Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: Sub. H.B. 472 of the 130th G.A. (LSC 130 2288)

Date: April 18, 2014

Status: In House Ways and Means

Sponsor: Rep. McClain

Local Impact Statement Procedure Required: No

Contents: Tax reform changes to the personal income, commercial activity, cigarette, and other tobacco products taxes

State Fiscal Highlights

STATE FUND	FY 2015	FY 2016	FUTURE YEARS
General Revenue Fund			
Revenues	$417 million loss	$375 million loss	Continuing losses
Expenditures	- 0 -	- 0 -	- 0 -
Local Government Fund (LGF, Fund 7069)			
Revenues	$7 million loss	$6 million loss	Continuing losses
Expenditures	- 0 -	- 0 -	- 0 -
Public Library Fund (PLF, Fund 7065)			
Revenues	$7 million loss	$6 million loss	Continuing losses
Expenditures	- 0 -	- 0 -	- 0 -
School District Tangible Property Tax Replacement Fund (Fund 7047)			
Revenues	$64 million gain	$90 million gain	Continuing gains
Expenditures	- 0 -	- 0 -	- 0 -
Local Government Tangible Property Tax Replacement Fund (Fund 7081)			
Revenues	$28 million gain	$39 million gain	Continuing gains
Expenditures	- 0 -	- 0 -	- 0 -

Note: The state fiscal year is July 1 through June 30. For example, FY 2014 is July 1, 2013 – June 30, 2014.

- Personal income tax rate reductions and increases in exemption and earned income tax credit amounts will reduce revenue.
- When these revenue losses are incurred will depend in part on the timing and amount of withholding rate changes.
- Increases in revenue from the commercial activity tax (CAT) rate increase and from higher taxes on cigarettes, other tobacco products, and electronic cigarettes will offset part of the personal income tax revenue losses.

- Net losses to the GRF will reduce revenue to the LGF and PLF, which each receive 1.66% of GRF revenue.
- Property tax replacement funds for schools (Fund 7047) and other local governments (Fund 7081) will gain from increases in CAT revenue. These gains will likely be transferred to the GRF.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2014	FY 2015	FUTURE YEARS
Counties and other local governments			
Revenues	$3 million loss	$5 million loss	Continuing losses
Expenditures	- 0 -	- 0 -	- 0 -
Public libraries			
Revenues	$4 million loss	$7 million loss	Continuing losses
Expenditures	- 0 -	- 0 -	- 0 -

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- Revenue losses to counties and other units of local government from reduced LGF distributions will be partly offset by higher local sales taxes on cigarettes.
- Public libraries will lose revenues because of lower PLF distributions.
- Higher state cigarette taxes may result in lower revenue from the Cuyahoga County local cigarette tax.

Detailed Fiscal Analysis

The bill reduces personal income tax rates, increases the commercial activity tax (CAT) rate, increases taxes on cigarettes and on other tobacco products (OTP), and imposes the OTP tax on electronic cigarettes (e-cigarettes). The net effect of these changes is a reduction of GRF revenue estimated at $417 million in FY 2015 and $375 million in FY 2016. The amount of the revenue loss in each fiscal year will depend on the timing and magnitude of adjustments to income tax withholding to reflect the lower tax rates. Distributions to the Local Government Fund (LGF, Fund 7069) and the Public Library Fund (PLF, Fund 7065) are reduced by an estimated $14 million (by $7 million to each fund) in FY 2015 and $13 million ($6 million to each fund) in FY 2016. Distributions to the School District Tangible Property Tax Replacement Fund (Fund 7047) are increased by an estimated $64 million in FY 2015 and $90 million in FY 2016, and distributions to the Local Government Tangible Property Tax Replacement Fund (Fund 7081) are increased by an estimated $28 million and $39 million in those two years. The increased amounts estimated to accrue to Fund 7047 and Fund 7081 are likely to be transferred to the GRF.

