,878	29.89	22	86,976	31.32	22	92,288	33.02	18	97,447	34.54	18
Kentucky	151,199	40.57	7	187,573	50.90	3	214,688	57.82	1	206,917	55.10	2
Michigan	76,601	8.26	52	78,647	8.46	52	175,973	18.26	49	178,304	18.89	48
Minnesota	120,639	27.71	29	122,486	28.00	33	129,618	29.25	29	130,617	29.16	33
New York	582,240	32.44	17	699,529	38.88	10	594,889	32.94	19	610,046	33.67	24
Ohio	**252,271**	**23.13**	**42**	**255,149**	**23.52**	**41**	**269,929**	**24.68**	**40**	**281,301**	**25.54**	**39**
Pennsylvania	225,229	27.84	28	352,261	29.65	27	362,473	30.30	25	404,806	33.71	22
Texas	441,550	25.99	35	524,901	30.90	24	595,446	34.32	15	516,081	29.23	22
Wisconsin	76,693	15.76	50	76,882	15.72	50	83,278	16.81	50	68,975	13.78	52

Source: *State Government Finances* (various years); Bureau of the Census Population Projections, 1990-2020, and Insurance Information Institute Factbook (1994). Note that the per capita tax burdens do not include the retaliatory tax. Ohio's burden would be increased by $4.50 per person in 1991 if retaliatory taxes were included.



Source: ACIR, (1993).

FIGURE 12-6. Percentage of insurance tax capacity (United States average = 100%).

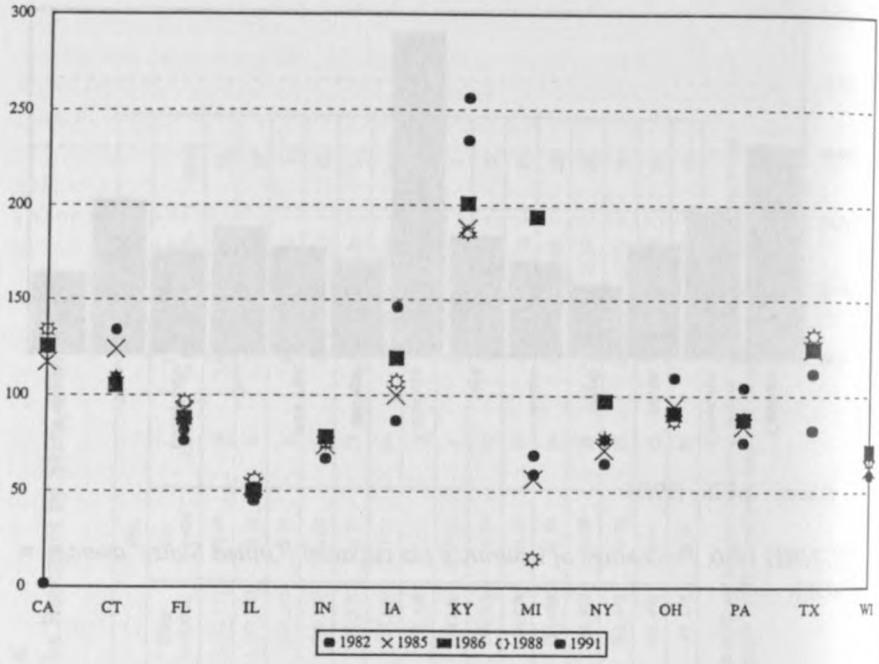
distribution of the tax burden between foreign and domestic companies and between large and small companies. In addition, it does not include the retaliatory tax. Also, Ohio provides a tax differential for small (and potentially mid-sized) domestics that significantly reduces their tax burden, leaving large domestics and foreign companies with a higher burden.

Figure 12-7 also shows the behavior of important insurance states and neighbors of Ohio taxation of insurance capacity during the last decade. Over time, Ohio's taxation of the insurance industry has remained constant, as the rate appears close to 100 percent during the years studied by the ACIR. Illinois, Indiana, Florida, and Wisconsin also experienced relatively constant tax policies over time. States with a large variation over time, such as Kentucky and Texas, are changing their insurance tax policies and this is reflected in the wide variation of the use of capacity. Of the states shown in Figure 12-7 only Iowa has experienced a declining trend. This is likely due to its desire to encourage the development of the Iowan insurance industry.

MAIN ISSUES AND PROBLEMS

The Pros and Cons of Premium Taxation

Why use a premium tax? As mentioned above, a premium tax is a relatively simple tax. In general, a company merely adds up its gross written pre-



Source: ACIR, *Significant Features* (various years).

FIGURE 12-7. Percentage of tax capacity for insurance premium tax.

miums and applies a tax rate to determine the tax bill. This is a very simple process for the company and a simple tax for the state to administer and audit. In addition, the premium tax generally produces a steadily increasing source of revenue.

Another reason a premium tax is preferable to other taxes is that the states have a long history of using this tax and there have been few complaints. Alternatives such as the income tax are difficult (in theory) to implement. Thus, simplicity, historical inertia, and the difficulty of implementation of alterative taxes are the major reasons to keep and use the premium tax.

