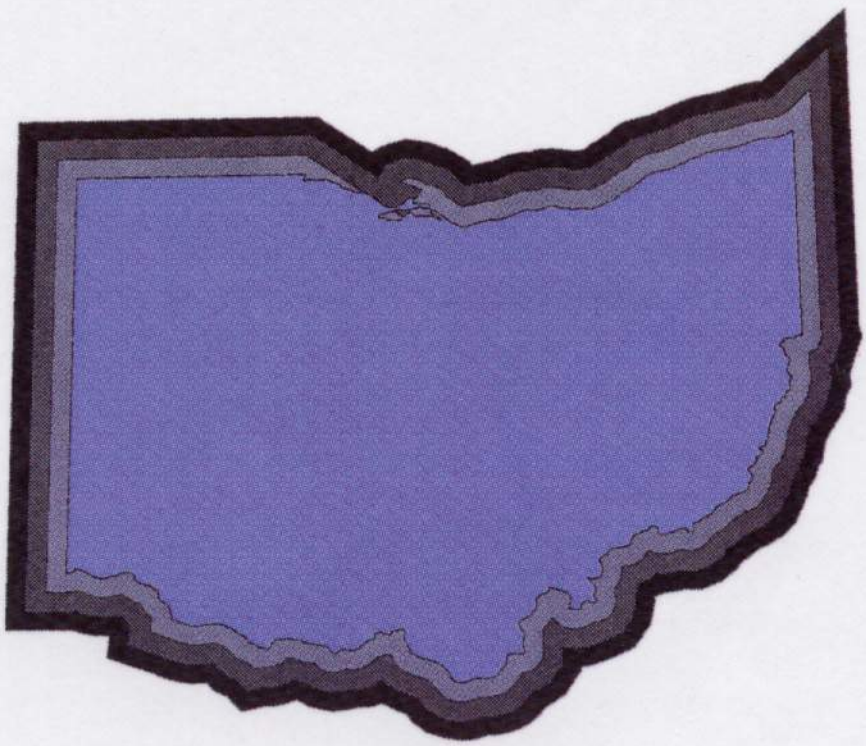
Taxation and Economic Development in Ohio: A Blueprint for the Future



Final Report of the Commission to Study the Ohio Economy and Tax Structure

December 23, 1994

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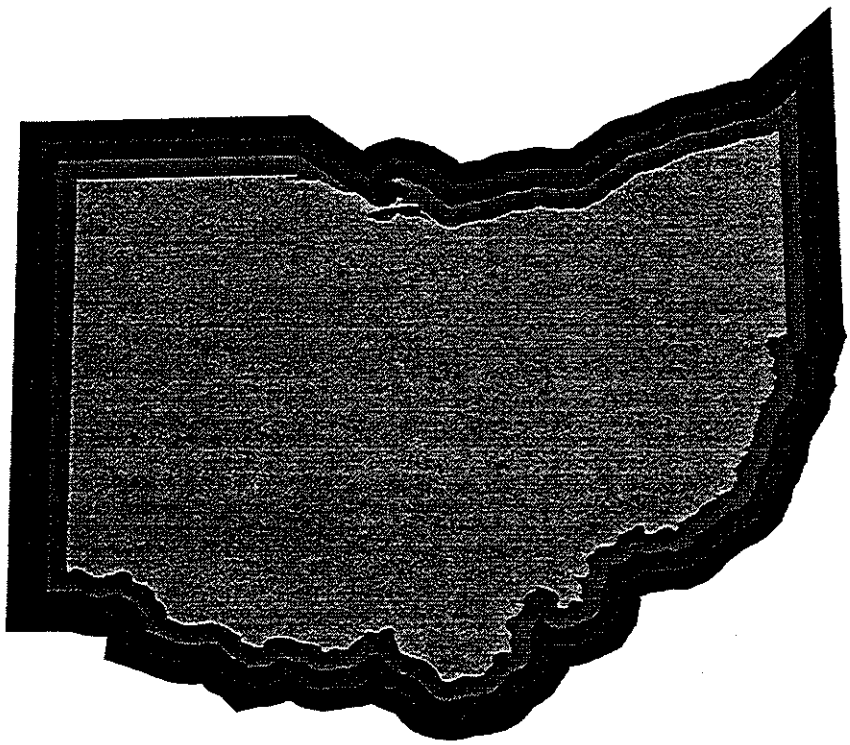

Final Report of the Commission to Study the Ohio Economy and Tax Structure

December 23, 1994

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No.	Title	Author	Date
1	The Setting for Fiscal Reform: Selected Tables	McHugh	May 31, 1994
2	Ohio's Sales Tax: Current Condition and Policy Options	Fox	November 2, 1994
3	Ohio's Economic and Demographic Structure	Duchi	November 15, 1994
4	Historical Review of Ohio State and Local Government Finances	Berno & Whitmore	November 8, 1994
5	Ohio's State and Local Individual Income Taxes: Analysis and Options	Wallace, Edwards & Lee	November 30, 1994
6	Real Property Taxation in Ohio: Analysis and Policy Options	Sjoquist	September 9, 1994
7	Ohio Metropolitan Area Revenues	Dearborn	November 15, 1994
8a	Public Utility Taxation: Tangible Personal Property	Cornia	November 18, 1994
8b	Ohio Tangible Business Personal Property: Property Taxation	Cornia	November 21, 1994
9	Business Taxation in Ohio: General Franchise Tax and Taxes on Financial Institutions and Insurance Companies	Martinez & Grace	November 14, 1994
10a	The Taxation of Telecommunications in Ohio	McHugh	October 10, 1994
10b	State and Local Tax Policy and the Telecommunications Industry	Case	December 23, 1994
11	The Role of Fiscal Incentives in Economic Development: How Ohio Stands Relative to Its Competitor States	Wasylenko	November 5, 1994

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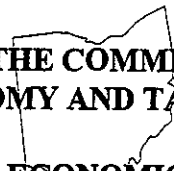
FINAL REPORT OF THE COMMISSION TO STUDY THE OHIO ECONOMY AND TAX STRUCTURE



TAXATION AND ECONOMIC DEVELOPMENT: A BLUEPRINT FOR THE FUTURE

EXECUTIVE SUMMARY

Ohio is blessed with many competitive advantages: quality human resources, a good infrastructure, a strong industrial base, and a location in a heavily populated and economically important region. It also has important competitive disadvantages, including a tax structure that does not encourage economic development. It is a time in the development of our state when barriers to new investment should be removed. Ohio's economic growth has lagged behind that in the rest of the U.S. for the past two decades. Though the early 1990s have seen a stronger performance from our economy, the long term decline has not been arrested, and projections are for continued slow growth in population, income and employment.

Our economic and population structure is changing. We are less of a manufacturing center and more of a producer of services, earn more of our income from transfer payments and less from wages, consume more services than goods, and are home to increasing numbers of the elderly and a growing concentration of poor.

With this backdrop, two questions have been central to our work. The first is whether the present tax structure is consistent with the objective of attracting more investment and jobs to the state, and moving Ohio to a higher economic growth path. The second is whether the present tax system "fits" our new economic structure and spreads the tax burden fairly over all sectors of the economy. We find the present tax system deficient on both counts and recommend a comprehensive reform.

What's Wrong?

The Ohio tax system has historically emphasized vertical equity. The individual income tax carries a progressive rate schedule,

the retail sales tax exempts food, property taxpayers are relieved through three credits, and local governments rely heavily on an income tax. There has not been so strong an emphasis on economic development. About 25 percent of the tax structure is carried by taxes on investment: taxes levied on income, net worth, and expenditures on machinery, equipment and inventories. One-third of the retail sales tax is collected on business purchases, and the top individual and corporate tax rates are high relative to other states. The Ohio system gets relatively good marks on progressivity, but not on investment friendliness.

A second problem with the Ohio tax system is that its pieces no longer fit together as they once did. Similarly situated businesses and individuals are treated differently by the tax system and there is potentially a problem with the balance between the natural growth of revenues and expenditure requirements. For example,

- General businesses, public utilities and financial institutions are all treated differently under the current tax system, for reasons that made more sense in an earlier time than they do now,
- a complicated system of rollbacks and credits have been added to the real property tax,
- a substantial amount of the consumption of services remains outside the sales tax base,
- the overall revenue system is not elastic enough to cover the future expenditure needs of the state and its local governments, and
- there is a mismatch between the division of revenues between state and local governments, and the expenditure requirements of the different levels of government.

A third problem is that the tax system is more complicated than is necessary. This effects the confidence that taxpayers have in the system, and raises both the administrative and compliance cost. The problem areas are the real property tax, the net worth tax, the personal property taxes, and the municipal income tax.

What Can Be Done?

The Commission proposes that the Ohio tax structure be changed to enhance the climate for investment, and improve the horizontal equity or fairness of the system. This program addresses these problems by proposing a reform that reduces taxes that have inhibited investment, job creation, and the development of necessary infrastructure; and by bringing all companies under the corporate net income tax. It is further proposed to eliminate the personal property taxes on business machinery, equipment and inventories, to eliminate the net worth tax, and to replace the gross receipts tax on public utilities with an equal yield user charge.

The elimination of personal property and net worth taxes must be matched by increases elsewhere if this reform is to remain revenue neutral. We propose that most of the tax reductions be made up by a combination of increased income taxation and increased retail sales taxation. We propose a broadening of the tax base primarily to include services, and if the voters choose, an increase in the sales tax rate. In the area of individual income taxation, we propose a shift to a flat rate tax on a base of federal tax liability.

This is a good reform for Ohio. The combination of changes proposed will significantly enhance the investment climate in the state, improve the horizontal equity of the system and simplify the tax code. The built-in growth of the revenue system will be greater, and the distribution of tax burdens between high and low income families will not be compromised.

Some will say that this is a proposal to shift taxes from businesses to people. This is simply not the case. People already pay these "business" taxes, sometimes in the form of higher prices, sometimes in the form of lower wages, and sometimes in the form of less return on their investment. This tax reform would rearrange the burdens among these groups, mostly by removing tax preferences that have been given in the past and by unburdening the sectors of the economy that have been overtaxed.

Some will say that this program is too big a shock for the Ohio population and the Ohio Legislature to absorb. In fact, the Commission's proposals are for a change in the tax structure that affects less than 15 percent of total taxes. We propose a phasing in of the system to give time to account for the difficulties of transition,

such as identifying alternative sources of finance for local governments.

Our charge was to think about the long run, and about how Ohio might turn its economic growth path upward, toward one that matches the growth in the rest of the country. Tax policy is not the only ingredient in Ohio's economic development strategy, but the Commission believes it to be an important ingredient, and one that needs to be put in better step with the realities of the growing competitiveness of the U.S. economy.

The Blueprint for Reform

The Blueprint for Reform is a long run program, to be carried out over a period of years. It contains the following elements:

1. Eliminate the net worth tax, and require combined income reporting for all corporations. These two reforms must be adopted together, or not at all, and both should be adopted immediately.

2. Eliminate the tangible personal property tax over a number of years. Eliminate the inventory tax immediately.

3. Eliminate the public utility property tax, and bring all utilities under the corporate income tax. The Commission recommends that utility rates be lowered to reflect the tax reductions. As a first step, interexchange companies should be brought immediately into and the tangible personal property tax regime for general business. All new investment by public utilities should be assessed at the 25 percent ratio used for general business. Other utilities would have their assessment ratio on existing properties stepped down over a 5 to 10 year period.

4. 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.

5. Abolish enterprise zones, and prohibit giving targeted tax incentives to recruit companies to Ohio.

6. 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.

7. Extend the sales tax to services, immediately to a narrow category of personal, business and professional services, and later to a broader category of professional services.

8. Give voters a choice on a ballot initiative, between the inclusion of food in the sales tax with a food credit for low income taxpayers, and a 1 percent increase in the sales tax rate.

9. Convert the present individual income tax to a flat rate tax on federal tax liability.

10. The Commission recommends the appointment of a working group to review the system of State-Local government finance in Ohio. The charge to this study group should include a review of the real property tax with an eye toward comprehensive reform.

11. Study the feasibility of 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.

12. Consider the possibility of allowing local jurisdictions to impose differential property tax rates on land and buildings.

13. The Commission recommends that the Department of Taxation undertake a review of its records to re-examine the question of whether estate taxes have induced out-migration of the wealthy.

CHAPTER ONE

INTRODUCTION

This Commission was established out of concern for the relationship between the Ohio economy and its tax structure. The economy has gone through a long period of slow growth relative to the rest of the nation, and though the early 1990s have seen some improvement, all signs are that this long term pattern will continue into the next century. Moreover, our economic and population structure is changing. We are less of a manufacturing center and more of a producer of services, earn more of our income from transfer payments and less from wages, consume more services than goods, and are home to increasing numbers of the elderly and a growing concentration of the poor.

Two major questions are central to our work. The first is whether the present tax structure is consistent with the objective of attracting more investment and jobs to the state, and moving Ohio to a higher income growth path. The second is whether the present tax system "fits" our new economic structure and spreads the tax burden fairly over all sectors of the economy. We find the present tax system deficient on both counts and recommend a comprehensive reform.

Mandate of the Commission

The mandate of the Commission is to identify a tax structure that will carry Ohio into the future. Our view was never short run, and the possibility of raising or lowering taxes to match next year's budget situation was never discussed. The focus on a tax structure for the future has carried over into the recommendation of the Commission for a phasing in of the proposed changes over a period of years.

The principles of a good tax system, which drove the conclusions to which we came, never included political acceptability as a criteria.

Neither were politics a major concern in our deliberations. The goal of this Commission is to identify a tax system that will help our state remove barriers to investment, raise adequate amounts of revenue, and spread tax burdens fairly. The principles of a good tax system, which drove the conclusions to which we came, never included political acceptability as a criteria. One does not need to appoint a blue ribbon panel or undertake analytic study to identify changes that are most acceptable to elected officials.

On the other hand, we took steps to insure that our proposals were realistic. In the case of every reform option evaluated, the practice in other states--neighboring states, competitor states and faster growing states--was considered. Any tax policy in practice in other states surely has met some test of feasibility, and warrants our examination. The Commission decided early that it would not be responsible to ignore the experience of other states simply because some tax policy had been politically accepted or

rejected in Ohio in the past. To place that constraint on our work would be to insure that the tax structure of the future would look very much like the tax structure of the past.

Scope of Work

The scope of work must go beyond the state government revenue system. State and Local government taxes and budgets in Ohio are inextricably linked. Virtually any changes in the state tax system effects the revenue base of local governments either because the tax base is shared (e.g., sales tax), the revenues belong to the local governments (e.g., personal property tax), or the revenues support the flow of state assistance to local governments (e.g., individual income tax). Hence the scope of this work, and these projections must include the state and local government sector. Accordingly, the work of the Commission has been concerned with state government taxes, local taxes that are administered by the State Tax Commissioner, and the real property tax, and the municipal income tax. The current revenue structure under consideration here is described in Table 1-1.

There are important areas, closely related to this work, where time and resources did not permit careful study and evaluation. The Commission could not evaluate the effects of its tax proposals on individual local governments, nor could we propose the detail on how each local government could be held harmless from the results of this tax reform. For example, the Commission does not believe that a property tax on business machinery, equipment and inventories, and the real property tax, are the right basis for education finance in Ohio in the future. That recommendation implies the need for a significant change in Ohio's methods for financing local governments. We propose the early appointment of a working group to evaluate alternatives for a restructuring of the system of state-local fiscal relations.

The proposals for tax reform in this report, are revenue neutral: they should yield no more revenue in year one of the reform than would the present system.

Neither have we studied the expenditure side of the budget. This is an important caveat to our work. Without such study it is not possible to identify an "adequate" amount of revenue to be raised from a new tax structure, or the "right" long run revenue growth. The proposals for tax reform in this report, are revenue neutral: they should yield no more revenue in year one of the reform than would the present system. However, we recommend that the state turn soon to the development of a long term expenditure plan, i.e., to the development of a projected capital and operating budget that is consistent with the projected long-term growth in the economy.

The Commission has not attempted to work out the specifics of the reform proposals here. Exact details on rate and base structure, legal drafting, and tax administration adjustments are left to the Legislature and to the Department of Taxation.

Work of Commission

The Commission considered the principles of taxation that have driven the reform of other states. These possible objectives for tax reform were ranked and weighted by the members after debate about the tradeoffs implied. Economic development and horizontal equity were identified by a wide margin as the priority

objectives of the Commission. This does not mean that vertical equity, revenue stability and other important considerations have been ignored, but it does mean that economic development and fairness are emphasized in this tax reform proposal.

The Commission began its work by holding hearings across the state, and receiving written testimony from all parts of the state economy. Analytic studies were prepared, covering each major tax and the economic base. These are listed in the references to this report. Every study considered the practice in other states vs the practice in Ohio, evaluated the present system based on the principles of "best" practice, and presented alternate reform options. The Commission weighed these choices against the objectives and priorities that were chosen.

Based on these analytic studies and the principles/objectives adopted, the Commission decided and voted on a reform package. This "Blueprint for Tax Reform" is presented in Chapter Seven.

The next three chapters of this report are concerned with the performance of the Ohio economy and with a projection of the fiscal position that will be driven by this economic performance. We then turn to an evaluation of the present tax system in terms of how it measures up against the principles of a good tax structure, and how it fits the Ohio economy. Chapter Six reports the objectives for reform adopted by the Commission, and Chapter Seven presents the proposed reform package. The report closes with a brief restatement of the conclusions and proposals. The full list of recommendations of the Commission is restated in the Executive Summary.

The Commission believes this report is true to the charge given: "a report summarizing the Commission's review of the Ohio economy and tax structure, and containing recommendations for ways in which the state and local governments can promote economic growth in the state while maintaining the stable revenue base necessary to support state and local government services. The recommendations may address changes in state or local statutes, policies, practices, or any other issues the Commission deems to be within the scope of government to implement."[1]

Table 1-1
Collections for Taxes Administered by Ohio Tax Commissioner, Real Property Taxes and Municipal Income Taxes 1993

State-Collected Taxes	Net Tax Collections[a] Percent Distribution	Percent Distribution
State Sales and Use	$3,960,181,109	18.3
Local Sales and Use	740,155,496	3.4
State Personal Income	4,719,028,442	21.8
Corporation Franchise	853,891,871	3.9
Motor Vehicle Fuel	1,121,757,345	5.2
Public Utility Excise	647,634,313	3.0
Cigarette Excise	248,492,268	1.1
Local Cigarette Excise	6,158,426	0.0
Intangible Personal Property (State Collected)[b]	13,135,362	0.1
Motor Fuel Use	52,431,813	0.2
Alcoholic Beverage Excise	45,666,720	0.2
Soft Drink Excise Tax[c]	18,278,303	0.1
Local Alcoholic Beverage	5,911,906	0.0
Horse Racing	13,749,230	0.1
Severance	9,204,102	0.0
School District Income	53,678,627	0.2
Total State-Collected Taxes	*$12,509,355,332*	*57.7*
Locally-Collected Taxes	**CY 1992**	
Tangible Personal Property Taxes	$1,201,218,193	5.5
Public Utility Property Taxes[d]	954,896,001	4.4
Estate Tax	220,117,148	1.0
Real Property Tax	4,676,940,872	21.6
Municipal Income	2,105,904,973	9.8
Total Locally-Collected Taxes	$9,159,077,187	*42.3*
Total Taxes Under Consideration	$21,668,432,519	*100.0*

Sources: For state-collected taxes, Ohio Office of Budget and Management. For locally-collected taxes, Ohio Taxation. State of Ohio, Department of Taxation, *Annual Report, 1993.*

[a]Gross tax collections less refunds.

