Ohio Constitutional Modernization Commission
Finance, Taxation, and Economic Development Committee

Modernizing the Treatment of Tax Expenditures in the Constitution

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Good morning, Chairman Cole and distinguished members of the Finance and Taxation Committee. My name is Jon Honeck. I am the Director of Public Policy and Advocacy of the Center for Community Solutions. The Center for Community Solutions is a nonprofit organization with offices in Cleveland and Columbus. The Center for Community Solutions provides strategic leadership and organizes community resources to improve health, social, and economic conditions through applied demographic research, nonpartisan policy analysis and advocacy, and communication.

I am here today to urge the committee to consider recommending the adoption of a constitutional provision that would improve the transparency and accountability of certain kinds of tax preferences. At present the state of Ohio has over 100 credits, exemptions, and deductions in its tax code. Most of these provisions apply to the income tax or the sales tax, but it should be noted that there also has been growth in the number of credits and deductions in the commercial activity tax, which has a very low tax rate that requires a broad base.

The origins of these tax preferences are diverse. Some of the sales tax exemptions for production equipment and machinery are meant to prevent "tax pyramiding," which is the attempt by firms to pass the cost of taxes up to the production chain to the final consumer. The state constitution itself contains exemptions to the retail sales taxe on food consumed off the premises and on wholesale taxes on food, food ingredients, or packaging, including non-alcoholic beverages. Ohio also uses a tax credit mechanism to equalize income tax rates between joint filers and individual filers, and to remove liability for non-residents' income that is not earned in Ohio. Others have a statutory basis that provides a preference to bolster a particular social or economic activity that is seen as desirable, such as income tax credits for the adoption of children or to incentivize the production of motion pictures.

Collectively, these preferences are referred to as "tax expenditures," because they can sometimes substitute for line item appropriations that would accomplish the same purpose. Preferences that are specifically enumerated in the state tax code are listed in the Ohio

Department of Taxation's biennial Tax Expenditure Report, a statutorily-required document that is part of the governor's biennial budget request. The report estimates the fiscal impact of each tax expenditure, but does not evaluate their effectiveness or impact.

Over the years, the design of tax expenditures has become more sophisticated and ambitious both in their administrative procedures and in their determination to provide a defined amount of resources to the taxpayer. Certain tax credits require recipients to submit to a competitive application process and to sign agreements that requite the fulfillment of conditions before tax credits are allowed. Job creation and retention, historic building rehabilitation, and motion picture tax credits are examples of this. Moreover, the state now has a small number of refundable credits that allow the recipient to receive a payment even if the amount of the credit exceeds tax liability. Other credits use a carryforward of unused portions of the credit for a certain number of years. This ensures that there are resources available for the credit, but over time the end result is the same: the state returns a certain amount of money to the taxpayer. The attached table summarizes some of the credits that are refundable or allow carryforwards.

As the use of tax credits with refundable or carryforward mechanisms increases, it becomes necessary to reconsider how they are treated in the state budget. The appropriations clause of constitution, Section 2, Article 22, states the following:

> No money shall be drawn from the treasury, except in pursuance of a specific appropriation, made by law; and no appropriation shall be made for a longer period than two years.

This has been interpreted broadly to require the appropriation of all tax refunds. This is accomplished through two agency (non-GRF) line items. Refunds for most state taxes are drawn from line item 110-635 in the Tax Department's budget, which has an appropriation level of slightly over $1.5 billion in FY 2015.[1] Most, but not all of the proceeds are drawn from the income tax and most income tax filers receive a refund.[2] Line item 090-635, the Treasurer of State's budget, contains tax refunds from the insurance and public utility excise taxes. This line item has an appropriation level of $6 million in FY 2015.

These line items merge the proceeds from various tax sources and do not allow policymakers or the public to identify specific amounts of money that are needed to meet fiscal obligations arising out of the use of a particular credit. This situation needs to be remedied so that the budget is more transparent. When the state commits resources over a period of years in a

[1] Legislative Service Commission, **Catalogue of Budget Line Items**, **2013**, p. 780.