Why States should not use a Premium Tax. There are a number of reasons to avoid using a premium tax, as outlined by Skipper.[29] First, the premium tax is regressive, meaning that the lower-income insured pay a higher portion of their income in these taxes than do the higher-income insured.

Second, since cash value life insurance can be a method of savings, a premium tax on cash value life insurance is a tax on savings, which can reduce the incentive to save or provide incentives for the consumer to purchase a savings product from another financial service provider.[30]

Third, the premium tax is regressive against age, health status, risk classification, and occupation. For example, older consumers pay higher premiums for life insurance and non-group health insurance. Thus, older people pay a higher proportion of their income in premium taxes than do the younger insured. The reverse is true for auto policies, as young people are considered higher auto risks and thus pay more premium taxes relative to older drivers. In addition, the insured who are in poor health or in hazardous occupations pay higher health and disability premiums relative to those in better health and lower-risk occupations. Finally, people who live in high-risk areas, such as rural areas without nearby fire departments or those in areas more prone to natural disasters, will pay more in premium taxes as their premiums will be higher than those of people living in low-risk areas.

Fourth, consumers who purchase small policies pay more taxes per unit of insurance than those who purchase larger policies. This is because premiums are set to cover the cost of the risk plus the cost of administering and maintaining the policy. This administration expense is a fixed cost, and for small policies percentage of the premium is relatively high compared to larger policies. This makes the small policy (which contains a higher proportion of expense costs relative to risk costs) bear a larger per insurance unit cost of the premium tax.

Fifth, there are a number of insurance substitutes, most notably self-insurance, which are not taxed. In Ohio, this is more likely to be a problem in the health insurance area. A company could potentially reduce its health care expenses by 2.5 percent by self-insuring. This could be a non-trivial expense for health care coverage.

The availability of tax-free self-insurance may cause the insured to opt out of the market in times of insurance shortages like that experienced in the liability lines during the mid-1980s. As premiums are bid up, consumers will reduce their purchases of insurance and self-insure.

Sixth, the premium tax also has problems when there is differential taxation between foreign and domestic companies. Under Ohio's tax law, companies may be able to benefit from a lower effective tax rate through the capital and surplus franchise tax. Smaller companies are not likely to be as efficient as larger companies because of the tremendous economies of scale in the insurance industry. Thus, the tax preference can protect inefficient domestic firms from competition in the free and open market. In addition, since capital and surplus are not apportioned to all states where an insurer operates, the tax break benefits and encourages single state companies, thus concentrating rather the spreading risk.[31]

Finally, the premium tax must be paid irrespective of whether the insurer earns a profit. This means the tax is regressive against start-up firms those that are losing money. Ohio's tax law provides an alternative tax for small companies through the capital and surplus franchise tax. Since this

tax typically benefits smaller companies, a large insurer that is in financial difficulty is hurt by the premium tax and this can affect the risk of insolvency.

The premium tax is regressive against profits, and Table 12-5 shows the effect of this regressivity by comparing effective tax rates based on net income for some industries in Ohio. Neubig (1994) uses a simulation to compute effective tax rates for a number of industries.[32] The tax rate is significantly higher for the insurance industry than for other selected industries in Ohio. However, these other industries (with the exception of banking) are also subject to a sales tax and thus the comparison is not as clean. The best comparison would be between the two financial service industries: banking and insurance. The difference here is 200-300 percent each year. Since banks do compete against insurers and other financial institutions, horizontal equity requires that competitors be treated equally.

Because of the nature of the insurance tax system in Ohio and the other states, there should be two major effects on Ohio companies of changing the premium tax rate. The first is that taxes payable to the state of Ohio change, and the second is that taxes payable to other states by Ohio companies change due to the operation of the retaliatory tax. A tax increase, for example, would increase the premium taxes due to Ohio as well as the premium taxes due by Ohio insurers to states with lower premium tax rates. Similarly, a decrease in tax rates would lower Ohio premium tax collections as well as lowering premium taxes paid to other states for retaliatory purposes, but may cause an increase in retaliatory taxes collected from foreign companies.

SIMULATION OF OHIO'S INSURANCE TAX STRUCTURE

This section is divided into three parts. First, we examine the effect of changing taxes on the insurance industry examining the effects on both the life and non-life industries. Second, we examine the effect of a tax changes on the life and health industry. Finally, we examine the effect of the retaliatory tax on the Ohio domestic industry and the resulting revenue change to the state.

THE PROPERTY-LIABILITY INDUSTRY SIMULATION

Table 12-7 shows the results of a simulation of changing the tax rate on the property-liability industry. The simulation shows that the domestic tax revenue falls as the premium tax is reduced from 2.5 percent to 2.0 percent. As the tax rate falls, premiums are taxed at a lower rate. Those companies that can pay the lower premium tax will do so. However, the franchise tax is

TABLE 12-7
Property-Liability Industry Simulation Results, 1992

A. Property-Liability Simulation of Changing Premium Tax Structure Holding Capital and Surplus Franchise Tax constant (in $ millions).