[b]Taxes paid by dealers in intangibles.

[c]Effective February 1, 1993.

[d]Includes only tangible personal property taxes levied for collection the following year.

CHAPTER ONE

ENDNOTES

1. Cap. Am. H.B. No 152.

CHAPTER TWO

PERFORMANCE OF THE OHIO ECONOMY

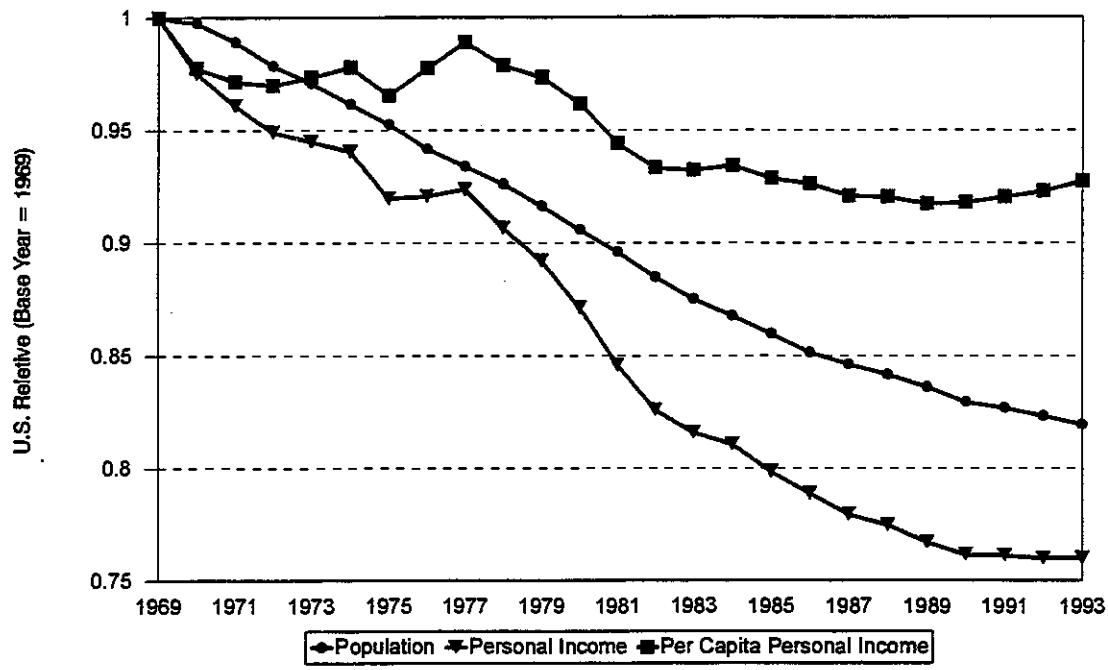
The slow growth of the Ohio economy, and its changing structure, are the reasons for the existence of this Commission. The recommendations here, and the analysis that underlies these recommendations, have been guided by two questions: does the tax system reinforce the economic growth advantages of the state and offset its comparative disadvantages, and does the present tax system fit the present and expected future structure of the Ohio economy. The Commission began its deliberations where this final report begins, with an analysis of the condition of the state economy.

Ohio's Share of the National Economy[1]

For more than two decades, the Ohio economy has declined relative to the rest of the United States. As may be seen in Table 2-1, the state share of both national income and national population has trended down, almost without interruption.[2]

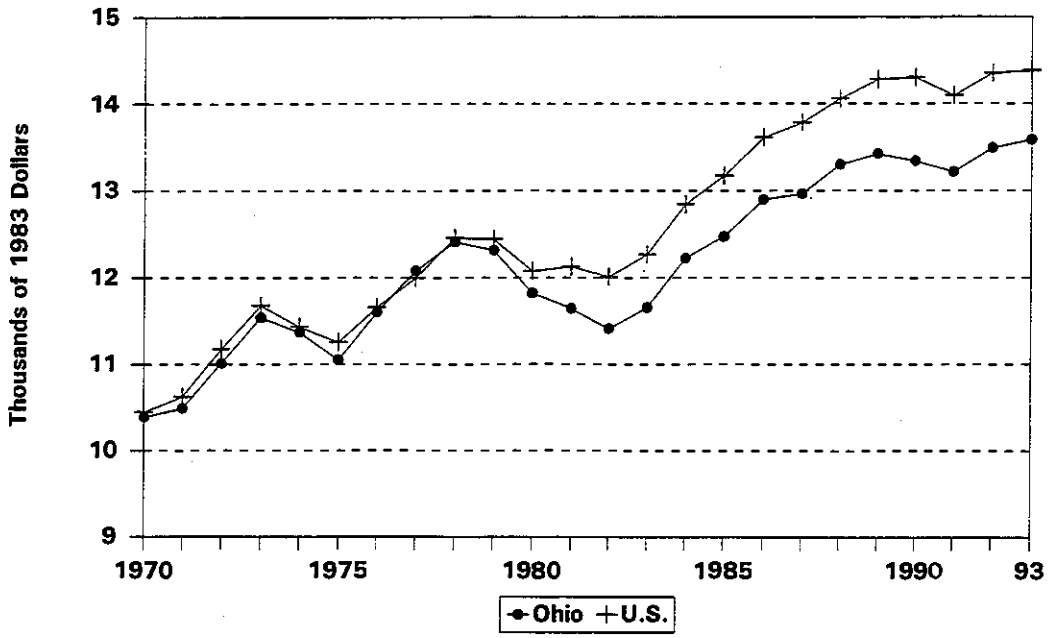
Ohio's total population has remained remarkably constant over the past twenty years. Its share of the total U.S. population, however, has fallen from 5.2 percent in 1969 to 4.3

Table 2-1
Ohio Income, Population, and Per Capita Income



Source: Bureau of Economic Analysis, "Regional Economic Information System," 1994.

Table 2-2
Real Per Capita Personal Income



percent by 1993. Ohio's share of total national income has fallen even faster. Over the 1969 to 1991 period, the proportion of income earned by Ohio residents dropped by about 15 percent. In 1980, Ohio residents and workers accounted for 4.70 cents of every dollar of income earned in the U.S., but by 1992, the share was only 4.05 cents. In short, the growth in population has been slow in Ohio, largely because of outmigration. For those who have remained behind, the slower growth in the Ohio economy has left them with much less real income than their counterparts in the rest of the country.

The consequences of this history can be summed up in the slow growth in average real income described in Table 2-2. While the real income of Ohio's residents has grown over the past two decades, it has done so at a slower rate than in the rest of the country. The per capita real income level in Ohio was essentially the same as that for the nation as a whole in 1970, but twenty-one years later had fallen to nearly seven percent below the national average. If Ohio had grown at the national rate, even since 1980, the real income of the average Ohioan would have been about $800 higher in 1991 than it actually was. This gap, equivalent to 5.3 percent of the average Ohioan's income, is the real cost of the state's slow economic growth.

The early 1990s have seen some improvement, though the trend of long term decline has not been arrested. Per capita income grew at 12.6 percent in Ohio between 1990 and 1993, as compared to 11.2 percent in the nation. Non-farm employment in Ohio grew by less than one percent, between 1990 and 1994. This is a lower rate than any adjacent state and about

one-fourth of the national rate over this same period (Table 2-3).

Why Has the Ohio Economy Grown Slowly?

There are many reasons for slow economic growth in Ohio. Some of these are factors that can be influenced by state policy (e.g. taxes, work rules, energy costs), and some are factors that are "uncontrollable" (e.g. international competition and weather). No reputable study has been able to provide indisputable evidence about which are most important and which are the marginal factors. The most reasonable view in the literature is that locational attractiveness is a function of a number of factors that work together to form a "climate" for doing business that is more or less favorable than that in competing states. It is this business climate, a host of situation-specific factors, and a good dose of luck that finally determines how well a state does in the jobs race.[3]

It is arguably true that Ohio's economic growth problems are less due to failure to attract new industry than to failure to hold on to the industry already in the state.

How does Ohio compare on the various indicators of business climate? Most research on the determinants of economic growth in various regions of the country point to the relative costs of doing business as a significant factor. This includes all costs, e.g., labor, land, taxes, energy, transportation, infrastructure, etc. Business investment and job creation are encouraged to the extent that the cost of doing business in Ohio is lower, especially if it is low enough to offset other disadvantages.

The information available on wage costs in Ohio shows that the wages of workers in the state are in general, below the national average. The exception is for those working in parts of the state's important manufacturing and construction sectors, within which employee costs are somewhat higher than in the rest of the country. Energy costs are generally below the national average (although there are areas of the state with above average costs).

Overall tax costs would not, at first blush, appear to be overly high. Per capita tax collections, taxes as a share of total income, and measures of the overall tax effort in Ohio do not indicate that the average burden of taxation is onerous enough to dissuade businesses from locating in the state. However, it may be the case that some of Ohio's taxes are still too high to offset other comparative disadvantages. Moreover, broad measures of tax effort often hide subtle features of the tax system which could discourage business activity. For example, although tax collections are below average, the top corporate franchise tax rate is high, and Ohio taxes machinery, equipment and inventories at relatively high rates. It is important to remember that the strategy is not simply attracting new companies to Ohio but also holding on to that industry already in the state and encouraging its expansion. It is arguably true that Ohio's economic growth problems are less due to failure to attract new industry than to failure to hold on to the industry already in the state.

A second major determinant of economic growth in a region follows from the notion that people follow jobs and also that jobs follow people. That is, people will move to where the job opportunities are greatest and jobs will spring up around markets (people). Ohio has

Table 2-3
Ohio Non-Farm Employment Compared with Selected States and the United States: 1990-1994[a]

	1990	1994	1990-1994 Percent Increase
TOTAL United States	111,744.0	114,366	2.3
Ohio	4,977.7	5,001.5	0.5
Pennsylvania	5,160.9	5,217.2	1.1
Michigan	3,947.1	4,127.5	4.6
Kentucky	1,477.8	1,565,7	5.9
Indiana	2,532.3	2,645.1	4.5
West Virginia	629.7	675.4	7.3
Manufacturing			
United States	19,256.0	18,144.0	-5.8
Ohio	1,129.7	1,059.9	-6.2
Services			
United States	28,479.0	32,053.0	12.6
Ohio	1,196.9	1,318.1	10.1

[a]Numbers of jobs, in thousands.

Source: U.S. Department of Labor, Bureau of Labor Statistics. *Employment and Earnings*. Data are for June (non seasonally adjusted) as reported in the September issue.

lost population because of the slow growth in the state's economy. The loss in population due to migration has been heavy in the younger working age groups. With the loss of families comes the loss of proximity to markets for many businesses. The outflow of people from the state fueled the downward spiral in the general level of economic activity. While it is true that Ohio's market share is declining, it is also true that Ohio is located in the heavily populated midwestern region, which holds 23 percent of the nation's income and 24 percent of its population.

A third explanation for the slow growth in the Ohio economy is that the state has specialized in manufacturing, a slow growing sector of the economy, and the fact that the service sector of the Ohio economy has grown more slowly than that in the rest of the U.S. The 1976-1993 growth rate in manufacturing employment in the nation averaged -0.4 percent, as opposed to -1.2 percent in the state of Ohio. In the area of services, the comparable numbers are 4.4 percent for the U.S. and 3.6 percent for Ohio. During the period since 1990, manufacturing employment in Ohio has continued to decline at a greater rate than in the rest of the U.S. (Table 2-3). Not only has the state of Ohio specialized in an industry which has not generated as many jobs in the nation as other sectors, but manufacturing has performed worse in Ohio than it has nationally. Neither has Ohio done as well in the service sector, in part because of the weakness in its more basic sectors, such as manufacturing, and in part because of its declining share of national income.

The factors which are cited as a cause for the slow growth in the Ohio economy are factors which affect all states in the industrial Midwest.

Finally, there are the non-economic factors (amenities), which seem to have attracted many firms to the growing regions of the country. These include factors that effect the quality of life of workers and executives, such as weather, the availability of recreational and cultural facilities, low housing costs, and less congestion. It is also true that the development of better systems of transportation and communications, and the maturing of the newer industrial regions of the country made possible the movement of large headquarters and production facilities to the south and southwest in the 1970s and 1980s. Ohio was one of the states that lost from the maturation process in the rest of the country.

The factors which are cited as a cause for the slow growth in the Ohio economy are factors which affect all states in the industrial Midwest. Much of Ohio's decline can be attributed to the fact that it is located in an area of the country which, because of the historical pattern of its development and maturation, and because of the shifting demographic trends which accompanied the development of the Southeast and Western part of the country, has not done well. It would have been truly remarkable if Ohio had stood out as an area of strong growth in the face of these broad and powerful changes in taste, technology and demography. What is troublesome, however, is that Ohio has also done poorly relative to surrounding states.

Changing Economic Structure

The economic and population structure of Ohio has changed dramatically during the last two decades. Important structural changes have occurred in what we produce, how we earn our income, how we spend our income, and in our age distribution. These changes all have important implications for what we should tax in order to keep our system fair, for how high our tax rates must be set to protect revenue, and for how we can restructure taxes to reinforce our competitive advantage.

There has been a dramatic job shift in Ohio, away from manufacturing and toward services. In 1970, 30 of every 100 jobs was in the manufacturing sector, and 17 of every 100 jobs was in services. By 1991, this position was nearly reversed: 19 of every 100 jobs was in manufacturing and 27 of every 100 jobs in services. This shift is a nationwide trend, but it has been distorted in Ohio. The gains have not been as great in the service sector and the losses have been greater in the manufacturing sector.

The losses in manufacturing employment have been widespread. Many of the industries experiencing the greatest job losses are traditional Ohio industries associated with primary metal products and industrial machinery. The state economy has reflected these losses. Manufacturing in Ohio has always been considered a basic industry, a sector which has drawn economic resources from other states and countries to Ohio. The weakness of this sector has rolled out into other sectors of the economy which directly and indirectly depend on and support the manufacturing base.

Over time, the consumption patterns of households has shifted away from the taxed purchases of tangible goods toward the exempt consumption of services.

To some extent, the loss in manufacturing jobs has been replaced by an increase in service sector jobs. Two facts are noteworthy about this trend. One is that Ohio's growth in this sector has been slow whether compared to the U.S. or to surrounding states. The other is that service jobs are heavily concentrated in health care, education and religious activities, all of which are outside the traditional business, income, property and sales tax bases.

Another factor which has affected the Ohio economy and tax base is the shift in the ways by which households get their income. Over the past few decades, the importance of "Transfer Income", income given to households from governmental or private pension sources, has become very important. In 1970, transfer income accounted for 10 percent of total income in the nation, and 9 percent in Ohio. By 1991, this transfer income had grown to 15 percent in the nation and 17 percent in Ohio. Again, a national trend has been magnified in Ohio.

This growth in transfer income compensated for a slower growth in wage and salary payments. In 1970, Ohio residents received 68 percent of income from wages and salaries, versus just 64 percent for the nation. By 1991, these shares were lower and almost even in Ohio (56 percent) and the U.S. (55 percent).

The shift in the source distribution of income is quite significant since transfer income does not carry the same taxpaying power as wage earnings and capital income. Medical assistance payments, welfare payments and pensions are often given preferential tax treatment. Moreover, a higher share of transfer income usually means a growing concentration of elderly population, whose consumption habits may lead to less sales and property tax revenues.

Consumption Patterns

Over time, the consumption patterns of households has shifted away from the taxed

purchases of tangible goods toward the exempt consumption of services e.g., personal, educational and health services. In the U.S., the share of total consumer expenditures for services (excluding food and housing) was 30 percent in 1976 but had risen to 43 percent by 1993. This is extremely important for the Ohio tax system, since service consumption is largely outside the sales tax base. The economic impact of this shift away from the demand for goods and toward services is not limited to domestic demand. In terms of international trade, the share of U.S. exports of goods and merchandise has fallen significantly relative to the exports of services (e.g., professional services). As a state with a reliance on the production of goods, this shift has potentially important implications for the Ohio economy.

Age Distribution

Because of historical variations in birth rates, immigration, and advances in life prolonging medical care, there are cycles in the age distribution of the population. At present, the nation is witnessing a steady aging of its population, with a growing cohort of people at or near retirement age. This national trend is even more pronounced in Ohio. The population of Ohioans aged 55 and over is much higher now than in 1970, and higher than the national share. This, in part, reflects the significant outmigration of the younger, working-age population.

This aging of the population suggests important fiscal implications over the next decade as these wage earners retire. The share of non-taxable income and consumption may grow, housing expenditures may fall, and there will be more pressure for preferential tax relief for the elderly, e.g., circuit breakers and pension income exemptions.

Central Cities[5]

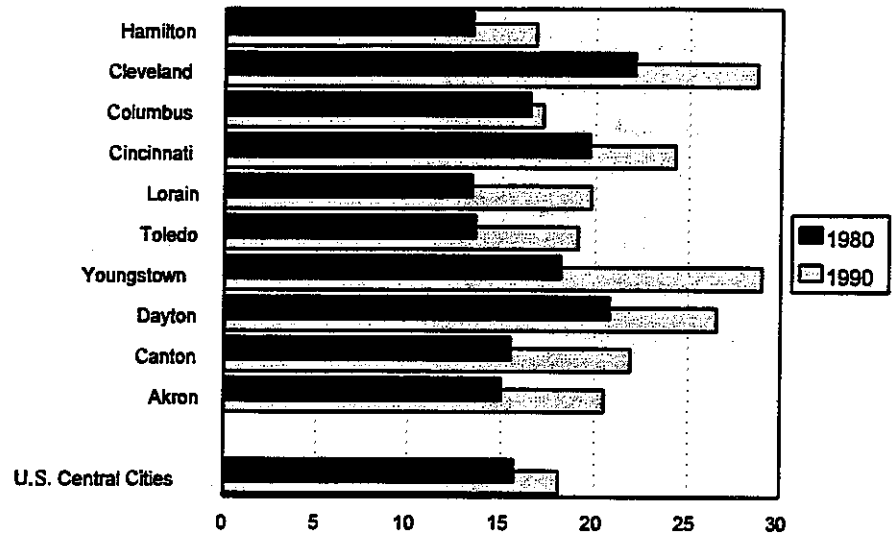
The most apparent indicator of the economic decline of Ohio's central cities is the loss of population. All of the ten central cities, except Columbus, have been losing population in recent decades. Although the aggregate rate of population loss slowed from 12.3 percent between 1970 and 1980 to 4.3 percent between 1980 and 1990, four of the cities (Cleveland, Youngstown, Dayton, and Canton) still experienced a population loss of more than 10 percent in the 1980s. It seems likely that the losses are continuing in the 1990s.

The significance of population losses is determined by how those losses affect the overall well-being of the residents that remain. Unfortunately, the evidence from Ohio cities suggests that wealthier residents are leaving, a large proportion of poorer residents is remaining, and the numbers of poor are increasing. In 1990, six of the central cities had poverty rates exceeding 20 percent of their population, and two more were at 19 percent (See Table 2-4).