Personal income tax

Income tax rate reduction

The bill reduces income tax rates for all individuals, estates, and trusts and across all income brackets by 3.5% for taxable years beginning in 2014 (TY 2014), by an additional 3.5% in TY 2015, and by a further 1.5% in TY 2016. The reduced TY 2016 rates apply thereafter, resulting in an 8.5% reduction compared to the current rates for 2016 and later years, and a top marginal tax rate of 4.88%. The rate reductions in the bill are from rates in current law for those years. Because rate reductions were already scheduled for TY 2014 and TY 2015, legislated in Am. Sub. H.B. 59 of the 130th General Assembly, the combined effect of the currently scheduled rate reductions and the additional rate reductions is a decrease in tax rates of 10% from TY 2013 to TY 2016.

The tax rate cuts reduce tax liabilities, on an all-funds basis, by an estimated $321 million in TY 2014, by $663 million in TY 2015, and by $842 million in TY 2016 when the rate reductions in the bill are fully phased in. These estimates are based on tax return information through 2011, projected forward using data and forecasts for economic variables. Revenue losses on a fiscal-year basis will depend on the timing and amount of adjustment of withholding rates and estimated tax payments to reflect the lower tax rates. LSC's estimates reflect an assumption that withholding rates and estimated tax payments are adjusted promptly in line with enactment of changes in tax rates, with the effective date of enactment assumed to be July 1, 2014. The bill (Section 4) specifies that these changes are for tax periods beginning on or after January 1, 2014. Projected revenue losses, on an all-funds basis, total $585 million in FY 2015, $735 million in FY 2016, and $856 million in FY 2017. A portion of the fiscal year revenue losses would be deferred if withholding rates and estimated tax payments adjust more gradually.

These losses will accrue to the GRF (96.68%), the LGF (1.66%), and the PLF (1.66%) under current law. Estimated losses to the GRF, net of distributions to the LGF and PLF, are $566 million, $711 million, and $828 million, respectively, in FY 2015, FY 2016, and FY 2017. Estimated losses to the LGF and PLF, divided evenly between the two funds, are $19 million, $24 million, and $28 million in these three years.

Increased personal income tax exemption amounts

The bill increases the personal exemption amounts for state income taxpayers whose Ohio adjusted gross income (AGI) is $80,000 or less. It increases the exemption amount in TY 2014 and TY 2015 from $1,700 to $2,700 for taxpayers with individual or joint Ohio AGI of $40,000 or less and to $2,200 for taxpayers with individual or joint Ohio AGI of more than $40,000 and less than or equal to $80,000. The exemption amount remains at $1,700 for taxpayers with an individual or joint Ohio AGI of more than $80,000. Under current law, the personal exemption amount for each taxpayer, taxpayer's spouse, and dependent is $1,700 for TY 2014 and TY 2015, unchanged from TY 2013. Inflation indexing of personal exemption amounts, suspended from TY 2013 through TY 2015, resumes in TY 2016 in current law and in the bill.

The higher exemption amounts reduce tax revenue by an estimated $143 million in FY 2015, $140 million in FY 2016, and $139 million in FY 2017. These estimates are calculated at the tax rates in current law, and do not reflect the tax rate reductions in the bill. They do reflect the effects of the tax rate cuts in current law in TY 2014 and TY 2015, as well as predicted income growth shifting taxpayers into the higher income ranges with smaller personal exemptions under this provision of the bill. The GRF share of this revenue loss is an estimated $139 million in FY 2015, $136 million in FY 2016, and $134 million in FY 2017. The rest of the revenue loss, about $5 million per year, is split equally between the LGF and the PLF.

Earned income tax credit

The bill increases the state earned income tax credit from 5% of the federal earned income tax credit to 15% of the federal credit, beginning in 2014. Continuing law authorizes this credit for taxpayers who are eligible to claim the federal credit. The state credit is nonrefundable, so can result only in a reduction of a taxpayer's remaining tax liability after other credits. The credit is further limited for taxpayers with Ohio taxable income (OTI) exceeding $20,000. For these taxpayers, the state credit cannot exceed 50% of the tax due after subtracting all other nonrefundable credits other than the joint filing credit.