	Alternative Premium Tax Rates				
	2.00%	2.25%	2.50%	2.75%	3.00%
Domestic Companies					
Premium Tax Revenues	8.56	9.53	10.50	11.37	12.40
Franchise Tax Revenues	25.38	25.49	25.57	25.74	25.74
Total Domestic Tax Payable	33.94	35.02	36.07	37.11	38.14
Number of Companies Paying Franchise Tax	67	68	70	73	73
Foreign Companies					
Premium Tax Revenues	85.26	94.45	104.36	114.57	124.80
Total	119.20	129.47	140.43	151.68	162.94

B. Property-Liability Capital and Surplus Franchise Tax Simulation Holding Premium Tax Rate Constant (in $ millions)

	Alternative Capital and Surplus Franchise Tax Rates								
	0.20%	0.30%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%	1.00%
Total Domestic Tax Revenues	16.68	22.82	27.42	31.80	36.07	40.33	44.56	48.39	51.48
Franchise Tax Revenues on Capital and Surplus	15.19	14.39	17.64	21.46	25.57	29.62	33.85	27.45	30.54
Number of Firms Paying C&S Tax	86	80	76	73	70	67	67	62	62
Premium Tax Revenues	1.49	8.43	9.78	10.34	10.5	10.71	10.71	20.94	20.94
Number of Firms Paying Premium Tax	21	27	31	34	37	40	40	45	45

Note: Current tax scenario highlighted in grey.

still in effect and there is little change in the number of companies paying the franchise tax over the premium tax as shown in Panel B..

As the tax rate increases the amount of tax payable to Ohio increases, with the increase coming from the increase in the premium tax. For the foreign companies, the change in the premium tax directly affects the premium tax due. As the rate increases, the revenues increase proportionally, while if the rate is decreased the revenue decreases similarly.

Life Insurance Industry Simulation

Table 12-8 shows the life insurance simulation results. The results are similar to those of the property-liability simulation. As the premium tax rate increases, the number of companies paying the franchise tax increases

TABLE 12-8
Life Insurance Simulation Results
Holding Franchise Rate Constant (In Millions)

A. Premium Tax Simulation for the Life Insurance Industry.

	Alternative Premium Tax Rates				
	2.00%	2.25%	2.50%	2.75%	3.00%
Domestic Companies					
Premium Tax Revenues	8.01	8.90	9.55	4.78	2.88
Franchise Tax Revenues	1.87	1.98	2.27	8.19	9.96
Total Domestic Tax Payable	9.88	10.88	11.82	12.97	12.84
Number of Companies Paying Franchise Tax	29	28	27	23	22
Foreign Companies					
Premium Tax Revenues	99.34	111.76	124.18	136.60	149.02
Total	109.22	122.64	136.00	149.57	161.86

B. Franchise Tax Simulation Results for the Life Insurance Industry.

	Alternative Capital and Surplus Franchise Tax Rates								
	0.20%	0.30%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%	1.00%
Total Domestic Tax Revenues	5.00	7.01	8.80	10.33	11.84	11.19	11.47	11.70	11.93
Franchise Tax Revenues on Capital and Surplus	0.58	1.39	2.12	3.79	2.29	9.03	9.65	9.65	9.65
Number of Firms Paying C&S Tax	32	32	32	30	27	24	21	17	13
Premium Tax Revenues	4.42	5.62	6.68	6.54	9.55	2.16	1.82	2.05	2.28
Number of Firms Paying Premium Tax	17	17	28	25	22	19	17	17	17

Note: Current tax scenario highlighted in grey.

slightly and the total amount of revenue increases slightly. As the rate increases, however, the premium tax becomes the lesser of the capital tax and premium tax revenues decline. Franchise tax revenues increase almost enough to offset the loss of the premium tax revenues when the rate increased to 3.0 percent. For the foreign companies the rate changes directly affect the premium tax bill. As the rate increases the foreign premium tax bill increases and as the rate decreases the foreign tax bill decreases. Premium tax changes have a larger revenue affect in the foreign market them in the domestic market.

Panel B of the Table 12-8 shows the effect of changing the capital and surplus rate on the revenues collected from the domestic industry. The current rate is 0.6 percent. Reductions in the rate cause the number of companies paying the capital and surplus tax to increase and the amount collected by

both the premium tax and the capital and surplus franchise tax to decrease. As the franchise tax rate increases, the number of firms paying the franchise tax decreases, but the franchise tax revenues increase dramatically. In contrast, as the tax rate increases the premium tax bill falls as more is collected through the franchise tax. Overall, the total tax bill from domestics increases as the franchise tax rate increases from 0.2 percent to 1.0 percent, but at the cusp of moving from 0.6 percent to 0.7 percent, the total amount of tax decreases slightly. This is due to the fact that the mixture of companies paying the franchise tax changes dramatically. Certain companies with previously large premium tax bills are now paying a slightly lower franchise tax.