Youngstown's poverty rate was 29 percent and Cleveland's was just slightly less. The poverty rates in all ten cities exceeded the 13 percent national rate, as well as the 16.6 percent rate for cities over 50,000 population, and all but Columbus and Hamilton exceeded the 18 percent national rate. The statewide poverty rate for Ohio was much lower, at 12.5 percent in 1990.

Adding to this grim poverty picture, the central city poverty rates all increased between

Table 2-4
City Poverty Rates 1980 Compared to 1990



Source: 1990 Census of Population.

1980 and 1990, led by Youngstown with a 10.8 percentage point increase, followed by Cleveland with a 6.6 percentage point increase.[6] It seems clear that the outmigration from central cities has not been led by poor residents.

Another perspective on the plight of central cities can be gained by examining the incomes of city residents compared to those in the surrounding suburbs. Per capita income in all ten Ohio central cities trails that in suburbs by large margins. Only residents of Cincinnati and Columbus have incomes that reach even 80 percent of that of their suburbs, and Cleveland's per capita income is barely above 50 percent of suburban levels. In six of the ten central cities, income levels are less than three-quarters of that in the suburbs.

Population losses coupled with increasing proportions of poor residents present two potential problems for the governments of central cities, namely, higher costs required to provide services for poorer residents and a smaller revenue base from which to finance those services. The prospects are that the imbalance will grow worse and that the fiscal self-sufficiency of local governments in central cities will weaken. In the long run this will represent a potentially large claim on the revenue of the state government.

Ohio's Comparative Advantage

This picture of decline relative to the rest of the U.S. does not mean that Ohio is without comparative advantage. In fact, it is home to a considerable investment in capital plant by manufacturers, and a skilled manufacturing work force. It is a reasonable proposition that it is much easier to hold on to an existing economic activity than to attract a new one. Inertia can be a great comparative advantage for

Ohio. Manufacturing always has played a significant role in Ohio's economic development, and it will continue to do so. Restructuring in the manufacturing sector in recent years has enhanced Ohio's competitive position.

Labor costs in Ohio are not particularly high for a unionized, industrialized Midwestern state.

Labor costs in Ohio are not particularly high for a unionized, industrialized Midwestern state. Compared to many parts of the country, wage costs are not out-of-line, though manufacturing costs in some sectors are high. The cost of living in the state also represents a comparative advantage. Based upon surveys performed by the American Chamber of Commerce Research Associates and by the National Association of Home Builders, the cost of living is attractive, particularly for a state with many large urban areas where the living costs are typically higher.[7]

Human resources are also an area of competitive advantage. Educational spending and attainment are factors which are frequently cited in rankings of state business climates as one of the state's strengths. The state also has a high level of science and engineering graduate students, an indicator of the quality of the educational system and potential work force. Ohio's technology resources and the presence of several federal laboratories have also been cited as competitive advantages in various business climate studies (Box 2-1).

Even the numbers that describe Ohio's declining national population and economic shares can be interpreted in a different light. A stable population size suggests less pressure on public expenditures, as do fewer school-aged children. Less manufacturing employment may relieve some environmental problems, and may leave the state with a less cyclical economy. Slower job growth in general can mean less pressure for increased infrastructure expenditures.

This combination of historically slow growth and comparative advantage presents two challenges to fiscal planners in Ohio. The first is to manage the budget within the constraints of slow growth. This second is to alter the fiscal structure so as to get on a higher growth path.

Box 2-1
Ohio's Competitive Advantages

The extent to which different factors affect the competitiveness of Ohio firms was investigated in three studies:

- Grant Thornton *Manufacturing Climates Study*
- *1994 Development Report Card for the States*, prepared by the Corporation for Enterprise Development
- *The Ohio Economic Competitiveness Project*, prepared for the Ohio Department of Development.

Although the methodologies were different, as were factors that were considered, some general conclusions can be drawn with respect to Ohio's competitive advantages and disadvantages.

Competitive Advantages. Human resources are an area of competitive advantage. The high school attainment of Ohio's population, as well as the number of science and engineering graduate students provides a strong base of human capital which can be drawn upon by business and industry. Given the ever increasing importance of a skilled workforce, Ohio's success with respect to this factor is particularly noteworthy.

Ohio's technology resources are also an important attribnte. The *Ohio Competitiveness Project* noted the success of Ohio's Thomas Edison Program, and the *1994 Development Report Card for the States* identified patents issued, federal research and development, and SBIR (Small Business Innovative Research) grants as all being indicative of the strength of Ohio's technology resources. The presence of many federal laboratories, bnt in particular the Wright Research and Development Center and the NASA Lewis Research Center, have provided opportunities for many supportive businesses.

Competitive Disadvantages. State employment and labor regulations are Ohio's greatest competitive disadvantages. They are less a disadvantage when Ohio is compared with its border states, but become more significant in national comparisons. Some of the factors that contribute to this finding are unemployment compensation, immigration and man-hours lost due to work stoppages. The Ohio Operations Improvement Task Force concurs that state employment and labor regulations are major barriers to Ohio's economic development.

There is contradictory information regarding industrial energy prices, but recent data indicate that, in general, Ohio's industrial electricity and natural gas prices are higher than in the majority of border states. The variability of rates between different parts of the state, and the availability of incentive rates, can make industrial energy prices a competitive advantage in some service areas.

There is some evidence that Ohio's investment in infrastructure has lagged behind its border states, and other competing areas. Sewage treatment needs were specifically identified. It is anticipated that several new infrastructure improvement projects will be initiated in upcoming years as the state implements the recommendations of *Access Ohio*, a multimodal transportation plan for the state.

Fiscal Impacts. The Grant Thornton *Manufacturing Climates Study* showed that Ohio did not rank well in terms of overall tax effort, perhaps because of the heavier tax load placed on capital intensive firms. However, there was not a great concern about changes in tax effort by comparison with surrounding states. The *Development Report Card* shows that the rating of Ohio's tax and fiscal system was generally comparable to the ratings received by most of the border and high growth states. Ohio ranked high on fiscal stability and balanced revenue, but ranked in the lower half of states with respect to tax fairness and fiscal equalization. According to the *Competitiveness Project*, Ohio's state government fiscal policy was worse than Indiana and Kentucky, but better than the other three border states. This jndgement was made on the basis of four factors:

- Ohio is closer to maximizing its capacity and effort for both tax and non-tax revenue sources than the majority of border states;
- The business share of total tax burden is higher in all border states except Indiana;
- State corporate income taxes per capita are lower in Ohio than in all bordering states; and
- Ohio's state and local tax revenues per capita are higher than Kentucky, Indiana, and W. Virginia, but lower than Pennsylvania and Michigan.

SOURCE: Duchi, 1994.

CHAPTER TWO

ENDNOTES

1. Richard McHugh. *The Setting for Fiscal Reform: Selected Tables.* Staff Report Number 1 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, May 1994) and Mary Laird Duchi. *Ohio's Economic and Demographic Structure.* Staff Report Number 3 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

2. The indexes represent Ohio's share of the U.S. in a given time period relative to Ohio's share in the base period (1969 for this graph). For example, Ohio's personal income accounted for 5.34% of the U.S. total in 1969. In 1970, this share fell to 5.21%. The index, therefore, fell from 1.00 to .975.

3. 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, October 1994).

4. A more detailed description of this shift is given in Duchi 1994, Chapter 2, and in McHugh 1994a.

5. Philip Dearborn. *Ohio Metropolitan Area Revenues.* Staff Report Number 7 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, October 1994).

6. By contrast, the poverty rate for the entire state, including the central cities, increased by only 1.7 percentage points over this period. The national rate declined by 0.6 percentage points.

7. McHugh 1994a, Table 32B.

CHAPTER THREE

PROJECTED FUTURE PERFORMANCE OF THE OHIO ECONOMY

Where is the Ohio economy headed? In this chapter we present a forecast of Ohio's economy, given anticipated changes in demography, tastes and technology[1]. These projections assume that there will be no fundamental changes in the Ohio economy, such as might be induced by a change in the international economy or a change in the state's tax structure. This forecast tells us where Ohio is headed if nothing is different in the future, not where we could be under a different policy frame.

Population

For more than two decades, the state's population has grown more slowly than population in the U.S. This pattern of relatively slow growth is expected to continue over the next thirty years, although the disparity in the relative growth rates between Ohio and the U.S. will narrow during the next century. (See Table 3-1). In each five year interval from 1995 to 2010, Ohio's population growth rate is expected to remain at 0.3 percent per year. For the next 25 years, then, Ohio's historical tradition of population stability will continue. This is good news on two counts: (a) there is no projection of a net outmigration substantial enough to offset natural growth, and (b) slow population growth might enable a slower growth in expenditure budgets.

The U.S. population growth rate will remain above that for Ohio for the next 25 years, but will slow over time, from 0.6 percent to 0.4 percent per year, narrowing the spread between Ohio and the nation. The implications of this pattern are that Ohio's share of national population will decline, bringing with it a smaller share of the national consumer market and possibly a decline in Congressional representation.

This pattern of relatively slow growth is expected to continue over the next thirty years, although the disparity in the relative growth rates between Ohio and the U.S. will narrow.

There are expected to be important changes in the age distribution of the population, both in Ohio and the nation. In Ohio, the growth rate will increase for the 65 years old and above cohort of the population during the next 25 years. This growth rate is slightly below that for the 18-64 year old group through the year 2000. The next decade, however, will see the beginning of a rapid increase in the elderly population; the rate of growth will rise from 0.4 percent between 1995 and 2000 to 2.7 percent in the decade from 2010 to 2020.

Between the years 2000 and 2010, the Ohio population is projected to increase by 335,000 but 53 of every 100 of these additional Ohioans will be over 65 years of age. After the year 2010, all of the net growth in the Ohio population is projected to be in the over 65 age group. The same pattern will hold in the rest of the country, but it will not be so pronounced.

Another characteristic of the changing structure of the population is the anticipated decline in school aged population. Beginning in the 1995-2000 period, the size of under eighteen years of age population is expected to decline in Ohio and in the United States. This should provide steady relief to state and local governments for school budgets and other youth related expenditures.

Employment Growth

Job growth is projected for Ohio over the next decade, in fact, for the remainder of the 1990s the rate of job growth will exceed the rate of population growth (Table 3-2). According to these projections, about 221,00 net new jobs will be created in Ohio between 1995 and 2000. Of these, 126,000 will be in the service sector, and only 2,000 will be in manufacturing.

By comparison with other states, however, Ohio's employment growth will be slow. Employment is projected to grow at about 70 percent of the national rate until 2000 and two-thirds thereafter (See Table 3-2). Under present conditions, therefore, the outlook is for Ohio's share of national employment to fall.

Beginning in the 1995 to 2000 period, transfer payments will become the fastest growing component of personal income in Ohio.

The sectors which will constrain Ohio's relative growth in employment are the same ones which have held it back in the past. In particular, employment growth in manufacturing is expected to be quite slow through the end of the century and then there will be absolute declines.

Most worrisome in the outlook is that the rates of decline are above those projected for all U.S. manufacturing (Table 3-2). This means that Ohio is losing in an area where its competitive advantages should be producing an above average performance by comparison with the rest of the country.

Projections of the growth in employment by occupation also hold mixed news for Ohio. There is projected strong growth in the trade, service, and managerial occupations, and slower growth in operator, fabricator, and laborer occupations.[2] The growth occupations are a mix of high and low wage jobs.

Personal Income

Real income will increase in Ohio over the next two decades, and it will increase faster than population. This ensures some growth in real per capita terms. The average Ohioan will be better off in real terms in 2005 than he/she was in 1995. As may be seen from Table 3-3, growth will exceed 1 percent per year for the next 15 years. This means, among other things, a greater purchasing power of residents, a greater taxpaying capacity, and perhaps a demand for more government services.

As welcome as the projection of real growth is, it must be noted that these real increases are projected to be well below that in the rest of the nation. Between 1995 and 2010, Ohio's real income is to grow 15 to 20 percent below the national average rate. Thereafter the gap widens. This slow growth means that Ohio's share of national income will drop, and it will be a less attractive site for consumer driven production and distribution.

What is more notable about this projected growth in personal income of Ohio residents are the trends in sources of income growth: earnings; dividends and rent; and transfer payments. Beginning in the 1995 to 2000 period, transfer payments will become the fastest growing component of personal income in Ohio (Table 3-4). While this shift toward transfer income is part of a national phenomena, the growth in transfer payments is not expected to exceed that for total personal income in the U.S. until the next century.

Table 3-1
Population Projections to 2020, Ohio and the U.S.

Ohio Population (Thousands)							
	1983	**1988**	**1995**	**2000**	**2005**	**2010**	**2020**
Under 18 Years	2,930	2,823	2,817	2,741	2,633	2,545	2,526
18-64 Years	6,578	6,660	6,784	6,970	7,184	7,324	7,199
65 Years and Older	1,252	1,372	1,516	1,550	1,601	1,727	2,261
Total	10,761	10,855	11,117	11,261	11,417	11,596	11,986
Average Annual Rate of Change in Ohio Population (Percentage)							
	1983-1988	**1988-1995**	**1995-2000**	**2000-2005**	**2005-2010**	**2010-2020**	
Under 18 Years	-0.7	-0.0	-0.5	-0.8	-0.7	-0.1	
18-64 Years	0.2	0.3	0.5	0.6	0.4	-0.2	
65 Years and Older	1.8	1.4	0.4	0.6	1.5	2.7	
Total	0.2	0.3	0.3	0.3	0.3	0.3	
Average Annual Rate of Change in U.S. Population (Percentage)							
	1985-1988	**1988-1995**	**1995-2000**	**2000-2005**	**2005-2010**	**2010-2020**	
Under 18 Years	0.3	0.5	-0.1	-0.5	-0.5	0.0	
18-64 Years	1.0	0.7	0.9	0.9	0.6	-0.1	
65 Years and Older	2.1	1.5	0.7	0.8	1.6	2.8	
Total	1.0	0.8	0.6	0.5	0.5	0.4	

Source: *BEA Regional Projections to 2040*, Volume 1, June 1990, as reported in Mary Laird Duchi, *Ohio's Economic and Demographic Structure.* Staff Report Number 3 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

Note: Cohort totals may not sum to total population due to rounding.

Table 3-2
Employment Projections to 2020, by Industry, Ohio and the U.S.

Average Annual Rate of Change in Ohio Employment (Percentage)						
	1983-1988	1988-1995	1995-2000	2000-2005	2005-2010	2010-2020
Agricultural Services	7.4	3.5	2.5	1.7	1.1	0.3
Mining	-4.8	-0.3	0.1	-0.2	-0.3	-0.7
Construction	6.6	0.7	0.6	0.3	0.1	-0.3
Durable Goods Manufacturing	0.7	-0.1	-0.1	-0.2	-0.2	-0.6
Nondurable Goods Manufacturing	1.2	0.2	0.3	0.0	-0.2	-0.5
Transportation, Communications and Utilities	2.1	0.7	0.6	0.3	0.1	-0.3
Wholesale Trade	2.8	0.8	0.5	0.4	0.3	-0.2
Retail Trade	3.7	0.7	0.7	0.4	0.1	-0.3
Finance, Insurance, Real Estate	3.5	0.8	0.8	0.4	0.2	-0.2
Services	4.7	2.0	1.5	1.0	0.5	-0.1
Government, Total	1.3	0.3	0.3	0.1	-0.1	-0.4
Total, Non-farm	3.0	0.9	0.8	0.4	0.2	-0.3
Farm	-3.0	-0.6	-0.5	-0.6	-0.7	0.0
Total Employment	2.8	0.8	0.7	0.4	0.2	-0.3
Average Annual Rate of Change in U.S. Employment (Percentage)						
	1983-1988	1988-1995	1995-2000	2000-2005	2005-2010	2010-2020
Total Employment	3.0	1.2	1.0	0.6	0.3	-0.2
Durable Goods Manufacturing	1.3	0.2	0.2	0.0	-0.1	-0.4
Nondurable Goods Manufacturing	0.8	0.4	0.4	0.1	-0.1	-0.5

Source: *BEA Regional Projections to 2040*, Volume 1, June 1990. As reported in Duchi, 1994.

Table 3-3
Real Personal Income Projections to 2020, Ohio and the U.S.

Average Annual Rate of Change in Ohio Personal Income (Percentage)						
	1983-1988	**1988-1995**	**1995-2000**	**2000-2005**	**2005-2010**	**2010-2020**
Non-farm personal income	2.6	1.7	1.5	1.2	1.1	0.5
Farm income	33.5	0.9	0.8	0.6	0.5	0.1
Total personal income	2.6	1.7	1.5	1.2	1.1	0.5
Average Annual Rate of Change in U.S. Personal Income (Percentage)						
	1983-1988	**1988-1995**	**1995-2000**	**2000-2005**	**2005-2010**	**2010-2020**
Non-farm personal income	3.6	2.1	1.8	1.5	1.3	1.0
Farm income	10.0	0.3	0.5	0.4	0.3	0.1
Total personal income	3.6	2.1	1.8	1.5	1.3	1.0

Source: *BEA Regional Projections to 2040*, Volume 1, June 1990. As reported in Duchi, 1994.

Table 3-4
Projections of the Source Distribution of Personal Income, to 2020: Ohio and the U.S.

Average Annual Rate of Change in Sources of Income, Ohio (Percentage)						
	1983-1988	**1988-1995**	**1995-2000**	**2000-2005**	**2005-2010**	**2010-2020**
Total Earnings by Place of Work	3.1	1.6	1.5	1.2	1.0	0.5
Dividends, Interest, and Rent	2.4	2.1	1.9	1.6	1.3	0.8
Transfer Payments	1.7	1.5	1.1	1.2	1.8	2.7
Other Adjustments	5.2	2.0	2.0	1.8	1.6	1.2
Total Personal income	2.6	1.7	1.5	1.2	1.1	0.9
Average Annual Rate of Change in Sources of Income, U.S. (Percentage)						
	1983-1988	**1988-1995**	**1995-2000**	**2000-2005**	**2005-2010**	**2010-2020**
Total Earnings by Place of Work	4.0	2.1	1.8	1.4	1.2	0.7
Dividends, Interest, and Rent	3.9	2.4	2.2	1.7	1.4	0.8
Transfer Payments	2.0	2.2	1.7	1.6	2.1	2.8
Total Personal income	3.6	2.1	1.8	1.5	1.3	1.0

Source: *BEA Regional Projections to 2040*, Volume 1, June 1990. As reported in Duchi, 1994.

CHAPTER FOUR

TAX CAPACITY AND TAX EFFORT: WHERE IS OHIO HEADED?

What are the implications of this projected slow growth in the Ohio economy for the state and local government sector? How has the state coped with slow economic growth in the past in terms of its taxing and spending decisions, and can this pattern be continued? If there is a fiscal gap ahead, what is its magnitude? What is the desired revenue-income elasticity of a reformed tax system?[1] The answers to these questions are essential inputs to determining the "right" tax reform for Ohio.

The recent history of the state has been one of increasing the average tax rate to make up for the lagging economic growth.

Tax Capacity and Effort

The U.S. Advisory Commission on Intergovernmental Relations (ACIR) regularly produces estimates of the tax capacity and tax effort of states (Box 4-1).[2] These estimates show that Ohio's fiscal history has been one of increases in tax effort as its fiscal capacity has declined. The ACIR estimated Ohio's taxable capacity at about 4 percent above the national average in 1977 (Box 4-1). The 1977 tax effort index, i.e., the extent to which Ohio used this capacity, was more than 20 percent below the national average. At that time, Ohio was among the lower taxing states in the U.S. and had traditionally been a low taxing state.