The fiscal effect of this provision, when measured in isolation from any other potential changes to current law, is an estimated revenue loss of $30 million in FY 2015 when TY 2014 tax returns are filed, and of $31 million in FY 2016 and FY 2017. The GRF share of this revenue loss is $29 million in FY 2015 and $30 million in FY 2016 and FY 2017; the remaining revenue loss is split equally between the LGF and the PLF.

Net effects of three personal income tax changes

The revenue loss from enacting all three of these changes to the personal income tax is less than the sum of the three considered separately. For example, gains to taxpayers who qualify for larger exemptions are reduced if their tax rates are lower. More taxpayers will be unable to use all of their credits from the earned income tax credit, which is nonrefundable, if lower tax rates and larger exemptions reduce the remaining tax that they owe to less than the amount of those credits. The estimated net loss of revenue, on an all-funds basis, from enacting these three changes is $748 million in FY 2015, $887 million in FY 2016, and $1,001 million in FY 2017. Losses to the GRF are estimated at $723 million, $858 million, and $967 million, respectively, in these three years. Losses divided evenly between the LGF and PLF are $25 million, $29 million, and $33 million, respectively, in the three years.

Commercial activity tax rate increase

The bill increases the rate of the CAT from 0.26% to 0.30% (3 mills per dollar) of taxable gross receipts in excess of $1 million per year, beginning July 1, 2014. Under current law, taxpayers who exceed the $150,000 minimum threshold to be taxable under the CAT pay $150 (the minimum tax) if their taxable gross receipts are $1 million or less. Taxpayers with taxable gross receipts between $1 million and $2 million pay $800 plus 0.26% of the taxable gross receipts in excess of $1 million; those with taxable gross receipts between $2 million and $4 million pay $2,100 plus 0.26% of the taxable gross receipts in excess of $1 million; and those with taxable gross receipts in excess of $4 million pay $2,600 plus 0.26% of the taxable gross receipts in excess of $1 million.

The rate increase in the bill will increase CAT revenue by about $184 million in FY 2015 and $257 million FY 2016. Under current law, the GRF receives 50% of CAT revenue; thus the GRF revenue gain would be $92 million in FY 2015 and $128 million in FY 2016. The remaining revenue gain would accrue to the School District Tangible Property Tax Replacement Fund (Fund 7047) and the Local Government Tangible Property Tax Replacement Fund (Fund 7081). Fund 7047 would receive about $64 million and $90 million, respectively, in FY 2015 and FY 2016. Fund 7081 would receive about $28 million and $39 million. CAT receipts that are deposited into the local government funds are used to reimburse school districts and other units of local government for lost revenues from the phase-out and reductions in tangible personal property taxes. Current law requires a GRF subsidy if distributions to the funds are insufficient for the required reimbursements. Alternatively, moneys in the funds not needed for the required reimbursements may be transferred back to the GRF. The revenue yield from the rate increase is likely to accrue entirely to the GRF as required reimbursements are generally fixed.

From the increased GRF tax receipts resulting from the increase in the CAT rate, 1.66% or about $2 million per year would be transferred to each of the LGF and PLF. The GRF would retain about $89 million in FY 2015 and $124 million in FY 2016.

Cigarette and other tobacco products taxes

The bill increases taxes on cigarettes and OTP, and imposes the existing excise tax on OTP on e-cigarettes. For all three types of products, estimates include adjustments for reductions of taxable consumption of the products due to changes in the bill.

Higher tobacco taxes, and thus prices, will prompt a number of smokers to quit. For those who continue smoking, differences in cigarette and other tobacco taxes among states create incentives for consumers to cross borders, either physically or online, and make purchases in lower-tax jurisdictions. In many cases, the potential savings to smokers could be substantial, depending on the amount of cigarettes or other tobacco products consumed. Due to expected consumer avoidance of higher tobacco products taxes, additional revenues from rate increases may potentially be less than estimated in this Fiscal Note, depending on consumer responses to the level of taxes proposed in the bill. Tax rate changes in the neighboring states may also affect revenues from increased taxes on tobacco products in the bill.