Retaliatory Tax Simulation

The retaliatory tax due to Ohio is relatively small, amounting to approximately $2.5 million in 1993 and representing 0.9 percent of the total franchise and premium tax bill for insurance companies. However, the retaliatory tax paid by Ohio companies to the rest of the states is substantial. Through a simulation of the retaliatory tax provision of Ohio's insurance tax law it was determined that at the current rate, Ohio companies paid approximately $58 billion to other states. Table 12-9 shows the results of the simulation. As the rate is reduced from the current 2.5 percent, we see an increase in the amount collected by Ohio. The amount collected does not

TABLE 12-9
Retaliatory Tax Simulation (In Millions)

	Collected by Ohio	Paid to Other States		
Rate	Total	Life	Property-Liability	Total
2.50	2.54	12.38	46.00	58.38
2.25	3.26	8.20	26.38	34.58
2.00	5.32	4.66	10.85	15.51
1.75	19.79	2.65	5.43	8.08
1.50	34.72	1.33	2.53	3.86
1.35	43.72	0.66	0.77	1.42

Note: Current tax situation is highlighted in grey.

seem to increase dramatically until the rate falls below 2.0 percent. This is to be expected, since the United States average rate is slightly less than 2.0 percent. In addition, as the rate falls the amount paid to other states decreases. This is also expected, as the states' retaliatory provisions require payment only if the home state taxes at a higher amount. Thus, Ohio companies would benefit dramatically as a result of a reduction in the rate.

REFORM OPTIONS AND IMPLICATIONS

Options for Reform

Equalize foreign and domestic rates. By trading all foreign and domestic companies similarly it would be possible to lower the effective tax rate. This is shown in Table 12-10. Table 12-10 has the total premiums written for the Ohio insurance industry. For the first comparison, by adding up all the life premiums (net of annuities) and including the fraternal life premiums to the sum of property-casualty premiums (net of HMO premiums) and dividing this by the total premium and franchise tax collected, the revenue neutral rate would by 1.83 percent in 1993. This is shown as Ratio 1. Over the last five years Ratio 1 has been relatively stable ranging between 1.77 percent to 1.83 percent. Adding the fire marshall and retaliatory tax collections into the numerator yields Ratio 2. Thus, the revenue neutral level of insurance taxation would be 1.87 percent in 1993. This amount has ranged between 1.85-1.90 percent in the last five years.

Note that Ratio 2 rate is biased upward. This is due to the operation of the retaliatory tax. At a rate of 1.90 percent, the Ohio rate will be lower than the national average and potentially significant retaliatory tax revenues will accrue. These additional revenues could then be employed to lower the effective rate further, which in turn will generate a further collection of retaliatory taxes. Table 12-9 shows that by moving from a rate of 2.50 percent to a rate of say, 1.75 percent will yield almost $20 million in retaliatory collections. Those effected by equalizing the rate would be those in the domestic industry paying the capital and surplus tax. These are predominantly small property-liability companies and the Blues. However, the larger companies operating in interstate markets would benefit tremendously because the retaliatory tax burden would be dramatically reduced. At an effective rate approaching 1.35 percent our simulation predicts a net gain of $43 million—due to foreign company payments of retaliatory taxes due to Ohio.

Equalize tax treatment between HMOs and health insurers. By exempting all health insurers and HMOs from paying the premium or franchise tax, there would be a loss of revenue. If we were to use a rate applicable to all other insurers, the effective rate on gross premiums written net of policyholder dividends would be approximately 1.64 percent (in Ratio 2A). This is

TABLE 12-10
Calculated Effective Rates from Broadening the Tax Base and Taxing All Premiums Equally

	1993	1992	1991	1990	1989
Total Life Premiums and Annuity Considerations	$9,081,722,000	$7,497,835,000	$7,194,570,066	$7,169,898,105	$6,565,924,100
- Domestic annuity considerations	178,219,000	221,949,000	183,739,076	125,871,164	143,772,221
-Foreign annuity considerations	1,440,366,000	1,473,470,000	1,515,980,025	1,625,038,500	1,472,956,281
+all Fraternal Premiums	223,328,000	249,892,000	197,718,328	168,791,724	148,232,527
Net Life Premiums	7,686,465,000	6,052,308,000	5,692,569,293	5,587,780,165	5,097,428,125
Total PC Premiums	12,285,361,000	11,554,705,000	11,069,768,005	10,670,968,663	10,029,780,202
-Domestic HMOs	2,378,568,000	2,183,931,000	1,900,930,864	1,593,099,358	1,317,552,690
-Foreign HMOs	88,315,000	43,787,000	82,547,481	85,341,646	30,687,230
Net PC Prems	9,818,478,000	9,326,987,000	9,086,289,660	8,992,527,659	8,681,540,282
Total Net Premiums (Net Life + Net PC)	17,504,943,000	15,379,295,000	14,778,858,953	14,580,307,824	13,778,968,407
Total Premium & Franchise Tax collected	319,565,254	282,668,411	270,980,387	259,462,913	244,254,539
Total Premium, Franchise, Fire Marshall & Retaliatory Taxes	327,357,383	291,489,583	280,947,009	270,274,666	255,056,067
(1) Ratio of Premium and Franchise Taxes to Total Net	1.83%	1.84%	1.83%	1.78%	1.77%
(2) Ratio of All taxes to Total Premiums	1.87%	1.90%	1.90%	1.85%	1.85%
(1A) Ratio 1 with HMOs Paying Premium Tax	1.60%	1.61%	1.62%	1.60%	1.61%
(2A) Ratio 2 with HMOs Paying Premium Tax	1.64%	1.66%	1.68%	1.66%	1.69%