As the relative level of economic activity in Ohio declined, the state and local governments in Ohio compensated by taxing their bases more heavily. By the early 1990s, the state had a taxable capacity that was 7 percent below the national average. The use of this capacity, the level of tax effort in Ohio, was 4 percent below the national average. Between 1981 and 1991, Ohio's percentage increase in state and local government tax burden was 112 percent--the 9th highest increase in the country during that period.[3]

From this history, one might draw two important conclusions. The first is that Ohio is still a low taxing state. The second is that the recent history of the state has been one of increasing the average tax rate to make up for the lagging economic growth.[4] One of the questions before the Commission is the wisdom of continuing this pattern.

Fiscal Projections

Where is the public sector in Ohio headed under present conditions? That is, under present circumstances will there be a gap between future revenues available and future expenditure requirements? If there is a gap, what will be its size, how might it be covered, and will it lie at

Box 4-1
Measuring Taxable Capacity and Tax Effort

How does one determine whether a state is using its taxable capacity to the same extent as other states? A shorthand approach is to calculate the state and local government tax share of personal income and compare this across states. Taxes raised by Ohio state and local governments in 1992 accounted for 10.6 percent of total personal income, as compared to 11.2 percent for the U.S. average.

This approach has been criticized as an oversimplication. The Advisory Commission on Intergovernmental Relations argues that personal income is a poor indicator of taxable capacity because not all taxes used by state and local governments are levied on income and because many are not even closely related to income. The ACIR has developed an alternate measure of fiscal capacity – the yield of a Representative Tax System. The Representative Tax System is a national average set of tax bases and tax rates. Fiscal capacity is the amount of revenue a state could raise if it levied that "average" tax system on its economy. The ACIR estimated that Ohio had a per capita taxable capacity of $1936 in 1991, about 7 percent below the national average (a taxable capacity index of 93), and that it ranked 29th in the U.S. Since Ohio actually raised $1851 per capita in that year, it had a tax effort index of 96 (4 percent below the national average). By this measure Ohio's tax effort was ranked 23rd among the 50 states in 1991.

Tax Capacity

	1967	1977	1980	1985	1988	1991
U.S. Average	100	100	100	100	100	100
Ohio	100	104	97	91	91	93

Tax Effort

	1967	1977	1980	1985	1988	1991
U.S. Average	100	100	100	100	100	100
Ohio	82	78	87	103	97	96

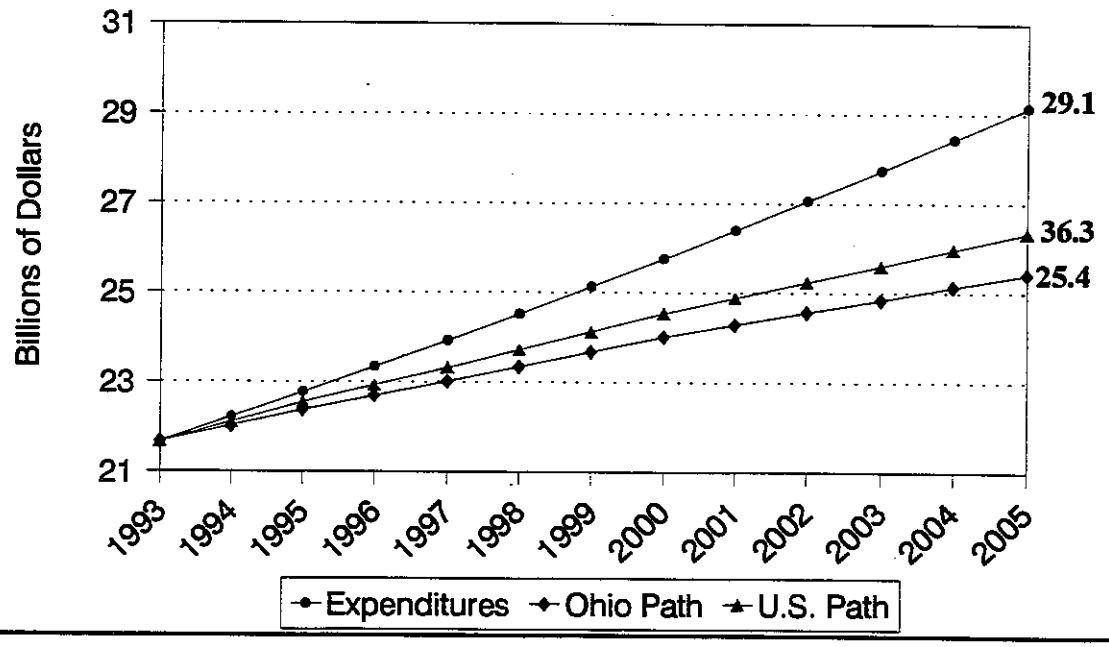
the state or the local government level? During the 1983-1992 period, state and local government expenditures in Ohio grew by an average real rate of 3.5 percent.[5] This is the amount of revenue growth, on average, that it required to provide the level of government services that the state has enjoyed over this period. To project expenditure needs forward to the year 2005, we have used a more conservative growth assumption. Our model assumes that real expenditures will grow at an annual rate of 2.5 percent per year. This is less than the historical rate, but one that is still above the projected real personal income growth in the state.

The results of this projection are described by the top curve in Table 4-1. Real (deflated) expenditures will increase from a base of $21.7 billion in 1993 to $24.5 billion by 1998 and $29.1 billion by the year 2005. The detail of these projections are presented in the penultimate row of Appendix Table 4A to this chapter.

The question to be answered is whether adequate revenues will be generated to match these expenditure needs, or whether discretionary tax rate increases or expenditure retrenchment will be required. The revenue projections we present are based on the income elasticity of the major taxes in the system, and the projected growth rates in personal income reported in the preceding chapter. The estimated elasticities are lowest for the corporate franchise and property taxes, and higher for sales and individual income taxes. The income elasticity of each tax (the responsiveness of revenues raised from that tax to increases in personal income) was estimated and reported in the various staff papers. These resulting elasticities are listed in Appendix Table 4A to this chapter. It is assumed that no discretionary rate and base increases take place over this period, hence all the revenue growth is "automatic" The resulting revenue projections are shown as the bottom curve in Table 4-1, and in Appendix Table 4A.

If the Ohio economy grows as projected by BEA, and if expenditures increase by 2.5 percent per year in real terms, a significant fiscal deficit will emerge. By the year 2005, projected revenues ($25.4 billion) will be 14.7 percent short of projected expenditure requirements ($29.1 billion) Some combination of a level of taxation that is 15 percent higher, or expenditure reduction will be required. This is a sizeable

Table 4-1
Ohio Expenditure and Revenue Growth



gap. If a 5 percent inflation rate is assumed, it translates into a nominal revenue shortfall of $7.2 billion, an amount equivalent to 33 percent of 1993 state and local revenues as shown in Appendix Table 4A.

The question might be asked, what is the contribution of slow economic growth to this picture? If the Ohio economy grew at the U.S. rate, would the gap narrow markedly? In fact, the result would be as shown in Appendix Table 4B to this chapter and graphed as "U.S. path" in Table 4-1: the gap would be reduced from 14.7 to 10.6 percent of total revenues. About one-fourth of the problem is the slow growth in the Ohio economy. The remainder is due to the relatively low elasticity of the state tax system, and to the fact that public expenditure demands are increasing faster than personal income.

The conclusion one reaches from this analysis is that the present tax system is not going to carry public expenditure requirements into the future, and the probabilities are high that tax increases are in the offing.

The conclusion one reaches from this analysis is that the present tax system is not going to carry public expenditure requirements into the future, and the probabilities are high that tax increases are in the offing. This prospect might be avoided in several ways. One is find a better economic performance, and to grow out of the problem. Another is to raise the elasticity of the tax system, hence to gradually raise the level of taxes. A third option is to retrench on the expenditure side, bringing budgetary outlays into line with the realities of a slower growing economy.

State-Local Fiscal Balance

These projections point out a second problem: that Ohio's fiscal gap is largely due to a local government sector that has responsibility for important expenditure functions but is saddled with a relatively inelastic tax base. The state government in Ohio relies on the relatively elastic individual income tax and general sales tax, hence its revenues will grown in step with income and there will be some balance with growing expenditure needs. Local governments, however, use the relatively inelastic property taxes more heavily and revenues from these taxes do not automatically grow in proportion to expenditure needs (assuming that increases in expenditure demands roughly track increases in personal income). To a large extent the gaps which are projected are due to this imbalance in the expenditure and revenue elasticities.

Local governments in Ohio have used discretionary changes in effective tax rates to circumvent part of this problem, and have relied on increasing expenditure and state assistance retrenchment to cover the remainder. In fact, state assistance to local governments in Ohio has increased from 55 percent of state general revenues in 1987 to 60 percent in 1992.

What are the options for dealing with this imbalance? One is to continue the present pattern, which will increase the local

government's claim on state tax revenue. Among the alternative policies are to increase the elasticity of the tax system by shifting revenue reliance away from the less elastic property taxes and toward the more elastic sales and income taxes. This would generate additional revenues for the state government to deal with the projected growth in the local fiscal gap.

CHAPTER FOUR

ENDNOTES

1. The revenue-income elasticity is the percent change in revenues divided by the percent change in personal income, exclusive of any revenue change resulting from discretionary tax rate or base adjustments.

2. Advisory Commission on Intergovernmental Relations, *State Revenue Capacity and Tax Effort*, M-187, (1991).

3. Donald Berno and Jack Whitmore, *Historical Review of Ohio State and Local Government Finances*. Staff Report Number 4 of the Commission to Study the Ohio Economy and Tax Structure, (Atlanta, GA: Policy Research Center, Georgia State University, November 1994), p. 1.

4. The ACIR has not made estimates beyond 1991, however, their estimates of taxable capacity have been extended here by regressing the estimated index of taxable capacity on per capita personal income and using the estimating equation to predict taxable capacity for 1992 and 1993. The results show that Ohio's taxable capacity has remained at about 7 percent below the national average.

5. These increases were computed from expenditure data taken from the Census of governments, deflated by the consumer price index. The real increases for recent years were 3.96 percent (1991/1992), 4.44 percent (1990/1991), and 3.06 percent (1989/1990).

Appendix Table 4-A
Present Path Projected Revenue-Expenditure Gap with 2.5 Percent Real Expenditure Growth
(Revenue in Millions of Dollars)

	1993[1] Actual	Income Elasticity Estimate	1998 Estimate	2005 Estimate
Major State Tax Revenues				
Personal Income Tax	$4,719	1.27	$5,208	$5,814
Sales Tax	3,960	0.97	4,273	4,662
Corporate Franchise Tax	853	0.6	895	947
Public Utilities Excise Tax	647	0.7	684	730
Other State Taxes	1,811	1.0	1,959	2,142
State Total	11,990		13,018	14,294
Major Local Tax Revenue				
Tangible Personal Property Tax	1,201	0.8	1,297	1,377
Public Utilities Property Tax	955	0.6	1,002	1,060
Local Sales Tax	740	1.0	800	875
Real Property Tax	4,677	0.8	4,982	5,361
Municipal Income Tax	2,105	0.9	2,260	2,451
Total	9,678		10,323	11,123
State and Local Total Revenue [2]	21,668		23,341	25,417
State and Local Expenditures at 2.5% Real Growth Rate	21,668		24,516	29,141
Surplus (Shortfall) as a Percent of Revenue	0.00		(5.03)	(14.65)

[1] State data are fiscal year and local data are lagged calendar year as reported in the 1993 *Annual Report* of the Commissioner of Taxation.
[2] See Table 1-1.

Appendix Table 4-B
U.S. Path Projected Revenue-Expenditure Gap with 2.5 Percent Real Expenditure Growth
(Revenue in Millions of Dollars)

	1993[1] Actual	Income Elasticity Estimate	1998 Estimate	2005 Estimate
Major State Tax Revenues				
Personal Income Tax	$4,719	1.27	$5,317	$6,084
Sales Tax	3,960	0.97	4,343	4,835
Corporate Franchise Tax	853	0.6	904	970
Public Utilities Excise Tax	647	0.7	692	750
Other State Taxes	1,811	1.0	1,992	2,224
State Total	11,990		13,248	14,862
Major Local Tax Revenue				
Tangible Personal Property Tax	1,201	0.8	1,297	1,420
Public Utilities Property Tax	955	0.6	1,012	1,086
Local Sales Tax	740	1.0	814	909
Real Property Tax	4,677	0.8	5,050	5,529
Municipal Income Tax	2,105	0.9	2,294	2,537
Total	9,678		10,467	11,480
State and Local Total Revenue [2]	21,668		23,715	26,342
State and Local Expenditures at 2.5% Real Growth Rate	21,668		24,516	29,141
Surplus (Shortfall) as a Percent of Revenue	0.00		(3.38)	(10.63)

[1] State data are fiscal year and local data are lagged calendar year as reported in the 1993 *Annual Report* of the Commissioner of Taxation.

[2] See Table 1-1.

CHAPTER FIVE

GRADING THE PERFORMANCE OF THE OHIO TAX SYSTEM

Does Ohio need a tax reform? Is the present system so fundamentally out of step with good tax practice, or with the state's economic development and equity objectives, that a comprehensive restructuring is required? To answer this question the Commission adopted a set of principles to guide its evaluation of the Ohio tax system. The principles, described in Box 5-1, can be used to develop a kind of report card for the tax system.

Economic Development

It is difficult to say exactly what constitutes a tax system that is most favorable to economic development. Investors are attracted to locations that provide a high after tax rate of return, and by certainty about the fiscal environment in which they will operate in the longer run. Those who make location choices report that they are swayed by lower taxes in some cases, a different tax structure in other cases, and better public

Box 5-1
Principles Adopted by the Commission

- Revenue Adequacy and Elasticity. The Commission will begin with a revenue-neutral proposal for restructuring, i.e., any proposed change in the system will yield the same revenue in the reform year as the present system would have yielded in that year. However, the longer term growth in revenues will be different for different reform packages. The Commission will take into consideration the need for a future revenue growth that will support the provision of government services at an adequate level.

- Vertical Equity. The Commission will consider how alternate reforms will effect the distribution of tax burdens across income levels. The ability to pay taxes is one criteria that will guide the Commission in choosing among alternate reforms.

- Horizontal Equity or Fairness. The Commission begins with the goal of an equal tax treatment of similarly situated individuals and businesses. To the extent possible, economic decisions should be guided by the market and not by the tax code. Where differential treatment is warranted for social, economic, administrative or other reasons, these will be explicitly recognized by the Commission.

- Economic Development. The Commission seeks a reform that will be consistent with promoting a healthy growth in the Ohio economy. All reform options will be evaluated based on their potential impact on employment, earnings and investment in the state, and on the competitiveness of Ohio businesses.

- Simplicity. The Commission will be guided by the objective of simplification of the tax system. The intention is to improve understanding of the system on the part of those who pay taxes, to reduce compliance cost, and to minimize administrative costs to the extent possible.

- Spatial Distribution. Changes in the tax structure will have major effects on the fiscal position of local governments. The Commission will evaluate these effects on places (of different income levels and on different types of local governments) in evaluating alternate structural reforms.

- Obsolescence. The Commission will consider whether any taxes in the system are "out of step" with the present day Ohio economy.

infrastructure in still others. Yet, a great body of research on the effects of fiscal structure on economic growth has not been able to produce a hard estimate of the number of jobs lost due to higher taxes.

Another approach to linking taxation to economic development is to rely on a priori evidence, i.e., to evaluate the possibility that various taxes in the current system are structured so as to discourage investment in this state. Here the evidence is clearer that there are flaws in the state tax system that are not in the best interest of future economic development.

Net Worth Tax[1]

The net worth tax was instituted to control tax avoidance, protect revenues, and provide for a stable flow of revenue (see Box 5-2). The net worth component of the corporate franchise tax eliminates the possibility of complete avoidance of Ohio taxes by those who have the ability to use transfer pricing to shift tax burdens to either unprofitable subsidiaries or to lower taxing states, and by those who make no profits. It has the desirable feature of charging all companies some amount for the use of state-provided infrastructure and services. About one-third of franchise tax revenues has traditionally come from the net worth tax.

The structure of the net worth tax harms the economic development potential of the state. The list of criticisms and shortcomings of the net worth tax is a long one, and it has been a major irritant to the business community for many years. First, taxpayers feel that the net worth tax is unfair because it puts an additional burden on those companies that have had a bad year, in terms of low income or net losses. The tax comes at a time when enterprises are least able to afford it, and thus it increases their financial risk. This may be particularly damaging to new companies, which often have losses in the early years of operation. In 1993, $158 million was paid in net worth taxes (out of a total of $228

Box 5-2
The Net Worth Tax

Corporations in Ohio must compute a tax on net income and a tax on net worth and pay the larger of the two. The tax base for Ohio's net worth tax is the total book value of the corporation's capital, surplus, retained earnings and reserves.

Many of the corporations liable for the net worth tax in Ohio do business in other states. The share of the corporation's net worth subject to tax in Ohio is determined through application of an apportionment formula which is based on two factors: property and sales, both very broadly defined.

The net worth tax was originally enacted in Ohio in 1903 and has not been revised since 1936. Several other states make use of a net worth tax, but only Ohio in the U.S. uses it as an alternative to the net income tax. Asset taxes of this type are also used in western Europe and in developing countries, mainly as a minimum tax to protect against tax evasion and avoidance.

million) by corporations with zero or negative net incomes.

The apportionment formula for the net worth tax discriminates against Ohio locations.

Second, the apportionment formula for the net worth tax discriminates against Ohio locations. The net income basis of taxation is apportioned according to three factors (payroll, property, and sales, with the latter double-weighted), while net worth is apportioned according to two factors (property and sales). The property factor in the net worth formula includes tangible and intangible assets. In contrast, the property factor in the net income formula includes only real and tangible personal property. The inclusion of intangibles in the net worth formula has created problems for situsing property and has given corporations an incentive to establish their legal domiciles outside of Ohio. The "business done" factor in the net worth formula is also a wider concept than the sales measure used in the net income formula, and discourages the choice of Ohio locations. The business done factor includes not only sales of tangible property and revenue from services, but also rents and royalties, dividends and interest, patent copyrights, and in some cases the sale of assets. Dividends, interest, royalties, and other intangible income are treated as allocable income under the net income tax, and therefore do not enter the net income apportionment formula.

The differences in the two formulas highlight some contradictions in the philosophy underlying the two components of Ohio's franchise tax. Under the net income base, a larger part of the tax is shifted to taxpayers outside Ohio because the sales factor is double-weighted. The exclusion of allocable income from the sales factor has the same effect, since its inclusion would increase the numerator of the factor more than the denominator. The exclusion of intangible property in the property factor of the net income tax formula also favors Ohio companies, since most of the intangible property would be situsted in Ohio. Under the net worth tax, however, the computation of the two factor formula shifts the tax burden more towards Ohio corporations. The shift occurs because income from intangible assets is included in the business factor and intangible assets are included in the property factor. As a consequence, Ohio companies experience an increase in both factors vis-a-vis non-Ohio companies, since most intangible property and income have an Ohio situs.