Cigarette tax rate increases

The bill increases the rate of the cigarette excise tax from the current $1.25 per pack in two stages: to $1.55 per pack beginning July 1, 2014, and to $1.85 per pack beginning July 1, 2015. (On a per-cigarette basis, the increase is from 6.25 cents to 7.75 cents beginning July 1, 2014, and to 9.25 cents beginning July 1, 2015.) These changes are estimated to increase revenue from the cigarette tax by about $153 million in FY 2015 and $279 million in FY 2016 (compared to current law). Revenue gain from the cigarette tax would be approximately $150 million and $266 million, respectively. Revenue from the sales tax on cigarette sales would rise by about $3 million in FY 2015 and $12 million in FY 2016. Generally, an increase in the excise tax for cigarettes increases the retail price of a pack of cigarettes, which increases revenue from the sales tax.

Revenue from both the sales tax and the cigarette tax is deposited in the GRF. A share of GRF tax revenue, 1.66%, is distributed each to the LGF and the PLF. Thus, the GRF would receive about $148 million in FY 2015 and $269 million in FY 2016. The remainder, about $5 million in FY 2015 and $9 million in FY 2016, would be distributed to the two local funds. The provision also would raise revenue from local permissive county and transit authority sales taxes, which are calculated using the same tax base as the state sales tax, by up to $0.4 million in 2014 and up to $1.8 million in 2015 (the fiscal year for local governments generally coincides with the calendar year).

The proposed increases in the cigarette tax would generally increase the current variance between Ohio's rate and that of the neighboring states, as shown in the table below.

State	Rate	Current Ohio Rate	Variance	Proposed Ohio Rate (FY 2016)	Proposed Variance
Indiana	$0.995	$1.25	$0.26	$1.85	$0.86
Kentucky	$0.60	$1.25	$0.65	$1.85	$1.25
Michigan	$2.00	$1.25	-$0.75	$1.85	-$0.15
West Virginia	$0.55	$1.25	$0.70	$1.85	$1.30
Pennsylvania	$1.60	$1.25	-$0.35	$1.85	$0.25

At an excise tax rate of $1.85 per pack of 20 cigarettes, Ohio's rate would be higher than in all neighboring states except Michigan, for which the rate would still be $0.15 greater than in Ohio. For the remaining states, the rate differential would range from $0.25 per pack (Pennsylvania) to $1.30 per pack (West Virginia).

Other tobacco products rate increase

The bill increases the rate of tax levied on "other tobacco products" (OTP, which includes cigars, little cigars, chewing tobacco, snuff, smoking tobacco, and other tobacco products that are not cigarettes). It increases the rate in two stages: to 41% of the wholesale price beginning July 1, 2014, and to 49% beginning July 1, 2015. Under current law, the tax rate is 37% of the wholesale price for little cigars and 17% of the wholesale price for all other tobacco products. The bill eliminates the rate difference for little cigars.

These changes increase revenue from the OTP tax by up to $63 million in FY 2015 and up to $83 million in FY 2016. These estimated changes in revenue amounts exclude receipts from e-cigarettes. Revenue from the OTP tax is deposited in the General Revenue Fund, with part transferred to the LGF and PLF and part retained by the GRF. Revenue to the GRF would increase by up to $61 million and $80 million, respectively, in FY 2014 and FY 2015. The LGF and the PLF would share $2 million in FY 2014, and $3 million in FY 2015. As is the case for the cigarette rate increases, the bill generally increases the rate differential in OTP rates between Ohio and adjacent states, presented in the table below. Current OTP rates are higher in Ohio than in those states, except Indiana and Michigan.

State	Rate	Current Ohio Rate	Variance	Proposed Ohio Rate (FY 2016)	Proposed Variance
Indiana	24%	17%	-7%	49%	25%
Kentucky	15%	17%	2%	49%	34%
Michigan	32%	17%	-15%	49%	17%
West Virginia	7%	17%	10%	49%	42%
Pennsylvania[1]	0%	17%	17%	49%	49%

[1] Pennsylvania imposes its cigarette tax rate on little cigars.