Source: Ohio Department of Insurance, *Annual Report* and unpublished data. Note: Equalized tax rate does not include potential retaliatory taxes collected by the State of Ohio as a result of lowering the effective rate. Inclusion of such taxes will lower the effective rate.

still less than the current 2.5 percent rate, and is lower than the national average effective tax rate. In addition, the simulation of the retaliatory tax shows that by reducing Ohio's effect rate it is possible to increase Ohio's collections from the retaliatory tax by more than $20 million. This could be used to lower the effective rate further.

Employ an income tax on the insurance industry. Since the premium tax is a tax on gross receipts rather than net income there is a relatively large difference between the burden on a corporation paying a net income tax and the burden on an insurance company paying a premium tax, all other things equal. Table 12-4 above shows that the effective income tax rate on the banking industry is about one-third that on the insurance industry.

The two industries should have approximately the same burden, as they are similar in many respects. In 1992, for example, the effective net income tax rate was 17 percent. By reducing that rate to what a non-financial corporation pays, it would be possible to lessen the burden. However, the effective tax rates shown in Table 12-4 do not include the effect of sales or other property taxes, and thus a strong argument can be made that the effective rate need not be reduced to the 5-6 percent range.

An income tax could be implemented relatively well, as insurers currently pay federal income taxes and, as with the non-financial corporations, Ohio could piggy-back on the federal definition of income. This would increase horizontal equity, especially if other financial institutions were taxed on an income basis. The problems with piggy-backing on the federal definition of net taxable income are three-fold. First, there is still some debate over the proper definition of income for an insurance company, and this debate becomes even more technical depending on the organizational form of the insurer, .i.e. whether it is a stock or mutual company. Second, by tying to the federal definition, Ohio takes all the potential problems of defining income and incorporates them into its tax law. Third, an important issue concerns the appropriate apportionment formula. Since insurers do not have large amounts of property, it may be appropriate to use a single factor formula based on sales or gross premiums written. Most states with corporate income taxes on insurance use this single factor apportionment formula. This formula would benefit domestic insurance companies for exactly the same reasons that single sales apportionment factor in the general corporate income tax would benefit Ohio corporations.

APPENDIX A
PREMIUM TAX RATES FOR VARIOUS LINES OF INSURANCES

TABLE 12A-1
Life Insurance Premium Tax Rates, 1993

State	Domestic Rate %	Foreign Rate %	State	Domestic Rate %	Foreign Rate %
Alabama (1)	1.00	3.00	Nebraska	1.00	1.00
Alaska	2.70	2.70	Nevada (2)	3.50	3.50
Arizona	2.00	2.00	New Hampshire	2.00	2.00
Arkansasl (1)	2.50	2.50	New Jersey	2.01	2.01
California	2.35	2.35	New Mexico (1)	3.00	3.00
Colorado	2.25	2.25	New York (6)	0.80	0.80
Connecticut	2.00	2.00	North Carolina (7)	1.90	1.90
Delaware	2.00	2.00	North Dakota	2.00	2.00
D.C.	2.25	2.25	Ohio	2.50	2.50
Florida	1.75	1.75	Oklahoma (10)	2.25	2.25
Georgia (1)	0.50	2.25	Oregon	2.25	2.25
Hawaii	2.75	2.75	Pennsylvania	2.00	2.00
Idaho	3.00	3.00	Rhode Island	2.00	2.00
Illinois	0.00	2.00	South Carolina	0.75	0.75
Indiana	2.00	2.00	South Dakota	2.50	2.50
Iowa	2.00	2.00	Tennesse (1)	1.75	2.00
Kansas	1.00	2.00	Texas (1)	2.40	2.40
Kentucky	2.00	2.00	Utah	2.25	2.25
Louisiana	2.25	2.25	Vermont	2.00	2.00
Maine	2.00	2.00	Virginia (2)	2.25	2.25
Maryland	2.00	2.00	Washington	2.00	2.00
Massachusetts	2.00	2.00	West Virginia	3.00	3.00
Michigan	1.33	1.33	Wisconsin (8)	2.00	2.00
Minnesota	2.00	2.00	Wyoming	1.60	1.60
Mississippi	3.00	3.00			
Missouri	2.00	2.00			
Montana (5)	2.75	2.75			

Source: CCH, State Tax Guide, ACLI

(1) Can reduce if investing in assets within the state.
(2) Domestic mutuals pay 1.00%.
(3) Franchise tax on all legal reserve mutuals based domestically.
(4) Franchise tax based upon authorized capital stock.
(5) Plus an additional 7.00% surcharge.
(6) Premium tax and income tax are payable up to 2.6% of premiums.
(7) 7.25% for 1992.
(8) Domestic rate is graduated and increases to foreign.

