A Business Leader's Guide to Ohio Tax Reform

An Economic Imperative Realized

OHIO
MEANS
BUSINESS

June 29, 2005

OHIO BUSINESS
ROUNDTABLE

Inside Cover Blank

From the desk of Chairman John F. Barrett …

Dear business leader:

With our wealth of riches and assets as a state, we can now say that Ohio also has one of the most business-friendly tax codes in the country. Tax reform is now a reality in Ohio because the business community worked hard with our elected state leaders – not simply to level the competitiveness "playing field" but to move Ohio to the head of the pack.

Imagine the first series of ads touting our new tax changes to the world – they would say something like "*… come to Ohio and grow your business; we won't tax your investment, your machinery and tools, nor your profits.*" What a story for us to tell Wall Street and business leaders across the country and the globe.

This brief guide is intended as a CEO read. In the months to come, law firms and accounting firms will produce tomes for their clients to explain the tax changes in technical language. Like many of you, when I receive such material I hand it over to my tax staff.

So, what are the three key message points for CEOs and other C-level executives?

- Unlike most so-called tax reform efforts that are presented as being "revenue-neutral," this one actually results in net tax reductions – as much as $7.9 billion over the next five years, which is only made possible by a corresponding slow-down in state spending which has been embedded into the budget bill.
- The reform reduces personal income tax rates by 21% and eliminates, in their entirety, the onerous and highly uncompetitive tangible personal property tax as well as the unproductive and highly cyclical corporation franchise tax. To help replace this revenue, the reform plan responsibly shifts the burden to consumption-based taxes, which is very much aligned with the thoughts expressed by Fed Chairman Alan Greenspan and other economists in testimony before the President's National Tax Reform Advisory Panel.
- The reform plan will grow Ohio's economy – increasing gross state product by $6.1 billion and personal income by $3.9 billion, injecting more than $6.4 billion in real fixed capital investment, and producing 82,000 new jobs by 2010.

In closing, allow me to thank all the members of the Ohio Business Roundtable and my colleagues here in Cincinnati and across this state for both your personal support and the strength of your leadership as we navigated these important policy changes. And all of us especially owe a debt of gratitude to the key leaders of state government – Governor Taft, Lieutenant Governor Johnson, Senate President Harris and House Speaker Husted – for making the reform happen.

Please do not hesitate to call me at 513-629-1105 or Richard Stoff at the Ohio Business Roundtable office at 614-469-1044 if you need additional information.

John F Barrett

29 June 2005

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A Business Leader's Guide to Ohio Tax Reform

An Economic Imperative Realized

Alarmed by Ohio's steady economic decline for more than two decades, the Ohio Business Roundtable announced, in January of last year, comprehensive tax reform as its top public policy priority for 2004-05 – and, immediately thereafter launched a process to research, benchmark, model, design, evaluate, craft and build support for a package of reforms to modernize the tax code and provide tax relief consistent with the organization's vision for robust economic growth.

It is no accident that the tax reforms contained in House Bill 66, and signed into law by Governor Bob Taft, are remarkably consistent with the philosophy, guiding principles, economic strategy and mechanics of the BRT's original **OhioGrows!**™ tax reform proposal.

The business community's sustained leadership and support prior to and throughout the legislative deliberations were seminal to the reform effort. The result of this major business-government collaboration is a responsible tax reform package that Ohio policy makers can be proud of, Ohio business leaders can embrace and Ohio taxpayers can welcome for the tax relief it will provide and the jobs it will create.

The reform package, effective July 1, 2005, sends a clarion call to the investment community and business leaders across the country that Ohio, indeed, means business.

The Vision

Ohio's tax reform package is true to the defining vision the BRT established at the outset of its tax reform initiative:

> *Ohio's tax climate will be viewed across the country as a distinctive public asset in our state's economic growth and standard of living; by the end of the decade, we will begin to see an upturn in business investment and job creation that is directly attributable to changes in state and local tax policy.*

Indeed, Ohio's most far-reaching tax reform effort in decades will modernize our tax code, stimulate investment and transform the state's economy.

Guiding Principles

The BRT's own tax reform master plan was shaped by six guiding principles, all of which are strongly reflected in the final tax reform package that emerged from the legislative process:

- **Grow the talent base,** which is the most critical element in building businesses and growing the economy, by eliminating high tax burdens on individuals.
- **Foster new capital investment,** especially in Ohio's beleaguered manufacturing sector.
- **Broaden the base to include all sectors of the economy**, including the fast-growing service sector.
- **Stimulate entrepreneurial and start-up activity,** which is the bedrock of a growing economy.
- **Make the tax code fair, equitable and simple for taxpayers.**
- **Rein in state spending,** while still providing the government with stable and sufficient revenue.