Other tobacco products tax on e-cigarettes

The bill subjects e-cigarettes to the existing excise tax on OTP beginning July 1, 2014, and defines the kinds of devices that constitute an e-cigarette for that purpose. This change is expected to increase revenue from the OTP tax by up to $8 million in FY 2015 (assuming a 41% tax rate) and up to $10 million in FY 2016 (assuming a 49% tax rate). Revenue from the OTP tax is deposited in the GRF. Of the revenue from this new tax, the GRF would retain up to $8 million in FY 2014, and up to $9 million in FY 2015.

Please note that the e-cigarette market is growing and changing rapidly. Some uncertainty exists about the size of the taxable base, as parts of certain products will not be included in the tax base. The bill specifies that the tax is computed on the basis of the wholesale price of products, even if the product includes components that do not contain nicotine, unless the wholesale price of the nicotine-containing part of the product can be readily identified as such on an invoice or bill, in which case the tax applies only to the wholesale price of the nicotine-containing part.

Effects on local governments and libraries

Estimated revenue losses under the bill to units of local government other than school districts, resulting from reduced LGF distributions because of the personal income tax cuts, exceed increased LGF distributions because of the higher CAT rate and higher taxes on cigarettes and OTP. These net losses are partly offset by projected gains from higher local permissive county and transit authority sales taxes under the bill, resulting in net revenue losses estimated at $3 million in 2014 and $5 million in 2015. The fiscal year for local governments other than school districts generally coincides with the calendar year, and some provisions of the bill go into effect July 1, 2014. Lower revenues from personal income tax cuts, and higher revenues from cigarettes and OTP, and part of higher CAT revenues, accrue to the GRF, a portion (1.66%) of which is directed through the LGF to local governments. The timing of revenue losses to local governments from the reduction in transfers to the LGF resulting from the personal income tax cuts will depend on when and by how much withholding rates are reduced.

Funding to public libraries is reduced by the bill, as net reductions in GRF revenue result in smaller transfers to the PLF. These losses are estimated at $4 million in 2014 and $7 million in 2015. The loss of PLF revenue from the personal income tax cuts exceeds gains from higher CAT, cigarette, and OTP revenues.

Under current law, some school districts and other units of local government receive partial reimbursement from the state for loss of revenue because of elimination of the personal property tax on general business, through Fund 7047 (school districts) and Fund 7081 (other units of local government). These payments may decline if a levy expires and is not renewed, but otherwise are fixed in amount, as specified in Am. Sub. H.B. 153 of the 129th General Assembly. Consequently, the additional revenue that would accrue to Fund 7047 and Fund 7081 under the bill, as a result of the increase in the CAT rate, would not be distributed to school districts or other units of local government under current law. The Director of Budget and Management is permitted, but not required, to transfer any balance in either fund to the GRF on June 15 of each year.

The existing local cigarette tax rate for Cuyahoga County is 34.5 cents per pack of 20 cigarettes (4.5 cents in support of sports facilities and 30 cents for a regional arts and cultural district). This local tax expires July 31, 2015, unless renewed by local vote. If the local cigarette tax is renewed, increases in the state cigarette tax rate are likely to reduce revenue from the Cuyahoga County cigarette tax. As a result of the state tax increases, taxed cigarette consumption is expected to decline statewide, including in the county. Assuming the county cigarette tax rate is unchanged, the expected reduction in taxed consumption in Cuyahoga County would result in lower local cigarette tax receipts.

Comparison with earlier estimates

Some of the estimates shown above differ from those in LSC's Comparison Document for the bill as introduced. For the personal income tax, differences reflect updates to the forecast of economic variables used to predict future taxable income. For the CAT, differences reflect a change in the timing of quarterly calendar taxpayer receipts at the new rate, to November 2014, instead of August 2014. For tobacco taxes, differences are based on a reduction of the estimated taxable base when compared to the bill as introduced.

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