TABLE 12A-2
State Premium Tax Rates on P&C Companies, 1993

State	Domestic Rate %	Foreign Rate %	Fire Rate*	State	Domestic Rate %	Foreign Rate %	Fire Rate
Alabama	4.00	1.00	+0.08	Nebraska	1.00	1.00	1.08
Alaska	2.70	2.70	+0.08	Nevada	3.50	3.50	
Arizona	2.00	2.00	2.20	New Hampshire	2.00	2.00	
Arkansas (1)	2.50	2.50		New Jersey	2.01	2.01	
California	2.35	2.35		New Mexico (2)	3.00	1.90	
Colorado	2.25	2.25		New York (12)	1.30	1.30	
Connecticut	2.00	2.00		North Carolina (13)	1.99	1.33	3.32
Delaware	1.75	2.00	2.00	North Dakota	1.75	1.75	
D.C.	2.25	2.25		Ohio(9)	2.50	2.50	3.25
Florida	1.75	1.75	1.00	Oklahoma (10)	2.25	2.25	2.63
Georgia (2)	2.25	0.50		Oregon	2.25	2.25	3.25
Hawaii	4.70	4.70		Pennsylvania	2.00	2.00	
Idaho (2)	3.00	1.60		Rhode Island	2.00	2.00	
Illinois(5)	0.00	2.00	2.50	South Carolina	1.25	1.25	2.35
Indiana (2)	2.00	2.00	2.50	South Dakota	2.50	2.50	2.55
Iowa	2.00	2.00		Tennessee	2.50	2.50	3.25
Kansas	2.00	1.00	2.00	Texas (2)	3.50	3.50	
Kentucky	3.50	3.50	4.25	Utah	2.25	2.25	
Louisiana (4)	1.25	1.25	2.00	Vermont	2.00	2.00	
Maine	2.00	2.00	3.00	Virginia	2.25	2.25	
Maryland (2)(6)	2.00	2.00	2.00	Washington	2.00	2.00	
Massachusetts(12)	2.28	2.28		West Virginia	3.00	3.00	4.00
Michigan (11)	1.33	1.33		Wisconsin	2.00	2.00	2.38
Minnesota	2.00	2.00		Wyoming	1.60	1.60	
Mississippi	3.00	3.00	4.00				
Missouri (7)	2.00	2.00					
Montana (8)	2.75	2.75	3.75				

Source: CCH, *Multistate Tax Guide*, NAIC, *Retaliatory Tax Manual (1993)*.

*Fire marshall taxes are added on to fire related lines of insurance. For states with differential rates between foreign and domestics, the rate is shown as an add on, for states with non discrimination between foreign and domestic, the rate shown is the total and final rate.

(1) Retaliatory taxes are 0 for companies with 15% or more of their assets in Arkansan owned companies.
(2) Qualified companies with investment in state can conceivably reduce to rate of domestics.
(3) Also corporate income tax (Indiana Financial Institutions Tax) of 8.5% on AGI.
(4) Including retaliatory taxes.
(5) Domestics pay an income tax.
(6) No premium tax payable for domestic mutual fire companies.
(7) Small mutual taxed lower.
(8) There is an additional 7% surcharge on premiums.
(9) Fire rate is maximum possible fire rate. Fire rate is 0.75 percent times the amount of fire business contained in the line.
(10) Can reduce up to 50% if company has home office in state
(11) Michigan Single Business Tax taxes premiums at 1.33%.
(12) Domestics pay 1 percent on gross investment income.
(14) Domestic fire pays 2.66