Overriding Economic Strategy

Ohio's tax reform package will stimulate robust economic growth by removing barriers to capital formation; specifically, **the reforms shift the burden <u>away</u> from taxing investment, profitability and wealth creation – and <u>toward</u> taxing consumption**. In simple terms, the reform package will reduce Ohio's relatively high tax penalty on saving and investing in Ohio's future. By increasing the reward for saving, i.e., consuming less **today,** the reforms will lead to more business investment, greater productivity and higher real incomes **in the future.** The payoff from reducing taxes on current saving and investment will be increased future consumption and a higher standard of living for Ohio's citizens.

Responding to the Economic Imperative

Ohio's comprehensive tax reform package, as embedded in Am Sub HB 66 (hereafter called HB 66), delivers a strategically focused response to an economic imperative created by years of unsuccessful efforts to address widely acknowledged liabilities in Ohio's incumbent tax system. The core problems, the legislative solutions and the key details of the changes are outlined below.

PROBLEM #1: The existing tax code is an anti-competitive disincentive to investment in innovation and job creation.

Ohio's antiquated tangible personal property tax impedes investment in manufacturing and other capital-intensive industries, especially in northeast and northwest Ohio. This thwarts innovation, undermines competitiveness and stalls growth. Additionally, Ohio's high corporation franchise tax (with a top rate of 8.5 percent) causes investors to view Ohio as a high-tax state, despite a plethora of ineffective credits and incentives that mitigate the actual tax burden. In effect, we have the worst of both worlds – high rates and low collections.

SOLUTION

HB 66 eliminates both the tangible personal property tax and the corporation franchise tax in their entirety – and replaces the revenue with a simpler, low-rate, broad-based Commercial Activity Tax (CAT) on gross receipts for all types of businesses. The law also provides targeted, growth-based incentives to stimulate entrepreneurship and start-up activity in economic clusters that hold demonstrated promise for Ohio.

KEY DETAILS

- Tangible personal property tax on machinery and equipment, inventory, and furniture and fixtures will be phased out over four years. All new machinery and equipment will be fully exempted immediately.
- Corporation franchise tax will be phased out over five years.
- The CAT will be assessed at a flat rate of .0026 and will be phased in over five years. Only business activity in Ohio will be taxed. There is no "throwback" provision.
- Small and emerging businesses with taxable gross receipts of less than $1 million per year are exempt from the CAT. Companies with receipts between $150,000 and $1 million pay only a $150 Minimum Tax; companies with receipts of less than $150,000 pay nothing.
- To provide a "macro cap" on the revenue from the CAT, the CAT rate of .0026 is recalibrated periodically over the next five years to ensure collection of only the forecasted amount of revenue. If significant excess revenue is collected, the tax rate is automatically reduced, the excess tax is rebated as a credit to each company's CAT liability in the following calendar year, and the rainy-day fund is replenished. In the unlikely event that the revenue from the CAT is significantly below the forecasted amount of revenue, a mechanism exists to recalibrate the CAT rate.
- The law provides for a future CAT credit for qualifying net operating loss carry-forwards and deferred tax assets.
- Key exclusions from the CAT include banks and insurance companies and their affiliates; interest, dividends, and amounts on sales of capital gain property; gasoline sales during the next two fiscal years; cancer treating drugs; and foreign trade zones with multi-modal transportation facilities.
- The public utility tangible personal property tax that applies to the telecommunications industry is phased-out over five years beginning in calendar year 2007, consistent with the policy of treating such firms as "general businesses."
- Generally, public utilities are included in the reform package, subjecting them to the CAT, except for those that pay the public utility excise tax. Electric companies remain subject to the public utility tangible personal property tax, albeit at a somewhat reduced listing percentage.

PROBLEM #2: Extremely high personal income tax rates undermine our ability to attract and retain talent.

With the state income tax and the multiplicity of special taxing districts – from schools to special authorities to municipalities – Ohio has among the highest personal income tax rates in the country. As a consequence, we have difficulty attracting talent into our state – and reversing the "gray drain" of older wealthy individuals who are lured away by attractive tax treatment into retirement-friendly states such as Florida and Arizona.

SOLUTION

HB 66 lowers tax burdens on individuals and on small businesses that pay their taxes using the individual income tax schedule.

KEY DETAILS

- An across-the-board 21 percent reduction in all brackets of the state income tax, phased-in over five years, bringing the top marginal rate down from 7.5 percent to 5.925 percent by CY 2009.
- Taxpayers with taxable income of less than $10,000 will have no state income tax liability, removing 550,000 Ohioans from the tax rolls.
- The "sponge" tax on estates is completely and retroactively eliminated.

PROBLEM #3: Spiraling state spending, in particular unsustainable growth in Medicaid spending, have created constant pressure to generate more state tax receipts.