A third problem with the net worth tax is double taxation. This arises first because the net worth tax falls on the same assets as are taxed by the property tax. The issue of double taxation of property has become more acute with the repeal (in 1993) of the credit against the franchise tax for property taxes paid. That credit, it has been argued, helped equalize property tax burdens for companies located in different local jurisdictions across Ohio. A second issue of double taxation arises when both parent company and subsidiaries located in Ohio must pay the net worth tax. However, this form of double taxation is partially addressed with the new credit for investment in qualified subsidiaries.

Fourth, the net worth tax may discourage investment in Ohio if the combination of the net income and net worth taxes imposes a tax burden on capital invested in Ohio that exceeds the average tax burden imposed on capital in all other states. Taxing capital investment more heavily than the average state, i.e., having a lower after-tax rate of return to capital, will

drive investment away. Ohio's level of corporation taxation is low by comparison with other states. In particular, Ohio has had a lower tax effort than any other of the ten largest industrial states with the exception of Indiana. Even so, the net worth component of the franchise tax (along with heavy property taxes) may discriminate against Ohio locations by imposing a differentially heavier tax on certain kinds of firms, and may drive capital from the state.[2] To the extent this is true, the effect will be more pronounced in the heavy industrialized sectors which have long been the backbone of the Ohio economy.

However, manufacturing firms and others that are producing for national markets will find it more expensive to locate in Ohio to the extent that Ohio sales taxes business purchases more than other states.

Sales Tax on Business[3]

The concept behind the sales tax as a consumption tax leads to the conclusion that all business purchases should be exempt and only the sale to the final consumer should be taxed. This approach results in no pyramiding of the tax. Decisions by states to tax some business purchases violate the consumption tax concept and leave policymakers without a clearly defined policy on where to draw the line on what is taxable. Moreover, sales taxation of business purchases raises the cost of doing business in Ohio, and may harm economic development. The location of retailers is unlikely to be affected, even though their costs rise, because the retailer wants to locate near the market for its goods. However, manufacturing firms and others that are producing for national markets will find it more expensive to locate in Ohio to the extent that Ohio sales taxes business purchases more than other states.

The relatively little research that has been conducted on how sales tax payments by business affect economic development, indicates that higher sales taxes reduce the number of firms in the 12 to 50 employee range, and that lower sales tax rates on business equipment purchases increase the rate of formation of small firms in a state.

Ohio exempts many business purchases from the sales tax. For example, exemption is given for purchases of products that are to be incorporated into tangible personal property through manufacture or when purchases are made to resell the item. Nonetheless, approximately 30 percent of sales tax revenues in Ohio comes from taxation of business. This percentage is not unusual in the U.S. There are two main reasons for including business purchases in the sales tax base.

- Revenues. Revenues are probably the most important reason why the sales tax base includes so many business purchases. Alternatively stated, the overall sales tax rate can be kept lower with business purchases in the base. Further, sales tax payments by businesses are hidden from the consumer/taxpayer perspective. The consumer does not realize what is happening when prices are raised to reflect the higher costs that businesses bear when their purchases are sales taxed. This pyramiding of taxes means the effective tax rate is higher than the stated rate.

- Administration. Determining whether a purchase is made by a business or by a consumer can be very difficult. For example, both a carpenter and a consumer can go to a hardware store to buy a hammer. Total business exemption would open many opportunities for tax evasion, and would increase the administration and compliance cost of the sales tax. The taxation of all business purchases except direct inputs has seemed a better route to most states.

The taxation of business purchases has some disadvantages as well. Some specific concerns include:

- Consumption tax concept. Taxation of business purchases distorts the concept of the sales tax as a consumption tax, since business purchases are not final consumption.

- Effects on vertical integration. Businesses are discouraged from engaging in business practices that otherwise would make good business sense. For example, sales taxation of business purchases encourages firms to produce their own inputs, because the sales tax payment can be reduced. Smaller firms can be hurt most by this incentive since small firms may be unable to produce their own inputs. Also, small firms may be less likely to start up if large firms are discouraged from outsourcing.

- Uneven tax burdens. The sales tax will pyramid as the tax is levied at several steps in the production process. As a result, the effective tax rate on goods depends on how many business purchases are in the tax base. Thus, horizontal equity is distorted by the taxation of business purchases. Further, items such as food or health care cannot be fully exempt from the sales tax because tax paid on these items will be implicit in costs of purchases by businesses.

A consistent thread in the hearings before the Commission was that the inventory tax is a major impediment to business development in Ohio.

The Tax on Inventories[4]

Arguably the most objectionable of the business taxes in Ohio is that on inventories. A consistent thread in the hearings before the Commission was that the inventory tax is a major impediment to business development in Ohio. A common complaint was "the worse my year the more inventory tax I pay." Among the major competitor states, Indiana, Kentucky, and West Virginia tax business inventories. California, Illinois, Michigan, North Carolina, Pennsylvania, South Carolina, and Tennessee do not tax inventories. In fact, most of the 50 states exempt inventories from property taxation.

There are many strong arguments to exclude inventories from the tax base. Investment in inventory is mobile, and such a tax may drive retail and wholesale distribution activities out of state. Moreover, there is an argument that inventories do not represent value in the same sense as company income or assets since they are goods in process of adding value and eventually will be taxed as final output. Finally, there is the point that a buildup of inventories may mean no more than a bad year and a diminished ability to pay taxes. It should be noted that in many local jurisdictions, enterprise zone legislation has been used to abate the personal property tax on inventories. One might take the view that with this legislation, the first steps to abolishing the inventory tax have already been taken. However, this is a very ad

hoc approach to tax reform and leaves similar firms with quite different treatments depending on their county of location.[5]

The tangible personal property tax in general (of which the tax on inventories is a component), might also be seen as a deterrent to state economic development. The base of the tax is capital investment, which would seem to discourage exactly the kind of activity which the state desires, and this tax discriminates against capital intensive firms. This reasoning, and administrative difficulties, have led some competitor states (Pennsylvania and New Jersey) to remove this tax.

Insurance Company Taxes[6]

Because Ohio's 2.5 percent premium tax rate is high, Ohio insurers must pay substantial retaliatory taxes when they sell in most other states (See Box 5-3). This additional tax places Ohio insurers at a competitive disadvantage and likely reduces their out-of-state sales. Obviously, this is a major disincentive for multistate insurers to locate or grow in Ohio. Other important insurance states and neighboring states provide a more favorable climate for insurance companies that choose to headquarter in their state.

The Estate Tax[7]

The Ohio estate tax is levied according to a progressive rate schedule on the value of the estate. In addition, Ohio like most states, imposes an additional tax on estates. The additional tax, the difference between the calculated state tax (based upon the rate structure) and the maximum allowable Federal credit for state estates taxes, is called the "pick-up" tax.

There are two potential economic development impacts from the estate tax. First, higher estate taxes may act as a disincentive to

Box 5-3
The Retaliatory Tax

The retaliatory tax is a unique tax applied only to the insurance industry. The tax was designed to reduce the incentive for states to tax foreign (out-of-state) insurance companies at high rates.

The tax works as follows. Suppose, for example, that Ohio has a 2.5 percent premium tax and Illinois has a 1 percent tax. Because Illinois' tax rate is lower than Ohio's, Illinois retaliates against Ohio companies operating in Illinois. This retaliation occurs by the state of Illinois taxing Ohio companies operating in Illinois the same way as Illinois companies are taxed in Ohio. Thus, Ohio companies pay 2.5 percent of their premium in taxes to Illinois, even though the Illinois rate is officially 1 percent. If Ohio decreased its premium tax rate to, say, 1 percent, Ohio companies would no longer have to pay retaliatory taxes to Illinois.

In general, the higher a state's premium tax rate relative to tax rates in other states, the more a state's domestic companies pay to other states in premium taxes and the less the state collects in its own retaliatory tax. Thus, payments to other states by a domestic industry are tied directly to a state's own tax policy.

save. Since the estate tax will take a share of a household's wealth (which has been accumulated as a result of a household's decision not to spend all that they have accumulated), the tax provides an inventive to spend from the estate, rather than to save.

Second, the state estate tax, introduces an incentive for households to "shop" for a place of retirement, i.e., for tax-favored retirement homes. For states like Massachusetts and New York, the incentive to move can be very strong. For Ohio, this incentive exists for estate levels below about $4 million.

Electric and gas companies, telecommunications firms, and financial institutions are all subject to a different treatment than are general companies.

Horizontal Equity

In some cases the tax system has been slow to follow changes in the structure of the Ohio economy, and the structure of markets. The result is that similar businesses are treated differently from one another, and this leads to undesirable distortions in economic decisions. For example, a discriminatory tax treatment may steer investment away from a particular sector of the economy, perhaps into a less productive sector; or economic methods of doing business may be discouraged by ill conceived tax practices; or new investments may be directed to other states to avoid an unfavorable tax treatment. Electric and gas companies, telecommunications firms, and financial institutions are all subject to a different treatment than are general companies. In some cases, there are historical and economic reasons for these differences, in others it appears that the tax system has simply failed to keep pace with the changing economy. Unless there are sound reasons for differential treatment, a good tax structure should aim for an equal treatment of similarly situated firms and individuals.

Telecommunications Firms[8]

The comparison in Table 5-1, which describes the differential treatment of telecommunications firms, highlights the issue. The first row shows the tax treatment of the local exchange companies (LECs), while the second row shows the tax treatment of a private business that does not provide telecommunication services. The remaining rows show the variations in the tax treatment of alternative telecommunications service providers. Clearly, there is much diversity in how these firms are treated. Though there is not a clear statement of the rationale for this differential treatment, one might attempt to develop some implied general principles based on the practice as described in Table 5-1.

- The first is the distinction between the treatment of public utilities and private businesses. As a public utility, the local telephone companies (LECs) are subject to the gross receipts tax, but to neither the corporate franchise tax nor the sales tax on their services. In addition, as a public utility, the LECs are subject to the tangible personal property tax at the 88 percent listing rate.

Table 5-1
Tax Treatment of Telecommunication Services

Type of Company	Sales Tax on Services Provided	Corporate Franchise Tax	Gross Receipts Tax	Property Tax Assessed at 88 Percent	Municipal Income Tax
Local Telephone	NO	NO	YES	YES	NO
Private Business	?	YES	NO	NO	YES
Interexchange Companies	YES	YES	NO	YES	YES
Cellular	YES	YES	NO	YES	YES
Private Communication (CAPS Paging)	NO	YES	NO	YES?	YES
Cable TV	NO	YES	NO	NO	YES
Resellers	?	YES	NO	YES?	YES

Source: Richard McHugh, *The Taxation of Telecommunications in Ohio.* Staff Report Number 10a of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, October, 1994)

As shown on the second line, private businesses are subject to both the corporate franchise tax and the general sales tax (should their goods or services be defined as taxable) but not to the gross receipts tax. Private businesses are subject to a lower 25 percent rate on their personal property.

- Any company which is subject to the gross receipts tax will not have its services subject to the general sales tax.

- Any company subject to the state corporate franchise tax will also be subject to the municipal income tax.

With these three general principles, the rationale for the system of taxation currently in place can be evaluated. Such an evaluation reveals serious shortcomings with the present system. First, the LECs are currently the only ones in the telecommunications industry still strictly defined and fully treated as a public utility (i.e., subject to the gross receipts tax and the higher personal property tax listing rate). Second, the interexchange and the cellular companies, since 1987, have not been subject to gross receipts tax but have been treated as a private company paying the franchise tax and a sales tax. However, a comparison of rows two and three of Table 5-1 shows the inconsistency

in the treatment of private business versus interexchange companies (IXCs), cellular and other telecommunications firms. Specifically, these telecommunications firms can be subject to the 88 percent listing rate, unlike a true private business.

Third, the private communications firms, like the CAPS and paging systems, are generally treated as a hybrid between a private company and a telecommunications firm. However, there are two gray areas. First, the services provided by the CAPS are not subject to the sales tax. Second, the CAPS and ALTS, strictly speaking, are subjected to the higher 88 percent listing rate for tangible personal property.

Fourth, cable television is subject to neither the general sales tax nor the state gross receipts tax, but is subject to local franchise taxes. Because cable companies do not provide two-way service at this point, under Ohio law they are not classified as a telecommunications firm and they are not subject to the 88 percent listing rate. Once two-way telecommunications becomes available, however (and a major cable company has already filed with PUCO for rights to provide telecommunications service in a large portion of Ohio), cable companies would technically become subject to the higher listing rate.

The high taxation of public utilities engenders a horizontal inequity in favor of those firms not classified as public utilities but which can provide services similar to those of the public utilities.

In sum, the State of Ohio continues to treat its LECs as it has for years, as a regulated franchise monopoly, not subject to the Corporate Franchise Tax but instead subject to a gross receipts tax. The State's general sales tax is not levied on local telecommunications services. The LECs are also levied a personal property tax with a listing rate of 88 percent versus 25 percent for private businesses. The interexchange companies, cellular companies and other actors in the industry are subject to the corporate franchise tax, have their sales subject to the general sales tax, and also pay the differentially higher personal property tax listing rate. There are serious horizontal equities in this tax treatment of the telecommunications sector.

Public Utility Property Tax[9]

The tangible personal property on public utility property is subjected to an 88 percent assessment ratio, while that on regular companies is assessed at 25 percent. The differentially high listing rate on personal property was justifiable in the past on the basis that, as a public utility, these firms were endowed with certain rights (e.g., access to public right-of-way) and were protected from competition through their franchise monopoly. Moreover, given the regulatory structure under which the utilities operated, the rate of return was guaranteed and differentially higher personal property taxes were not born by the utilities.

Over the past several years, there have been encroachments on the monopoly position of some of these companies. With the onset of competition in these markets, differentially high tax rates and the horizontal inequities which they imply, will begin to have important allocative effects. The relatively high taxation of public utilities will make it more difficult to attract investment funds to the industry. This is an important issue because investment in utility infrastructure is an important economic development factor.

Also, as the tax is currently configured, the high taxation of public utilities engenders a horizontal inequity in favor of those firms not classified as public utilities but which can provide services similar to those of the public utilities. This inequity is currently most acute in the telecommunications sector. In this sector, the interexchange companies (IXCs) are subject to a differentially higher tax on personal property although they operate in a highly competitive environment. Alternative local competitive access providers have also emerged and this creates a similar problem for local exchange companies.

As new providers of similar services have breached the market, the gross receipts tax has imposed some important horizontal inequities.

Banks and Insurance Companies[10]

Financial Institutions. Ohio has a problem with its definition of a financial institution subject to taxation under the financial institutions tax. This definition excludes a number of bank competitors from taxation under the law. This law is based on an antiquated notion of the banking business. The statute requires that, among other things, a bank must accept deposits in Ohio before it can be taxed. As a result, banks can lower their Ohio tax liability by producing financial services outside the state (accepting deposits through the mail or by way of interbank electronic transfers) and then selling them back to Ohio residents. This encourages non-depository functions to be sent out-of-state and results in revenue loss and potential job loss.

There are two issues here. The first is that different tax treatment leads to different tax burdens. This is a violation of horizontal equity. By taxing all financial corporations and general corporations in a similar manner it is possible to increase the horizontal equity among competitors or potential competitors.

A second issue that has potential ramifications for horizontal equity concerns those banks owned by a holding company. Since the financial institutions tax rate is approximately three times the rate for nonfinancial corporations, a bank owned by a holding company has an incentive to transfer net worth to the parent, thus reducing the yield of the financial institutions franchise tax. Of course, this transfer may be limited by regulatory capital requirements imposed as part of risk based capital rules implemented by federal regulators. This benefits large subsidiary banks which are part of a holding company relative to stand-alone banks.

Insurance companies. There are wide differences in the tax burdens imposed on insurance companies by Ohio's present tax structure. For example, while Ohio has a 2.5 percent premium tax rate, Ohio-based insurance companies can pay on a net worth basis. The option lowers the effective tax rate for many (but not all) Ohio insurers. Since this alternative computation is based on total rather than allocated net worth, it tends to favor single state companies with low capitalization, some of which are the largest premium writers in the state. In addition, some insurers (e.g., HMO's, foreign fraternals) are exempt from the premium tax. This diversity in treatment produces horizontal inequities that are difficult to justify.

Gross Receipts Tax on Utilities[11]

The principle motivation for a public utilities excise tax is to tax industries which are granted "franchise monopolies". By virtue of their franchise, they are theoretically protected from competition. They are also permitted the special privileges associated with "eminent domain" and

access to public right-of-ways. The levies represent an implicit quid-pro-quo for these privileges. However, there is growing encroachment upon the monopoly position of the utilities. As new providers of similar services have breached the market, the gross receipts tax has imposed some important horizontal inequities.

In the field of electricity there are several available avenues of obtaining power without relying on a provider which is subject to the public utilities excise tax. For example, there is the possibility of obtaining power through the process of cogeneration, in which a non-utility may produce power for itself and sell the excess supply to other users, bypassing the traditional power company and avoiding the gross receipts tax.

In the field of telecommunications, there are a whole host of new "by-pass" firms which provide access to long distance operators (a service traditionally provided by the local exchange companies) but are not covered by the public utility excise tax. Examples include the privately owned networks (built by competitive access providers), and privately operated PBXs. The new personal communication systems permit bypass of the local exchange. The availability of the alternatives which are not subject to gross receipts taxation represent a tax-induced incentive to alter behavior, a potential (and exploited) leakage from the gross receipts tax base, and an administrative problem.

In the realm of natural gas, the exemption of interstate business from gross receipts taxation carries with it an incentive to purchase gas from out of state. FERC Order 636, issued in April of 1992, requires that natural gas companies "unbundle" the pricing of their services (that is, separate the pricing of the storage, transmission and sales of natural gas). In effect, this permitted customers to purchase their natural gas from one supplier and pay the pipeline companies only for the transmission or transport of the gas. The practical impact of this, from the standpoint of the gross receipts tax, was that local customers could purchase natural gas from an out-of-state source which is not subject to the gross receipts tax. The only gross receipts taxes collected in this case would be those on the "wheeling charges" (those charges by the utility for the transport of natural gas). This provides another source of leakage from the gross receipts tax base and a disadvantage to local suppliers.

There are also inequities which arise from the combination of the exclusion of municipal electric utilities from taxation and the exemption of interstate business from taxation. While some municipal utilities produce their own power, most do not. Rather, they purchase the power wholesale from another utility. This, in itself, does not represent any sort of inefficiency or inequity. If a municipal utility purchases its power from another public utility in the state, then there is no purely tax-induced inequity since a gross receipts tax is paid by the in-state producer. However, since a municipal utility can purchase its electricity from an out-of-state provider, and all interstate business is exempt from taxation, no gross receipts tax is paid on this purchase either at the wholesale or the retail level. Since municipal utilities are also directly exempt from the excise tax, these purchases not only reduce the revenues from this tax but also impart a cost (price) advantage to municipal utilities at the expense of the investor-owned utilities.

This advantage, however, may be in part a well-defined policy of subsidizing power in communities served by municipal utilities which are disproportionately located in poorer rural communities and in central cities. There are approximately one hundred municipal electric companies, the vast majority being small and/or rural. However, there are several larger

municipally-owned utilities in the state, such as those in Hamilton, Columbus and Cleveland.

The asymmetry of the municipality granting a tax abatement for what is largely school district revenue does not have the ring of a well-designed fiscal incentive package.