TABLE 12A-3
Health Insurance on Annuity Premiums, 1993

State	Domestic Rate %	Foreign Rate %	Blue Cross Exemption*	State	Domestic Rate %	Foreign Rate %	Blue Cross Exemption*
Alabama	1.00	3.00		Nebraska (2)	0.50	0.50	
Alaska	2.70	2.70		Nevada	3.50	3.50	
Arizona	2.00	2.00		New Hampshire	2.00	2.00	Yes
Arkansas	2.50	2.50		New Jersey (3)	1.05	1.05	
California	2.35	2.35		New Mexico	3.00	3.00	
Colorado	2.25	2.25		New York (4)	0.80	0.80	
Connecticut	2.00	2.00		North Carolina	1.90	1.90	
Delaware	2.00	2.00		(8)	1.75	1.75	
D.C.	2.25	2.25		North Dakota	2.50	2.50	
Florida	1.75	1.75		Ohio (9)	2.25	2.25	
Georgia	2.25	2.25		Oklahoma	0.00	2.25	
Hawaii	4.70	4.70		Oregon	2.00	2.00	
Idaho	3.00	3.00	Yes	Pennsylvania	2.00	2.00	Yes
Illinois	0.00	2.00		Rhode Island	1.25	1.25	
Indiana	2.00	2.00		South Carolina	2.50	2.50	
Iowa	2.00	2.00		South Dakota	1.75	2.00	
Kansas	1.00	2.00		Tennessee	2.40	2.40	
Kentucky	0.00	2.00		Texas	2.25	2.25	
Louisiana	2.25	2.25		Utah	2.00	2.00	
Maine	2.00	2.00		Vermont	2.25	2.25	
Maryland	2.00	2.00	Yes	Virginia	2.00	2.00	
Massachusetts	2.00	2.00	Yes	Washington	3.00	3.00	
Michigan	1.33	1.33		West Virginia	0.00	0.00	
Minnesota (7)	2.00	2.00		Wisconsin (5)	1.60	1.60	
Mississippi	3.00	3.00		Wyoming (6)			
Missouri	2.00	2.00					
Montana(1)	2.75	2.75	Yes				

Source: ACLI, Premium Tax Manual.

*Not necessarily a complete list.

(1) Also, surtax of 7% (July 1, 1992 - June 30, 1993).
(2) .5% represents "Group" rate. individual rate is 1 %.
(3) 1.05% represents "Group" rate. Individual rate is 2.1%.
(4) Maximum tax liability is 2.6% of premiums. Additional surcharge based on franchise tax.
(5) Domestic companies pay no premium tax, but pay a 3.5% license fee on apportioned gross income.
(6) Will be 1.2% in 1993, and .75% after 1994.
(7) Rate of 1% on Blues commences in 1996.
(8) Blues taxed at 0.50%.
(9) Domestic companies pay the minimum of 2.5% gross premiums tax or 0.6% Capital and surplus tax.

TABLE 12A-4
State Tax Rates on Annuity Premiums, 1993

State	Tax Rate on Qualified Retirement Plans	Tax Rate %
Alabama	1.00	1.00
California	0.50	2.35
District of Columbia	2.25	2.25
Florida (1)	1.00	1.00
Iowa		2.00
Kansas		2.00
Kentucky	2.00	2.00
Maine		2.00
Mississippi		2.00
Nevada		3.50
North Carolina		1.90
South Dakota		1.25
West Virginia	1.00	1.00
Wyoming		1.00

Sources: CCH, *State Tax Guide*, and ACLI.

Note: All other states do not tax annuity premiums.

(1) Exempt if tax savings is passed to customer.

APPENDIX B
DESCRIPTION OF THE OHIO INSURANCE TAX SIMULATION PROCESS

Description of Simulation

The simulation of the insurance tax used the data compiled by the National Association of Insurance Commissioners (NAIC). These data are statutory filings with the states and contain nearly all the information necessary to calculate a taxpayer's actual tax liability.

Domestic Companies

Using information provided by the Department of Insurance and the Nationwide Insurance Group, we calculated the domestic tax bill for each company in much the same way the Insurance Department would calculate it. A very few assumptions needed to be made in order to obtain the final tax total. First, there is a deduction for ownership of stock in Ohio subsidiaries. These companies are not identified separately in the annual statement, as only the total ownership interest in affiliates is reported. Thus, it was assumed after trial and error that ½ of the affiliate investments were in Ohio companies.

Foreign Company Simulation

The simulation of foreign company tax returns was derived from the tax returns for both the life and health and property-liability industries. All the necessary data were contained on the NAIC statements.

Fire Marshall Tax

All necessary data were available on the NAIC tapes. Tax bills were then estimated using the tax returns.

Retaliatory Tax

This is a much more difficult tax to estimate, as it requires using the rates and tax base of every state with a lower tax bill. We assumed, to make the project treatable, that each states rate was that reported in Tables A-1 to A-4, and that the tax base in each state was premiums written net of policyholder dividends. This seems to be a very representative tax base, as most states allow for the deduction of policyholder dividends.

The retaliatory tax calculation also includes assessments for insolvency funds and license fees. These were assumed to be fixed and not to change according to changes in rates. This is not necessarily a poor assumption, as the license fees are relatively low and insolvency assessments change every year anyway, depending on the number and size of companies. Recent insolvencies have been relatively small, and do not add or detract from the simulation's general results.

ENDNOTES

1. Data regarding the number of companies in each industry were obtained from the ACLI's *Life Insurance Factbook* for years 1964 to the present and from the III's *Property Casualty Factbook* for years 1964 to 1994.

2. Not all of the 200 or so Ohio companies are true home offices. There are a number of companies that write a very small amount of business and thus do not contribute dramatically to employment opportunities in Ohio. In addition, there are shell companies that may not write any business at all in a given year, but when the parent company deems it necessary, may write business as needed. In addition, there is another set of companies that may operate as captives of a traditional corporation. These captive insurers may write insurance predominantly for the parent company.