[2] For tax year 2012, 4,031,610 out of 5,060,322 income tax filers reported overpayments totaling $1.48 billion, out of which $255 million were credited toward 2013 taxes.

carry-forward or allocates resources beyond the taxpayer's liability in a refundable credit, the costs of these decisions should be separately identifiable in the budget bill itself. The state budget bill reflects fundamental choices of resource allocation and should be updated in light of current tax practice. Therefore, we propose the following constitutional provision:

> Any tax credit that is refundable or allows a carryforward of an unused portion of the credit to a new tax year is subject to Section 22, Article 2, and its cost shall be accounted for in the general revenue fund of the state, unless its sole purpose is to reconcile payments made by individuals and pass-through entities in which the individuals have an ownership share.

Mandating the use of the GRF for carryforwards and refundable credits would make it clear that the resources necessary to satisfy claimants are available to be reallocated to other purposes as circumstances change. If the GRF is used, it is more likely that policymakers and the public will take a close look at these credits and evaluate their effectiveness. This change would be evolutionary, not radical, and is broadly consistent with current practice. It would leave most of the current refund line items unchanged. The technical barriers would not be great. Credits are claimed on tax forms and the tax department already estimates their fiscal impact in the Tax Expenditure Report. GRF funds could be transferred back to a final tax refund line item to make the mechanics of issuing a refund easier. It should be noted that it is not unheard of for administrative agencies to be required to estimate the cost of a tax provision. For example, H.B. 483, part of the mid-biennium review, contains a Small Business Deduction Augmentation Fund to enable the increase of that deduction from 50 percent up to 75 percent in 2014 depending on the amount of resources transferred into the augmentation fund.[3] The amount transferred to the fund is jointly determined by the Tax Commissioner and the Director of OBM.

Thank you for providing me with an opportunity to present this proposal. I respectfully ask that you include this provision in your recommendations to the full Commission. I would be pleased to answer any questions that you may have.

[3] Section 610.20, Am. Sub. H.B. 483, 130th G.A., amending Section 512.70 of Am. Sub. H.B. 59, 130th G.A. (H.B. 59 is the main operating budget).

EXAMPLES OF REFUNDABLE CREDITS OR CREDITS ALLOWING A CARRYFORWARD

Credit Type	**Carry-forward**	**Amount Allowable to Taxpayer**	**Aggregate Limit**	**Taxes**
Qualifying grape production property	7 years	10% of cost of purchase and installation		Income Tax, R.C. 5747.28
Small business investment R.C. 122.86	7 years	10% of qualifying investment, up to $1 million per taxpayer	Amount Claimed may not exceed $100 million in any fiscal biennium	Income Tax, R.C. 5747.81
Adoption credit R.C. 5747.37	2 years	$1,500 per child		Income tax
Research and Development Exp.	7 years	7% of R&D costs		FIT, R.C. 5726.56;
Job Retention R.C. 122.171	7 years	Up to 75% of project income tax revenue	Limit Rises by $13 million per year to $195 m/yr in 2024	FIT, R.C. 5751.50(B); Income Tax, R.C. 5747.058(B); CAT, R.C. 5751.50(B)
Job Creation R.C. 122.17	Refundable	Specified percentage of income tax withheld from employees at project site		FIT, R.C. 5726.50(A); Income Tax, R.C. 5747.058(A); CAT, R.C. 5751.50 (A);
Losses on loans made to venture capital program R.C. 150.07	Refundable	Fully refundable (No credits claimed to date)	$20 million per year; $380 million total	Income Tax, R.C. 5747.80, R.C. 5707.031, 5725.19, FIT, 5726.53, 5727.241, 5725.19, 5729.08,
Motion picture tax credit R.C. 122.85	Refundable	$5 million per production	No more than $40 million claimed in each biennium	Income Tax, R.C. 5747.66; FIT, R.C. 5726.55; CAT, R.C. 5751.54
Historic Preservation R.C. 149.311	$3 million refundable in one year, remainder carried forward	$5 million, or $25 million if a "catalytic project"	Up to $60 million may be issued per year, not including unused allocations from previous years	Income Tax, R.C. 5747.76; FIT R.C. 5726.52;