Independent of the interaction between the municipal exemption and interstate exemption, municipal public utilities are given an advantage when they produce the service themselves. For example, a municipal telephone service can fully escape the gross receipts tax. The technology in the field of telecommunications has progressed to the point that a system could be built to serve a small community or to serve parts of larger areas and be competitive with the local exchange companies which are subject to the gross receipts tax. Here, too, the incentive exists to avoid the tax (by making use of the affordable alternatives) thus resulting in tax-induced changes in behavior which erodes the tax base. Although it is difficult to ascertain the precise role which the exemption from the public utilities excise tax played in the development of municipal public utilities, it is surely the case that the exemption provides an option which tilts the playing field against the investor-owned companies.

Tax Incentives and Enterprise Zones[12]

Special tax treatment of businesses by definition creates a horizontal inequity. The choice facing any state is whether to give targeted tax incentives or to provide all of the state's businesses with the lowest taxes possible. Ohio has chosen the former approach, and provides a range of tax incentives. The most important is the Enterprise Zone Program.

The Ohio Enterprise Zone Program was created in 1982. The original intent was to improve the economic development prospects in distressed urban areas of the state through the exemption of property taxes related to an investment project. Since then, the program has been extended to rural areas and the list of potential tax incentives has grown to include credits applicable to the Corporate Franchise Tax. Currently there are 247 known enterprise zones in the state. Only a few counties do not have an enterprise zone. Property tax abatement and inventory tax abatement in particular are the most used tax incentive under the enterprise zone program, with only about 10 percent of enterprise zones utilizing the franchise tax credit.

The literature concerning the impact of tax incentives on economic development has shown that these incentives have their greatest impact within a region. That is, these incentives will not have much affect on a decision to locate in Ohio versus Texas but can have a greater impact on the decision to locate in Toledo, Ohio versus Perrysburg, Ohio. The benefits of the program from one Ohio community are likely to come at the expense of another Ohio community, or a community in a neighboring state. Ohio has far more enterprise zones than most any state in the country, increasing the potential for intra-Ohio competition.

The horizontal equity problem arises because firms in enterprise zones receive preferential treatment as regards the personal property tax. The result of this program, to the extent it works, will be to draw resources toward the 250

enterprise zones and away from other sites, or simply to give a comparative advantage to businesses included within this program.

Another problem that grows out of this practice is a complication in the intergovernmental fiscal system. When municipalities grant property tax abatements, the relief also applies to school district properties. Officials in many school districts feel that the municipal-granted tax abatements directly reduce funds for local education. Proponents of enterprise zones argue that the firms would not be in the school district at all except for the enterprise zone. While no doubt there is some truth on both sides of this argument, the asymmetry of the municipality granting a tax abatement for what is largely school district revenue does not have the ring of a well-designed fiscal incentive package.

Were all of the services listed in Table 5-2 to be brought into the sales tax base, the state government could reduce its tax rate to 3.3 percent and still collect the same amount of revenue.

Net Worth Tax and Debt-Equity Choice[13]

The net worth tax distorts methods of financing and encourages thin capitalization. Corporations that add to their real assets by borrowing from a bank or issuing debt will not experience an increase in their net worth tax base. However, those corporations that purchase the same real assets but finance them with new equity issues will experience an increase in the tax base by the entire amount of the investment. Thus, the marginal effective rate of taxation[14] on the same asset goes from zero, if financed with debt, to a positive rate of taxation if the asset is not exempt.

In addition, the net worth tax is horizontally inequitable because its burden depends on the structure of a business. Some business sectors require more capitalization for technological reasons and consequently a longer maturation period to profit-making. In this sense, the net worth tax can be viewed as discriminatory -- favoring enterprises that are lightly capitalized, such as those in the service sector, and penalizing enterprises that are more heavily capitalized, such as those in the manufacturing sector. Both types of companies would pay the net income tax in years of good performance, but in a recession those sectors that are more heavily capitalized will pay a much higher net worth tax.

The Sales Tax Treatment of Services[15]

A major horizontal inequity in the state tax system stems from the failure to include services in the tax base (Box 5-4). The result is that consumers who purchase tangible goods and services that are in the tax net are discriminated against in favor of those who choose to purchase non-taxable services. Since services now constitute more than half of all consumption, the implications of not including services in the base are significant.

Ohio has continued to add services to its retail sales tax in recent years, but much consumption still remains exempt. Were all of the services listed in Table 5-2 to be brought into the sales tax base, the state government could reduce its tax rate to 3.3 percent and still collect

Box 5-4
Sales Tax and Services

The consumption of services (excluding food and housing) in the United States accounted for 43 percent of total consumption in 1993. This share has slowly and consistently grown over the past twenty years. In 1976, for example, services accounted for 29 percent of total consumption. The most noticeable decline during the period was in the purchase of non-durable goods. These goods accounted for 41 percent of total consumption in 1976 and 31 percent of consumption in 1993.

There is no general rule that describes what services states have chosen to tax. The percentage of consumption covered by the retail sales tax varies quite widely across states. The table below provides an estimate of the breadth of the sales tax base in Ohio and in surrounding states, and lists the highest combined state and local tax rate.

Sales Tax Base as a Percent of Personal Income
And Highest State and Local Sales Tax Rate, FY 1991

	Base as a Percent of Income	Highest Combined Tax Rate
Ohio	36.9	7.00
Indiana	53.4	5.00
Kentucky	38.8	6.00
Michigan	46.0	6.00
Pennsylvania	30.5	7.00
West Virginia	52.9	6.00

Source: 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, November 1994).

Ohio can be characterized as having a relatively narrow sales tax base, and a tax rate that is toward the high end by comparison with its neighbors. Within the region, Indiana takes the opposite approach with a relatively broad base and a relatively low rate.

Table 5-2
Number of Services Taxed in Ohio, by Category: 1990 and Current

Category	Services Taxed in 1990	Services Taxed in 1994	Change: 1990-1994
Agricultural Services	0	1	1
Industrial & Mining Services	0	0	0
Construction	0	0	0
Transportation	1	1	0
Storage	0	0	0
Utilities	6	8	2
FIRE	0	0	0
Personal Services	4	6	2
Business Services	4	13	9
Computer Services	2	2	0
Automotive Services	3	3	0
Admissions & Amusements	1	2	1
Professional Services	0	0	0
Leases	1	1	0
Fabrication, Repair & Installation	12	12	0
Miscellaneous	0	0	0
TOTAL	34	49	15

Source: Inter-Office Communication from Christopher W. Hall to Ronald A. Mucha, Ohio Department of Taxation, June 16, 1994, as reported in Fox, 1994.

the same amount of revenue. The addition of services to the tax base adds significant scope for the improvement of horizontal equity.

Real Property Tax[16]

The real property tax is structured in such a way that it does not treat all property owners the same, even if they own properties of equal value. Under the provisions of HB 920 and subsequent legislation, separate tax reduction factors are calculated for class 1 property (residential and agriculture) and class 2 property (all other real property). Since price changes have been greater for class 1 property, the effective property tax rate (i.e., the rate after application of the tax reduction factor) is lower for class 1 property than class 2 property.

Vertical Equity

Every state is concerned about how its tax system spreads the burden among high, middle and low income taxpayers. The Ohio tax system gets relatively good marks on vertical equity. About one-fourth of the taxes are raised from levies that fall partly on owners of capital, the individual income tax has a progressive rate structure, and food consumption is exempt from the sales tax.

Individual Income Tax[17]

Ohio's individual income tax has several features that enhance its progressivity.

- The top marginal rate is relatively high.
- The large number of tax brackets increases progressivity.
- Retirement and senior citizen credits afford lower income retirees a relatively large benefit.

On the other hand, progressivity is dampened by a low threshold for tax payment, i.e., a large number of low income individuals are brought into the net, due to a low personal exemption and the absence of a standard deduction. The personal exemption credit mitigates this effect, especially for taxpayers with children.

The result of empirical analysis of the individual income tax, as may be seen in Table 5-3 is a progressive distribution of individual income tax burdens, rising from 0.1 percent of income at the bottom bracket to 4.7 percent at the top. These estimates exclude the local income taxes in Ohio, which are imposed at relatively steep levels, and at flat rates. The local taxes would be expected, therefore, to reduce the progressivity of the state income tax. The right column shows the distribution of burdens that would occur if every municipality and school district levied a 1 percent income tax. Again, the result is a progressive distribution of burdens, but much less than in the case of the state system.

Sales Tax[18]

The distribution of Ohio's sales tax burden is regressive when measured against current income. Households with incomes between $5,000 and $9,999 pay 2.6 percent of their income in sales taxes and households with incomes above $50,000 pay 1.3 percent of their income in sales taxes (Table 5-4). Thus, the burden on low-income households is almost twice as large as that on high-income

Table 5-3
Distribution of Individual Income Tax Burdens
(Percent of FAGI)

Federal Adjusted Gross Income Class (FAGI)	Taxes As A Percent of Income (State Income Tax)	Hypothetical Burden: Taxes as Percent of Income
		State and Local Government Income Taxes
under $5,000	0.1	1.96
5,001-10,000	0.4	2.24
10,001-15,000	0.8	2.49
15,001-20,000	1.4	3.14
20,001-40,000	2.2	4.06
40,001-80,000	3.1	4.98
80,001-100,000	3.8	5.64
greater than 100,000	4.7	6.41
Average	2.9	4.60

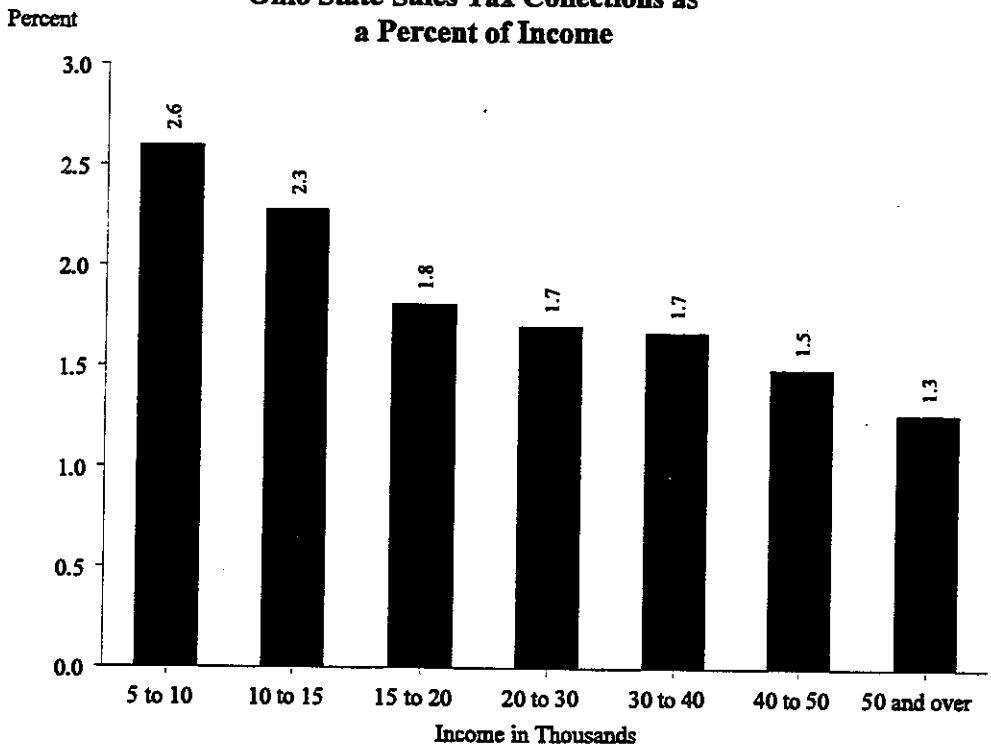
Source: Sally Wallace, *Ohio's State and Local Individual Income Taxes: Analysis and Options.* Staff Report Number 5 for the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November, 1994).

households. Still, more than 60 percent of the sales tax on consumer purchases is paid by households with $30,000 or more in income. Moreover, the per household tax payment is much greater for higher-income households. For example, households with incomes over $50,000 pay nearly five times more in taxes than households with income between $5,000 and $9,999.

The regressive sales tax results from the propensity of lower-income households to spend a higher percentage of their income. In fact, families in every income class below $20,000 have higher levels of expenditure than income. Thus, the regressive sales tax is more the result of different levels of consumption relative to income than to the purchase of different "market baskets".

Some economists have argued that lifetime income is a better basis for comparing tax burdens than is annual income.[19] The concept is that people set their expenditure patterns based on the overall consumption level they expect to maintain over their lifetimes. For example, people who recently lost their jobs may spend more than would be expected from their current income. Both retirees and young people consume more than is expected given their

Table 5-4
Ohio State Sales Tax Collections as a Percent of Income



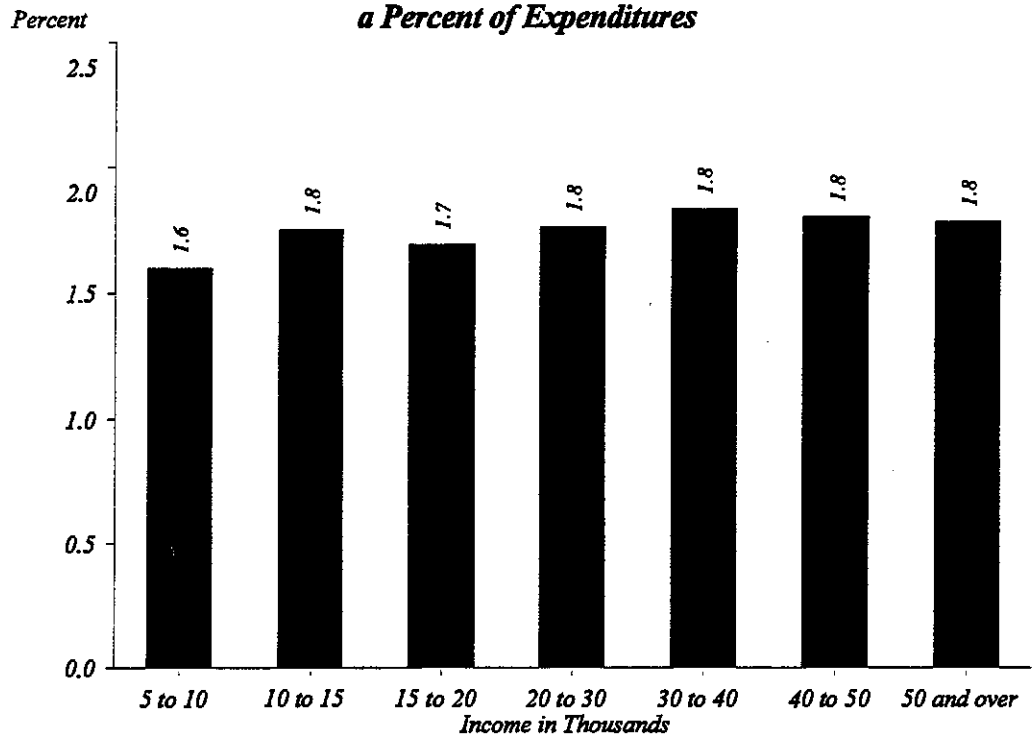
Source: U.S. Department of Labor, *Consumer Expenditure Survey, 1990-91* and author's calculations. See Fox 1994.

income level, because their lifetime income is greater than their current income. This reasoning has led many economists to argue that annual (or current) expenditures are a good proxy for lifetime income. Therefore, estimated Ohio sales tax burdens were compared with annual expenditures for each income category. The results show the distribution of burdens to be proportional to slightly progressive when measured against consumption rather than annual income (See Table 5-5). By these estimates, a family with an income of $50,000 and a family with an income of $20,000 both would pay 1.8 percent in sales tax. Thus, the sales tax is not regressive when compared with lifetime income.

Property Tax Burdens[20]

The distribution of property tax burdens is a hotly debated issue in economics. Most would agree that the tax on owner occupiers is borne by them, hence the regressivity in the distribution of tax burdens depends on whether low-income owners spend disportionately more for housing, and on whether there is an assessment bias that favors those who own high value properties.

Table 5-5
Ohio State Sales Tax Collections as a Percent of Expenditures



Source: U.S. Department of Labor, Consumer Expenditure Survey, 1990-91 and author's calculations. See Fox, 1994.

An estimate of the impact of a 5 mill increase in the property tax on residential property, with and without the present system of tax credits, shows a regressive distribution of tax burdens (See Table 5-6). For example, a taxpayer with an income of $25,000 would see an increase equivalent to 0.50 percent of income, a taxpayer with an income of $50,000 would see an increase of 0.28 percent, and a taxpayer with an income of $100,000 would see an increase equivalent to 0.21 percent of income.

The incidence of the non-residential property tax, and the incidence of a property tax that is collected from a landlord, are more difficult matters. Most would agree that the real property tax levied on businesses is shifted forward to consumers and backward to labor and to owners, with the division of the tax burdens depending on market conditions. The same is true of rented properties -- the tax burden is divided between owners and renters. To the extent this tax is shifted backwards to owners, the real property tax has a progressive distribution of tax burdens. To the extent it is shifted forward to consumers and renters, it is regressive. We are unable to make an accurate estimate of this division in Ohio.

Elasticity

The revenue income elasticity of a tax is the percent change in revenues that occurs when

Box 5-5
The Revenue-Income Elasticity of a Tax

The elasticity of any tax has two components: the rate elasticity and the base elasticity. The rate elasticity measures how tax revenues change as taxable income changes. If a tax structure has many marginal tax rate brackets, the elasticity will be relatively high for that tax. The base elasticity measures how taxable income changes with a change in personal income (or some other measure of comprehensive income). If most of personal income is taxable, the growth in the tax base will be very close to the growth in overall personal income. The overall elasticity (the percent change in revenue for a percent change in personal income) is calculated as the rate elasticity multiplied by the base elasticity:

$$\frac{\textit{Percent Change in Income Tax Revenue}}{\textit{Percent Change in Personal Income}} = \frac{\textit{Percent Change in Income Tax Revenue}}{\textit{Percent Change in Taxable Income}} \times \frac{\textit{Percent Change in Taxable Income}}{\textit{Percent Change in Personal Income}}$$

The rate elasticity of Ohio's state income tax is high, approximately 1.5. This means that a 5 percent increase in taxable income of filers will yield a 7.5 percent increase in individual income tax revenue. The base elasticity of Ohio's individual income tax is approximately 0.85. This means that as personal income grows by 10 percent, taxable income grows by only 8.5 percent. This lower taxable income growth is mainly due to the growth of untaxed transfer and medical payments as components of personal income. The majority of these payments are not included in taxable income.

The overall elasticity of the individual income tax is 1.27, still relatively elastic, bnt less than the rate elasticity alone.

income changes by one percent, exclusive of any discretionary rate or base adjustments (Box 5-5). In general, Ohio has a relatively inelastic tax system, that is, most taxes do not automatically grow in proportion to income.

The individual income tax is an exception, and provides most of the buoyancy of the Ohio tax system. The overall elasticity of the state individual income tax in Ohio is 1.27, i.e., a ten percent increase in income generates a 12.7 percent increase in tax revenues.[21] The high elasticity is due to the combination of a low threshold and an unindexed progressive rate structure that leads to "bracket creep".