3. These companies are Blue Cross-Blue Shield Mutual of Ohio, Central Benefits Mutual Insurance Company, and Community Mutual Insurance company. Central Benefits Mutual is no longer associated with the Blue Cross organization. Data are from Ohio Department of Insurance, *Annual Report* (1992).

4. Ohio Department of Insurance, *Annual Report* (1992).

5. Open enrollment means that enrollment in an HMO is open to any consumer, whether as part of a group or as an individual.

6. Community rating is the practice of rating for determination of premiums a group based on the characteristics of a "community" rather than on the characteristics of an individual.

7. See H.D. Skipper, (1987).

8. Ohio. Rev. Stats. §§5725.18-.26

9. Ohio. Rev. Stats. §§5729.02

10. Ohio. Rev. Stats. §§5729.04. This is more likely relevant for mutuals as stock companies generally do not have participatory policies.

11. This is not necessarily a bad policy, as a health insurance company would not need as much surplus as one that specialized in riskier and longer lines of business.

12. A number of states exempt the Blues, while others provide lower rates to health insurers. Further, studies have shown that states with preferences for the Blues have higher Blue market shares (see, e.g., Frech and Ginsberg (1978)) whether more people are insured because of this preference has not been shown.

13. In addition to some state tax breaks health insurance enjoys a benevolent federal tax policy. For employer sponsored health plans, the employer can deduct the entire cost of the health plan from taxable income. Small business too can take advantage of this deduction. On the individual basis, there is also a deduction if health expenses including insurance are greater than 7.5 percent of adjusted gross income. As there are a number of federal tax preferences for health insurance consumption, a state should as part of its health care policy decide whether the additional benefits of coverage are worth the fiscal costs of differential treatment.

14. There is an important cost to society from trading off open enrollment and community underwriting for a tax break. This cost is one that is generally not discussed outside of the insurance industry; it is the cost of adverse selection. High-risk individuals (i.e., those having a higher than average probability of being sick in the next year) can and will enroll (assuming they can otherwise pay for the coverage) in an HMO, since the community rate is based on average characteristics of the community. By allowing unlimited entry of high risk insured and charging them a price not reflecting their actual risk, the HMO's losses increase. These losses are then (at least) partially spread to the other members of the HMO. For insured who are on the margin whether to purchase health insurance through an HMO or to go without insurance, the open enrollment and community rating make the HMO coverage more expensive and may cause individuals to go without coverage.

15. The states are AL, CA, DC, FL, ID, KS, ME, MS, NV, NC, SD, WV, and WY.

16. The states are ID, KS, ME, NV, NC, ND, and WY.

17. This number assumes all annuities are subject to the premium tax.

18. This determination of percentage of fire coverage was done by the Insurance Services Office.

19. For a description of the state's authority over insurance companies see Kenneth Meyer, "The Political Economy of Insurance Regulation," (Albany: SUNY Press, 1987).

20. The number of states that have blatantly discriminated between foreign and domestic companies has diminished since *Metropolitan Life v. Ward*, 470 United States 869 (1985) where the Supreme Court stated that it was permissible to discriminate between foreign and domestic insurers under the equal protection clause of the XIVth Amendment only if the state had a rational basis for doing so. Some states, like Ohio and Georgia, still provide some domestics with a tax advantage. This will be discussed further below.

21. See *Metropolitan Life Insurance Company v. Ward,* 470 United States 869 (1985).

22. Massachusetts recognized this fact and decided to tax its domestic industry at a higher rate that the foreign companies so the domestic industry would not have to pay increased retaliatory taxes to other jurisdictions.

23. This could lead to a bizarre result if the right fact pattern exists. For example, suppose there is a Kansas company (with a majority of its writings in Ohio) that fails. Kansas' premium tax rate is less than Ohio's; thus a retaliatory tax must be paid to Kansas by Ohio companies writing in Kansas. The tax paid by Ohio companies is increased because of the failure of a Kansas company. Thus, the Kansan treasury benefits from the insolvency of a Kansas firm due to the retaliatory tax paid by foreign companies

24. O.R.C. §3956.20.

25. These informational returns are used to monitor the firm's solvency and contains information concerning premiums, losses, and expenses for the company.

26. See Martin Grace and Julie Hotchkiss, (1994), and Stewart, (1984).

27. The states with statutory rates higher than Ohio are AL, AK, HI, MT, and NV for life insurance and AL, AK, HI, KY, NY, TX, and WV for property-liability insurance. Note that with the exception of Texas, the state markets are relatively small. Thus, Ohio is among the largest markets with a high tax rate.

28. The national effective rate is the sum of all premium taxes collected as a percentage of total direct premiums written. Ohio's effective rate is similarly calculated. Data employed in these calculations and in Table 12-4 are from ACIR (1993). Note that retaliatory taxes paid to other states are not included.

29. H. D. Skipper, (1987).

30. *Ibid.*

31. If these small companies engage in reinsurance to spread the risk, they are still inefficient if a larger company would not have to engage in similar activities.

32. Price Waterhouse and Levin and Driscoll, (1994).