With respect to the *sales tax*, much of the revenue growth in Ohio has come from adjustments to the tax rate. An analysis of the growth in the base of the tax suggests that the elasticity is 0.97, i.e., a ten percent increase in income will lead automatically to a 9.7 percent increase in sales tax revenues.[22] The sales tax, then, would tend to support an expenditure growth that was more or less in line with income growth.

Most of the other taxes in the Ohio system are income inelastic. The estimate of the income elasticity for the real property tax for the entire period 1971 to 1992, excluding agriculture and minerals, is 0.90. The estimated elasticity for all real property over the period 1974 to 1992 is 0.78. Both estimates imply that the real property tax base grew slower than personal income.[23] This inelasticity is no surprise. Ohio is a state with a slow growing population and a declining industrial base. Both of these factors suggest a lagging amount of new construction to add to the property tax base. The aging of the population is another reason why the property tax base may be growing slowly.

Table 5-6
Incidence of a 5-Mill Increase in the Property Tax Rate: Residential Only

Income Class	Tax as a Percent of Income	
	With Credit	Without Credits
$ 1,001 - 2,500	5.27	5.58
2,501 - 5,000	1.97	2.11
5,001 - 7,500	1.31	1.45
7,501 - 10,000	0.99	1.09
10,001 - 12,500	0.81	0.88
12,501 - 15,000	0.70	0.74
15,001 - 17,500	0.63	0.66
17,501 - 20,000	0.54	0.57
20,001 - 25,000	0.47	0.50
25,001 - 30,000	0.39	0.42
30,001 - 35,000	0.33	0.36
35,001 - 40,000	0.29	0.32
40,001 - 50,000	0.25	0.28
50,001 - 75,000	0.21	0.24
75,001 - 100,000	0.19	0.21
100,001 - 150,000	0.18	0.20
150,001 and higher	0.15	0.17

SOURCE: David Sjoquist, *Real Property Taxation in Ohio: Analysis and Policy Options*, Staff Report Number 6 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, September 1994).

For tangible personal property, there appeared to be little increase in the real value of the tax base throughout the 1980s and early 1990s.[24] The pattern shown in Table 5-7 indicates that real per capita assessed values have declined significantly during the past 15 years. Clearly, revenue increases from the tangible personal property tax must come primarily from discretionary rate increases.

Revenues from the gross receipts tax have grown slowly over the past decade, for several reasons.[25] First, the sluggish growth in these collections was due to legislated changes in the taxable base (e.g., the elimination of long distance carriers from the base of the telephone gross receipts tax and the deductibility of access charges from the taxable receipts of local exchange companies). Second, there are low income elasticities of demand for the goods which are taxed: natural gas, electric, etc. That is, the demand for these goods or services rises more slowly than income. Third, this is an ad valorem levy, and there has been a slow growth

Table 5-7
Real Per Capita Appraised and Assessed Value of Tangible Personal Property: 1977-1992

Year	Per Capita Real Appraised Value[a]	Per Capita Real Assessed Value[a]
1977	2,828	1,279
1978	2,860	1,236
1979	2,815	1,161
1980	2,719	1,066
1981	2,722	1,012
1982	2,756	1,002
1983	2,726	967
1984	2,494	848
1985	2,557	844
1986	2,701	864
1987	2,696	836
1988	2,682	805
1989	2,762	801
1990	2,820	790
1991	2,800	756
1992	2,774	721

[a]Using the Consumer Price Index as a deflator.

Source: Gary Cornia, *Ohio Tangible Business Personal Property: Property Taxation*, Staff Report Number 8b of the Commission to Study the Ohio Economy and Tax Structure, (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

growth in the price of these goods in recent years. Since the tax is based upon the value of utility services instead of the quantity consumed, growth in prices has led to slow growth in revenues. Research has found the demand for these products to be relatively insensitive to prices. The price of these public utilities are regulated by the Public Utility Commission of Ohio (PUCO) and the number of requests for rate increases from PUCO has dwindled in recent years. Finally and most importantly, structural problems in the design of the public utility excise tax base has eroded the tax base over time as users have substituted non-tax for taxed consumption.

Stability

The instability of revenues over the business cycle leaves state and local fiscal planners in a position of making the choice between expenditure cuts or tax increases during a time of recession. The more cyclical a state's revenue structure, the more difficult the choice, because the revenue shortfall will be greater in the contraction. In fact, the Ohio economy is cyclical, and to some extent this is amplified by the tax structure.

All sales taxes have unstable revenue growth, but it is the combination of the sales tax structure and the state's economy that determine the degree of instability. On both counts, the Ohio sales tax would appear to be highly cyclical.[26] The elasticities are lowest in recession years (FY91, FY81, FY80, and FY75), and are much higher in expansion years. The falling revenue during recessions occurs because consumers postpone expenditures on major durable goods (such as automobiles and appliances) and housing, and because businesses invest less. The impact of lower durable goods purchases is pronounced, because these items are consumed over many years, but the entire sales tax is paid when the items are purchased. The result of delayed purchase is a magnified reduction in sales tax receipts. The reverse happens during economic expansions when the purchase of durable goods and business investment goods expands rapidly. The exclusion of food from the tax base makes the Ohio sales tax base inherently less stable. Not surprisingly, most tax rate changes in Ohio (and in other states) come near the end of recessions and are intended in part to offset the very slow revenue growth that has occurred during the recession.

Annual estimates in the *individual income tax* show that the tax is cyclical,[27] due to the effects of the business cycle on the tax base. As the economy contracts, the growth in wages and capital income falls off more than overall personal income. In the early 1980s, for example, while personal income growth fell below 4 percent, wage and salary growth fell well below 1 percent. In the most recent recession, dividend and interest growth was less than 10 percent of personal income growth and wages grew about 50 percent less than personal income.

There is relatively little cyclical variation in personal property tax revenues.[28] Purchases of new machines and equipment may be postponed in a contraction year, but this does not have a dollar for dollar effect on the overall tax base, because the latter is based on the depreciated, reproduction cost of the entire stock of machinery and equipment held by the company. Moreover, the value of the inventories may actually increase during a recession. The result, over time is described in Table 5-7 as a virtual constancy in the real value of the tax base.

The real property tax base is subject to considerable cyclical variation.[29] During recessions the growth in both income and the property tax base slows. However, because of

Table 5-8
Corporate Franchise Tax Liability With and Without Net Worth Tax Component, 1988-1993

Tax Year	Total with Net Worth	Percent Change over Previous Year	Total without Net Worth: Net Income Basis Only	Percent Change over Previous Year
1988	$719,430,413	___	$586,959,047	___
1989	771,130,137	7.2	645,077,393	9.9
1990	728,156,622	-5.6	585,163,816	-9.3
1991	650,538,338	-10.7	461,164,160	-21.2
1992	613,496,098	-5.7	429,994,616	-6.8
1993	630,040,000	2.7	422,805,000	-1.7
Coefficient of Variation	0.083	---	0.166	---

Sources: Ohio Department of Taxation, *Annual Report* and staff computations. See Martinez and Grace, 1994.

the highly cyclical nature of the construction industry, the fall off in the growth of the property tax base (new construction) is large relative to that in income, and revenue growth is slowed commensurately. The reverse is true in periods of economic expansion.

The *net worth tax* has lent some stability to the Ohio tax system.[30] It serves as a revenue floor when profitability is down, and as a protection against transfer pricing practices which might otherwise drive corporate tax liability to zero. The simulation presented in Table 5-8 shows the extent to which the net worth component helps iron out cyclical variations. The two left panels show the revenue yield under the present system, and the two right panels show the yield if only the net income basis were used. The results indicate that the inclusion of the net worth tax strengthens the stability significantly, e.g., the present system led to a 10.7 percent revenue decline in 1991 whereas the system without a net worth component would have led to a 21.2 percent decline.

Administration

A good tax structure is one that imposes as little compliance cost as is necessary, as little administrative cost as is necessary and gives taxpayers confidence in the system. Usually

these maxims lead to a system that is as simple as possible. To be sure, a state tax system cannot be simple in this complicated economy -- there is just too much to take into account. Businesses organize themselves in complicated ways to finance, produce and deliver goods and services, individuals have many different types of situations that require special treatment, the sales tax must reach new products where situsing is extremely difficult, and real property tax limits are a fact of today's political economy. Still, the goal is as much simplification as is possible without compromising the fairness and efficiency of the tax system.

By any grading system, however, Ohio's tax structure is unnecessarily complex, and imposes heavy compliance burdens on taxpayers.

By any grading system, however, Ohio's tax structure is unnecessarily complex, and imposes heavy compliance burdens on taxpayers. At the top of the list of problems is the net worth component of the corporate tax. Both tax options under the franchise tax -- net income and net worth -- must be fully computed every year despite the fact that only one will be used. The computation of the net worth tax is especially cumbersome because it requires the situsing of every component in the balance sheet based on complex rules which in some instances go back half a century.[31]

The personal property tax presents administrative difficulties that, arguably no other business tax presents.[32] In theory, every asset should be valued, depreciated and trended to an estimate of depreciated reproduction cost. A retirements list should be maintained, and the central valuation authority should keep up a valuation schedule for a great number of different types of assets. It should also maintain an active audit program. Moreover, since this is primarily a local government tax, the asset list should be kept for every jurisdiction where the firm operates. Even a moments reflection will suggests that this is a task that requires considerable investment in valuation and audit staff in the Department of Taxation.

The state individual income tax is relatively clean, but the administration of local income taxes add considerable complexity to the overall system.[33] In the current Ohio Code, no legislation establishes uniform guidelines for compliance with the municipal income tax throughout the state. Thus, a diversity of practices exists regarding such fundamental requirements as the forms required for filing, withholding, estimated taxes, and final payments, due dates for filing, penalties, and extensions for filing. While the administrators of the tax may be very efficient in their collection and audit procedures, there is no doubt that these differences and the apportionment calculations for business, are cumbersome. Individuals who work and reside in two different municipalities, each with a local income tax, have the added burden of multiple filing. The long tradition of this tax in terms of its use and the municipalities' autonomy would make conformity of the municipal income taxes with the state difficult, but the long-run savings to businesses and individuals would be substantial.

The real property tax is the most complex in the Ohio system largely because of the tax reduction factors and the rollback credits.[34] It is arguably true that it is one of the more complex property taxes in the U.S. (See Box 5-6). The tax base is defined properly as full market value, but is assessed at 35 percent of market value.

Box 5-6

Real Property Taxation in Ohio: A Complicated System

There are five basic steps involved in determining property tax liability in Ohio.

Step 1. Discovery.

The first step is the discovery of property, i.e., the identification of each parcel of land and all improvements, including new construction, changes to existing structures, and changes in ownership.

Step 2. Valuation.

The second step is to determine the fair market value for each property. Each county is required to appraise each piece of property every six years, a process known as the "sexennial" reappraisal. The sexennial reappraisal requires a site inspection of every parcel. During the third year after the sexennial reappraisal, the county is required to adjust property values for changes in values that have occurred. This triennial update involves adjusting "classes" of property for changes in market conditions.

Owners of agricultural land devoted exclusively to agricultural use can request that the value of the land be based on its current use rather than fair market value. The current use value of agricultural land is based on the productivity of the farm, the potential amount and mix of each of several crops, and a five-year average of prices of crops and cost of seed, etc.

Step 3. Determining assessed value.

The third step involves calculating the assessed value, i.e., taxable value. Ohio assesses most real property at 35 percent of fair market value (or current use value in the case of agricultural land). Certain property is exempt from property taxes in whole or in part. These exempt properties, which include property used for charity, religion, government, and economic development incentives, were 14.5 percent of the total of taxable and exempt real property in 1992.

Step 4. Determining the gross amount of the tax.

The fourth step involves applying the tax rates to taxable value. Each jurisdiction in which the parcel lies, e.g., county, municipality, school district, etc., has one or more property tax rates. These rates are reduced by a "tax reduction factor" (HB 920). The reduction factor limits the increase in property tax revenue to that which results from new construction only. The state government calculates the ratio of (a) the taxable value at the time the millage was passed, plus new construction, to (b) the new assessed value including the price increase. This ratio is known as the "tax reduction factor." The approved millage rate is multiplied by one minus the tax reduction factor to obtain the effective millage rate. The resulting product of the effective millage rate and the new assessed value yields the tax liability.

A further complication occurs when a school district approves a "replacement levy". Although the new levy may be the same millage as the existing levy, the new millage starts fresh in terms of

the tax reduction factor. For example, if the existing millage was 7 mills and the tax reduction factor was 0.8, the effective millage would be 6.3 mills. If a replacement millage of 7 mills is voted in, the calculation of the tax reduction factor starts anew, so that no tax reduction factor is applied in the first year. Thus, the effective millage is now 7 mills. Note that the procedure for a "renewal levy" is different. A renewal levy is considered a continuation of the existing levy and so the reduction does not start anew, but continues from the point the levy was first adopted. For each millage rate, separate tax reduction factors must be calculated for each of two classes of property. Class one includes residential (housing of 4 units or less in which the owner lives) and agricultural property. Class two includes all other real property.

The property tax for an individual parcel is a combination of the millage rates and reduction factors for all jurisdictions in which the parcel is located. Suppose that a parcel is located in three jurisdictions that levy a property tax. Suppose that the school district has an inside millage rate of 5 mills and two outside millage rates, one for 6 mills and one for 12 mills. Assume that the county has an inside millage of 3 mills and one outside millage of 15 mills, while the municipality has an inside millage of 2 mills and one outside millage of 12 mills. Suppose that the reduction factors for the two school millage rates are 0.50 and 0.45, respectively, while the reduction factors for the other two rates are 0.75 and 0.67 respectively. Suppose that the appraised value of the parcel is $150,000, so that the assessed value with an assessment rate of 35 percent is $52,500. The property tax for this parcel will be $1,841.73. This is calculated as follows:

School district:	5 mills * $52,500	= $ 262.50
	2 mills * 0.50 * $52,500	= $ 52.00
	12 mills * 0.45 * $52,500	= $ 252.00
County:	3 mills * $52,500	= $ 157.50
	15 mills * 0.75 * $52,500	= $ 590.63
Municipality	2 mills * $52,500	= $ 105.00
	12 mills * 0.67 * $52,500	= $ 422.10

Step 5. Determining the tax liability.

The fifth step involves reducing the gross tax liability for certain credits to arrive at the net or final tax liability. Once the gross tax liability for the parcel has been determined, it is reduced by 10 percent in the form of a credit. There is a second rollback of 2.5 percent that applies only to property which is owner occupied.

There is a third credit which is referred to as a" homestead reduction". The homestead credit is restricted to owner occupied housing in which the owner is at least 65 years of age, permanently and totally disabled, or a surviving spouse of an eligible homeowner. The value of the credit depends upon the household income.

Source: Sjoquist, 1994.

Increases in market values automatically result in a reduction in the effective millage rate to eliminate much of the natural growth in the property tax base, and property tax rollbacks are given in the form of credits to taxpayers. This whole process is complicated from a point of view of taxpayers, and difficult to administer and to monitor.

The quality of the state tax administration is strong. Relative to other states, staffing is highly professional, and procedures are modern. The tax structure itself is a difficult one to administer, and this puts pressure on the resources of the department, but there is no question about the ability of the state tax administration to support a modern tax system.

Obsolescence

There are some respects in which the present tax system is obsolete, i.e., it is not in step with modern realities of the economy and with generally accepted taxing practices. The following are areas where this is arguably the case:

- the failure to include a broader range of services under the sales tax base;
- the failure to recognize the competitive status of interexchange telephone companies, and the failure to give the same classification to all telecommunications companies;
- the failure to properly recognize and plan for competition in the electric utility and natural gas sectors;
- the failure to adopt combined income reporting to close off avenues for large corporations to use transfer pricing to avoid Ohio tax liability;
- the absence of a standard deduction in the state income tax; and
- the requirement of apportionment for local businesses in complying with local income taxes.

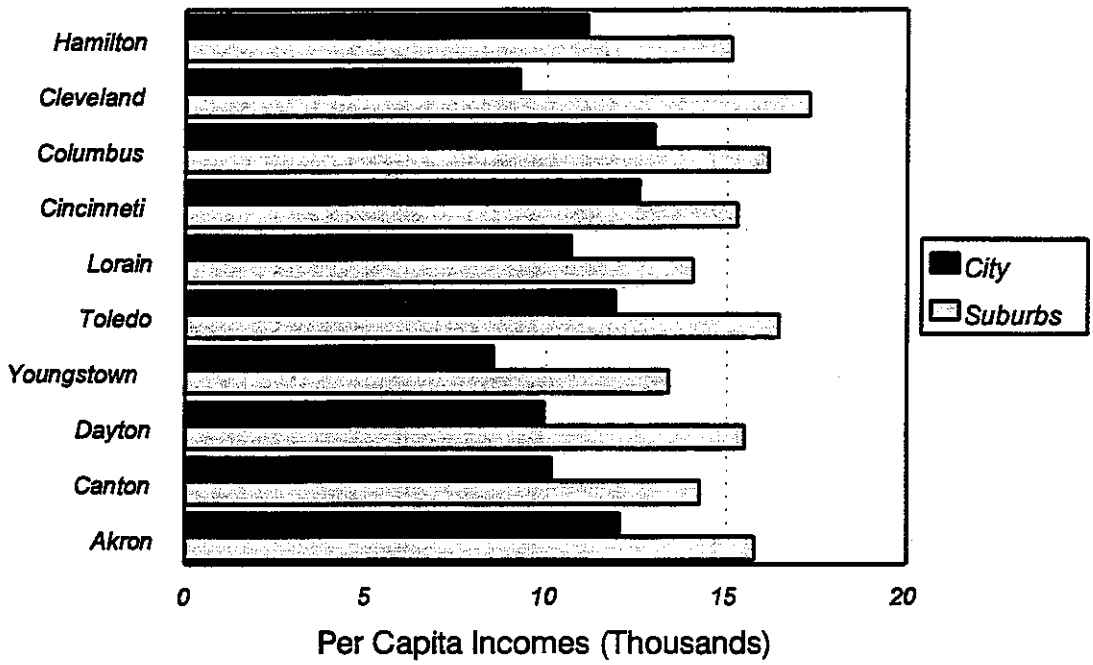
Poor Places[35]

Ohio is burdened with a heavy concentration of the poor in central cities, and with central cities that are themselves declining in population. The disparities in personal income between cities and suburbs is large and growing (Table 5-9), suggesting a chronic fiscal problem for the central cities.

If judged by annual revenue increases, the revenue structure of cities can be said to have performed relatively well in recent years. Between 1983 and 1991, five of the seven cities for which comparable information could be obtained (Youngstown and Canton excepted) averaged annual increases in own-source revenues that were greater than inflation. Four of these cities had revenues increasing at rates exceeding those for all Ohio cities.

The apparent reason why central city revenue growth was so robust is the heavy dependence on the municipal income tax. In Ohio, cities are permitted to tax all wages, salaries, and other compensation earned by residents and may also tax earnings by non-residents who work in the city. The income tax also applies to business net profits attributable to activities in the municipality. This relatively broad base (including resident businesses and non-resident individuals) offsets the relatively low income base of city residents, and permits the city to share in the general prosperity of the metropolitan area. Moreover, the income tax has given the city a buoyant revenue source. The average annual changes in income tax revenues

Table 5-9
City Per Capita Income Compared to Suburbs
1990 Census



Source: 1990 Census of Population.

compared to average annual changes in property tax revenues shows that income tax revenues increased faster in each city. With over half of their revenues from income taxes and only about 10 percent from property taxes, central cities are much better positioned to offset the adverse effects of economic disparities on their tax bases.

In contrast to city governments, central city school districts rely almost entirely on property taxes for their locally-raised revenue support. The ten central city school districts average 46 percent of their revenues from property taxes. State payments, including property tax rollback payments, provided about 49 percent, with the remaining 5 percent coming from other sources, including the school district income taxes.

The central city school districts have experienced good annual revenue growth from local taxes (principally property taxes). Among the seven cities for which comparable information could be obtained, the average annual increase between 1982 and 1991 ranged from 4.1 percent in Cleveland to 8.8 percent in Cincinnati, with four of the cities exceeding the statewide average of 7.0 percent. This good property tax performance continued through 1992 and 1993. However, the increases in property taxes were not sufficient to offset the effects of low state aid in 1992, and six of the ten cities had total revenue declines in that year.

Despite this favorable property tax growth, the central city property tax bases are not good revenue generators relative to those of the

suburbs. On a per pupil basis, the central cities average only about 70 percent of the suburban bases, with Cleveland, Toledo, and Youngstown below 60 percent. This leaves the cities in a position of (a) imposing higher tax rates than the wealthier suburban systems, (b) depending on state aid to offset their weak tax bases, or (c) having lower per pupil spending. This condition will prevail as long as local school districts are heavily dependent on property taxes.

Past changes the tax system have been more in the nature of periodic adjustments that were driven by the need to cover a revenue shortfall and disenchantment with the property tax than by the desire for comprehensive change that focused on the entire structure.

Urban county governments overlay the metropolitan areas and provide many services to residents of central cities and suburbs. Because of their broad tax bases, counties are able to redistribute revenues from the wealthier to the poorer parts of metropolitan areas. The funds are used primarily for health and social services. Many of these programs are mandated by the state and counties receive large amounts of state aid (42 percent of revenues), including passthrough federal aid. Locally, they get about 28 percent of their revenues from property taxes, another 13 percent from sales taxes, with the remaining 17 percent primarily from user charges. The county sales tax is much less important, and is not used uniformly by all urban counties. It does, however, provide an important alternative revenue source for counties that want to reduce their dependence on property taxes.

The revenue structure for urban counties is diversified, and has provided good annual average growth of revenues over the period 1983-1991. Because the counties have a broader geographic base, property tax revenue growth has far exceeded the growth rates for property tax revenues in the central cities. Overall, property taxes have provided a dependable and growing county revenue source.

Conclusion

The Ohio tax system has historically emphasized vertical equity. The individual income tax carries a progressive rate schedule, the retail sales tax exempts food, the property tax is relieved through credits, and local governments rely heavily on an income tax. It has placed less emphasis on economic development objectives. About 25 percent of the tax structure is carried by taxes on businesses -- including taxes levied on income, capital invested, and machinery, equipment and inventories. About one-third of the retail sales tax is collected on business purchases. The Ohio system gets relatively good marks on progressivity, but not on investment friendliness.

A second observation about the development of the Ohio tax system is that it grew up in a piecemeal way. Past changes in the tax system have been in the nature of periodic adjustments that were driven more by the need to cover a revenue shortfall and disenchantment with the property tax than by the desire for comprehensive change that focused on the entire structure.[36] As a result, the pieces of the tax system no longer fit together as they once did and horizontal inequities have developed.

- General businesses, public utilities and financial institutions are all treated

differently from one another, for reasons that made more sense in an earlier time than they do now;

- Rollbacks and credits have been added to protect the burden on property taxpayers, but these relief measures have restricted the growth in property tax revenues and are a poorly designed form of assistance to local governments;

- The overall system is not elastic enough to automatically generate sufficient revenues to meet the expenditure needs of the state and its local governments;

- There is a mismatch between the division of tax revenues between state and local governments, and the expenditure requirements of the different levels of government; and

- A substantial amount of the consumption of services remains outside the sales tax base.

The results of this piecemeal development are that the tax system does not get good marks on fairness or horizontal equity, and there is potentially a problem with the balance between the natural growth of revenues and expenditure requirements.

A third issue is that the system is complicated, probably more than is necessary. The problems areas here are the real property tax, the net worth tax, the personal property taxes, and the municipal income tax. This complexity affects the confidence that taxpayers have in the system, and raises both the administrative and the compliance cost.

There are some significant strengths in the Ohio tax structure. In fact, this system has remained relatively free of crisis adjustments, it has produced a relatively stable flow of revenues, and it features a relatively favorable tax structure for central cities because of the municipal income tax. The level of taxes has remained below the national level.

In summary, it is a not a tax system that emphasizes economic development, it is horizontally inequitable, and it is unnecessarily complex. It does not exhibit an elasticity that will support expenditure growth above that in total personal income. Its strongest features are vertical equity, stability over the business cycle, and protection of the revenue position of central cities.

CHAPTER FIVE

ENDNOTES

1. Jorge Martinez and Martin Grace, *Business Taxation in Ohio: General Franchise Tax and Taxes on Financial Institutions and Insurance Companies*, Staff Report Number 9 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

2. The franchise tax, the property tax on tangible personal property and public utility property, and the real property tax on non-residential properties together account for about one-fourth of revenue collections.

3. 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, November1994).

4. Gary Cornia, *Ohio Tangible Business Personal Property: Property Taxation.* Staff Report Number 8b of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

5. 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, November 1994).

6. Martinez and Grace, Staff Report Number 9.

7. Richard McHugh, "Memorandum on the Ohio Estate Tax", November 1994.

8. Richard McHugh, *The Taxation of Telecommunications in Ohio*, Staff Report Number 10a of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, October 1994) and Karl Case, *State and Local Tax Policy and the Telecommunications Industry*, Staff Report Number 10b of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, December 1994).

9. Gary Cornia, *Public Utility Taxation: Tangible Personal Property.* Staff Report Number 8a of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

10. Martinez and Grace, Staff Report Number 9.

11. Richard McHugh "Memorandum on the Gross Receipts Tax in Ohio", November 1994.

12. Wasylenko, Staff Report Number 11.

13. Martinez and Grace, Staff Report Number 9.

14. The marginal effective rates of taxation are calculated by assuming identical pre-tax rates of return for different assets and economic sectors and calculating after-tax rates of return for each type of investment after all aspects of taxation affecting those investments has been taken into consideration.

15. Fox, Staff Report Number 2.

16. David Sjoquist, *Real Property Taxation in Ohio: Analysis and Policy Options*. Staff Report Number 6 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, September 1994).

17. Sally Wallace, *Ohio's State and Local Income Taxes: Analysis and Options*, Staff Report Number 5 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

18. Fox, Staff Report Number 2.

19. Don Fullerton, *Who Bears the Lifetime Burden?* (Washington, DC: The Brookings Institution, 1994.)

20. Sjoquist, Staff Report Number 6.

21. Wallace, Staff Report Number 5.

22. Fox, Staff Report Number 2.

23. Sjoquist, Staff Report Number 6.

24. Cornia, Staff Report Number 8b and McHugh, Staff Report Number 10a.

25. Richard McHugh "Memorandum on the Gross Receipts Tax in Ohio", November 1994.

26. Fox, Staff Report Number 2.

27. Wallace, Staff Report Number 5.

28. Cornia, Staff Report Number 8a and Staff Report Number 8b.

29. Sjoquist, Staff Report Number 6.

30. Martinez and Grace, Staff Report Number 9.

31. Martinez and Grace, Staff Report Number 9.

32. Cornia, Staff Report Number 8a and Staff Report Number 8b.

33. Wallace, Staff Report Number 5.

34. Sjoquist, Staff Report Number 6.

35. Philip Dearborn, *Ohio Metropolitan Area Revenues*, Staff Report Number 7 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

36. Donald Berno and Jack Whitmore, *Historical Review of Ohio State and Local Government Finances*. Staff Paper Number 4 of the Commission to Study the Ohio Economy and Tax Structure (Atlanta, GA: Policy Research Center, Georgia State University, November 1994).

CHAPTER SIX

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 (Box 5-1) describe the features of a good tax system, but it remains to decide which of these principles should be emphasized.

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.

To make this decision, the Commission members individually ranked and weighted each of the principles. The results of this vote are presented in Table 6-1, 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:

- 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.

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

- 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 6-1
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

[a]13 members voted. Averages rankings and weightings are presented here.
[b]Ranking: 1 (most important)
[c]Weighting: 10 (most important)

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.

CHAPTER SEVEN

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.

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 7-1). 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

Box 7-1
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.

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

Box 7-2
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 arms-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.

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 7-2). 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.

A state such as Ohio that is short on investment and job growth should not single out capital investments for differentially heavy taxation.

Tangible Personal Property Tax

Proposal: Eliminate the Tangible Personal Property Tax. This phaseout would take place over a number of years. The CY 1992 revenue cost would have been $1.2 billion. Eliminate the inventory tax immediately. The CY 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 eleven states which 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 which 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.

The Commission recommends that the tax on inventories be eliminated immediately.

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 (Table 5-7). 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 five to ten 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 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 five to ten 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 different 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.

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.

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 five to ten 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 a vis* investor owned utilities, and the other is that it leaves Ohio utilities in a non-competitive 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 which 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 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 over 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.

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.

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 for Ohio is that the more Enterprise Zones there are in a state, the more likely it is that the zonal benefits do a poor job at reaching targeted populations as population mobility diffuses benefits among targeted zones and non-targeted 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 since 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 non-financial 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 non-standard 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 non-financial 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 non-standard 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.

Ohio's 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.

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 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 (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.

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?

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.

- An expansion of the sales tax base to cover additional service consumption.
- An expansion of the sales tax base to cover food consumption, accompanied by a food tax credit for low income families.
- An increase of one 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 important, the inclusion of services would improve the horizontal equity of the tax system by removing tax preferences from those who consume significant amounts of services. A cursory glance at the list of exempt services in Box 7-3 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 U.S. grew from 30 percent in 1976 to 43 percent in 1993, suggesting that the

Box 7-3
Services Presently Exempt under the Ohio Sales Tax

Type of Service	Number of States Taxing
Admissions and Amusements	
Parimutuel events	27
Amusements, recreations, & museums	21
Billiard parlors	36
Bowling lanes	27
Cable TV services	24
Circuses and fairs - admits. and games	34
Coin operated video games	20
Admission to sports events	27
Theatrical productions	31
Pinball	22
Professional sports	36
Rental of films by theaters	9
Motion picture theater admission	NA
Automotive Services	
Road service and towing (w/o repairs)	15
Parking	19
Business Services	
Outdoor ad. services	4
Media ad. representatives	3
Misc. advertising	
Newspaper advertising	4
Magazine advertising	5
Advertising agency (not ad placement)	8
Misc. business services	
Bail bond fees	5
Interior design and decorating	9
Telemarketing services/contract	6
Phone answering service(human)	10
Collection services	8
Commercial art and graphic design	20
Credit reporting services (on line)	13
Business services (cont.)	
Lobbying and consulting	13
Marketing	6
Packing and crating	8
Process server fees	6
Management and public relations	7
Testing laboratories	8
Computer Services	
Computer programming (application software)	34
Software-custom program-material	28
Software-custom programs-services	15
Information retrieval services	14
Mainframe access and processing service.	11
Construction Services	
General contractor service.	11
Special trade contractor service.	13
Misc. contractor service.	11
Water well drilling contractors	9
Finance, Insurance & Real Estate	
Service charges of banks	3
Insurance services	6
Investment counseling	6
Loan broker fees	6
Real estate services	6
Leases & Rental	
Campgrounds	27
Personal Services	
Barber and beauty shops	6
Coin operated laundries	8
Funeral services	15
Misc. services	
Dating services	10
Debt counseling	7
Tanning parlors	18
Swimming poor cleaning and maintenance	15
Tax return preparation services	7
Professional Services	
Accounting	5
Legal	5
Dentistry	4
Engineering	5
Surveying	7
Medical Labs	4
Nursing and personal care facilities	4
Medical doctor services	4
Utilities Services	
Electricity (Industrial)	37
Electricity (Residential)	23
Natural gas (Industrial)	38
Natural gas (Residential)	23
Sewer and refuse (Industrial)	11
Sewer and refuse (Residential)	10
Water supply (Industrial)	20
Water supply (Residential)	12

SOURCE: Federation of Tax Administrators, *Sales Taxation of Services: An Update*, No. 143.

Table 7-1
Significant Ohio Service Exemptions
(in millions of dollars)

		FY 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.

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 7-3). It also identified the order of magnitude of revenues that could be expected from this base expansion (Table 7-1). Clearly, there is much room for base expansion.

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 7-1). Narrow base expansion includes cable television, hair salon services, coin-operated amusements, parking, laundry and dry cleaning, golf course tees, funeral services, and motion picture admittances. 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.

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.

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.

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.

- 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;
- More than food is typically consumed at food stores hence there are administrative difficulties with the exemption;
- The differential treatment of food-at-home vs food-in-restaurants leads to many administrative ambiguities that compromise the original intent of this dichotomy;
- 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.
- 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 one-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 one percent higher rate are low; and a one 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 six 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 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.

The present system of individual income taxation brings lower income taxpayers into the net at a low level of income.

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

Box 7-4
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 (650*4)	$ 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
Apply Ohio Rate (23.2%) to obtain: Ohio Tax Liability:	$ 500

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 which 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 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.

It is estimated that about 300,000 returns (out of 4.8 million) could have been eliminated had this reform been adopted in 1993.

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.

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 percent and 7.5 percent, to five effective marginal rates ranging from 3.48 percent to 9.19 percent for the revenue neutral option and 4.13 percent 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 percent 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 effected 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 (See Box 5-5). 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.

The problem in Ohio, unlike other states, is not with the level of property taxation. The problem is complexity.

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, it's 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:

- 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.

- 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 removed by 20 percent each year, with mandated reduction in the voted millage used to keep the effective millage levy constant.

- 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.

- 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.

- The Commission recommends that consideration be given to allowing local jurisdictions the option of imposing a differential tax rate on land vs 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.

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 twenty 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 7-2 illustrates how a program to move to 100 percent assessment,

Table 7-2
Impact of the Proposed Reform Program
(dollars 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	

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.

Two points should be noted:

- 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 7-2 uses different tax rates for the two classes.

- 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.

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.

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 re-examine 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 which 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 upon 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:

- Increase the sales tax rate by one percent to yield about $800 million.
- Extend the sales tax base to a broad range of services, to yield about $600 million.
- Extend the sales tax base to include food with a refundable low income credit against the income tax, to yield $400 million.
- Restructure the individual income tax to yield $850 million.
- 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.
- 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 7-3, using 1993 amounts as a basis for computation.

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.

Table 7-3
A Blueprint for Tax Restructuring:
Estimated Amounts of Increase and Reduction Implied

Revenue Reductions	Estimates Based on FY 1993 Collections[a] (in millions)
Eliminate Tangible Personal Property Tax	-1200
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	2410
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 Individual Income Tax, to a Flat Rate (27.5) percent on 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

[a]Data for personal property tax are for CY 1992. Estimates marked (u) mean that revenue impact could not be estimated, but the expectation is that it will be positive.

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 non-residential 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 would also be improved by bringing all types of companies under the general business tax, and eliminating special treatment that is presently 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.

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.

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 7-4, it 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

Table 7-4
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	Capital intensive firms; firms with net losses; small, start-up firms[1]	Firms who 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 tax[1]; Utility consumers	--
Eliminate Gross Receipts Tax on Utilities and Replace with User Charge on Consumers	--	Municipal utility company consumers; consumers from out of state companies

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

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.

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.

The Blueprint for reform would lead to a simplification of the Ohio tax system.

variable over the business cycle. The option of taxing food, if it were chosen, would add some stability to the revenue flow.

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 can 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

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.

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

- 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.

- 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.

- 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 recognizes, however, that this reform cannot be implemented immediately as a single comprehensive package.

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.

Local governments can remain unharmed through a temporary, compensating state assistance program financed from the increased state taxes resulting from this program.

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 the 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 their 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.

The Commission recommends that the State move to adopt a phase one reform, as a first step in implementing this blueprint for tax reform.

However, if one takes the view that a monopoly no longer exits when the "monopolist" must make its pricing and production decision with an eye towards 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 which 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. The introduction of combined income reporting for all corporations, and the expansion of sales taxes to services both 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.

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 rate payers 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.

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 non-inventory 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.

CHAPTER SEVEN

ENDNOTES

1. Of these sixteen states, seven allow other 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.

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, the "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 phase-outs: one for personal exemptions and one for itemized deductions. For taxpayers "caught" in the phase-out 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.

CHAPTER EIGHT

CONCLUSIONS

This is a proposal for a shift in the emphasis of the Ohio tax structure toward economic development. It is prompted by a long period of slow growth in the Ohio economy relative to the rest of the nation, and by the conclusion that our tax structure has weighed heavily on investment in the past. We have traditionally taxed businesses according to the value of their machines, equipment, inventories, structures, net worth and income. We also have created a tax structure with a bias against capital intensive industries, our economic mainstay, and startup firms, one of our hopes for the future.

The Commission proposes that the Ohio Tax structure be changed to address its major problems: the degree to which it enhances the climate for investment, and the horizontal equity or fairness of the system.

The Commission proposes that the Ohio tax structure be changed to enhance the climate for investment and to improve the horizontal equity or fairness of the system. This program addresses these problems by proposing a reform that reduces taxes that have suppressed investment, job creation, and the development of necessary infrastructure. It is proposed here to eliminate the personal property taxes on business machinery, equipment and inventories. It is also proposed to eliminate the net worth tax and to replace the gross receipts tax on public utilities with an equal yield user charge. All companies would be brought under a unified corporate net income tax under this reform.

The elimination of the personal property and net worth taxes must be matched by increases elsewhere if this reform is to remain revenue neutral. We propose that most of the tax reductions be made up by a combination of increased income taxation and increased retail sales taxation. The sales tax reform would include a broadening of the tax base primarily to include services and if the voters choose, an increase in the tax rate. In the area of income taxation, we propose a shift to a flat rate tax on a base of federal tax liability.

Some will say that this is a proposal to shift taxes from businesses to people. This is simply not the case. People already pay these "business" taxes, sometimes in the form of higher prices, sometimes in the form of lower wages, and sometimes in the form of less return on their investment. This tax reform rearranges the burdens among these groups, mostly by removing tax preferences that have been given in the past and by unburdening the sectors of the economy that have been overtaxed.

Some will say that this program is too big a shock for the Ohio tax structure and the Legislature to absorb. In fact, the Commission proposals are for a change in the tax structure that effects less than 15 percent of total taxes.

Moreover, we propose a phasing in of the system to give time to accommodate the difficulties of transition, such as finding alternative sources of finance for local governments.

Some will say that this program for reform is politically naive. That it may be, because good politics was never part of the charge to the Commission. Had it been our principle concern, we likely would have recommended little change in the tax system. Our charge was to think about the long run and how Ohio might turn its economic growth path upward; toward one that matches the growth in the rest of the country. Tax policy is not the only ingredient in Ohio's economic development strategy, but the Commission believes it to be an important ingredient, and one that needs to be put in better step with the realities of the growing competitiveness of the U.S. economy.

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