Despite the almost universal recognition that we must link tax reform to spending constraints and good-faith belt-tightening by the Administration, state government continues to face structural deficits that are averted only by the constitutional requirement that the Governor submit and the General Assembly enact balanced budgets. Runaway Medicaid costs and increased support to K-12 education in response to the *DeRolph* court challenges have exacerbated the problem. Higher education funding has been the main casualty and, as a dire consequence (if not the ultimate paradox), state investments in college access and research and development, two critical engines to grow the talent base, lag the national average.

SOLUTION

HB 66 provides state government with additional revenue to balance the budget **and** reduce the rates on the state income tax by retaining selected consumption taxes and increasing the excise tax on cigarettes. Equally important, HB 66 includes a package of Medicaid reforms that will help curb the state's unsustainable growth in Medicaid spending.

KEY DETAILS

- Half of the temporary one-cent increase in the state sales tax enacted in 2003 will be retained.
- The cigarette tax will increase by $0.70 per pack from $.0.55 per pack to $1.25 per pack.

- As the BRT had urged, legislators adopted many recommendations from the blue-ribbon Ohio Commission to Reform Medicaid, including an infusion of competitive marketplace forces and incentives for quality improvements, introduction of a new formula for determining nursing home reimbursements that will improve efficiency and accountability, and an expansion of managed care to Medicaid's highest risk populations. These legislative changes will slow Medicaid spending to no more than 4 percent per annum – the lowest growth rate in the past ten years – without reducing eligibility or needed services for low-income and elderly citizens.

Impact on Ohio's Competitiveness and Standard of Living

Ohio's citizens will greatly benefit by the growing economy brought about by implementation of this tax reform plan. Our beleaguered manufacturing sector will see a boost in capital investment opportunities unlike anything experienced in the past thirty years. Small business-owners will share in the revitalization of an economy that removes high tax burdens on individuals, generates additional personal income and levels the field on the estate tax. Targeted, growth-based incentives will be offered to stimulate entrepreneurship. With increases in capital formation and start-up activity, the state's commercial lending institutions will attract new depositors and make new loans. Every Ohioan will receive a substantial across-the-board reduction in their income tax rates – and more than 550,000 low-income citizens will be removed from the tax rolls altogether. And by restoring fiscal discipline to our budget, we can have **both** reduced tax burdens on households and businesses **and** the ability to reinvest and unleash our potential in higher education, technology and innovation, which are the engines of a growing economy and an improved standard of living.

But – so much for the rhetoric. Here are the numbers:

Chart 1

Distribution of Tax Reform Changes
Households and Businesses, FY 2010 ($ millions)

Tax Change	Households	Businesses	Total
Sales Tax	-$507	-$338	-$845
Excise Taxes	$420		$420
Personal Income Tax	-$1,750	-$262	-$2,012
Corporate Franchise Tax		-$790	-$790
Commercial Activities Tax		$1,417	$1,417
Property Tax		-$1,255	-$1,255
Other	$39		$39
Total Taxes	**-$1,798**	**-$1,228**	**-$3,026**
Percentage of Total Change	**59%**	**41%**	**100%**

Chart 1 presents the distribution of the tax reform changes for both households and businesses. Households receive 59 percent of the $3 billion of tax reductions in FY 2010. This is approximately the same proportion of current state and local taxes paid by households. In other words, the reform package does not change the distribution of Ohio state and local taxes between households and businesses.

Chart 2

Percentage Change in Effective Tax Rates on New Ohio Investments

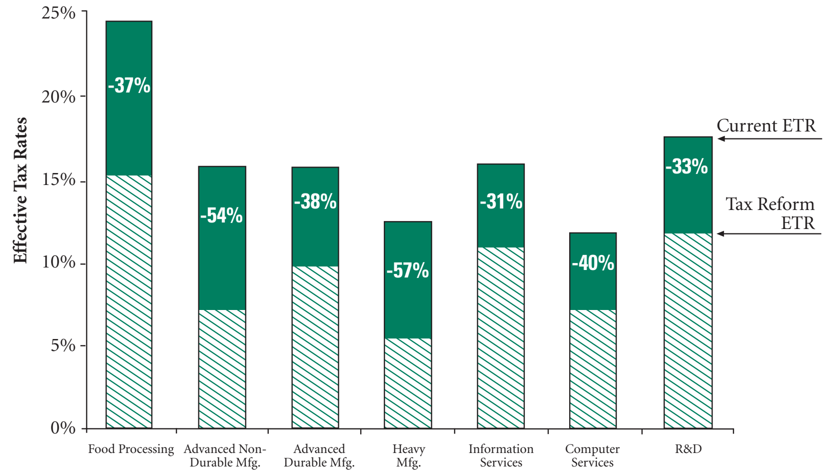

Chart 2 shows the significant reductions in business effective tax rates (taxes as a percent of income) on new Ohio investments. For the selected industries, tax rate reductions range from 31 to 57 percent.

Chart 3

Comparison of Average Effective Tax Rates on New Investments by State

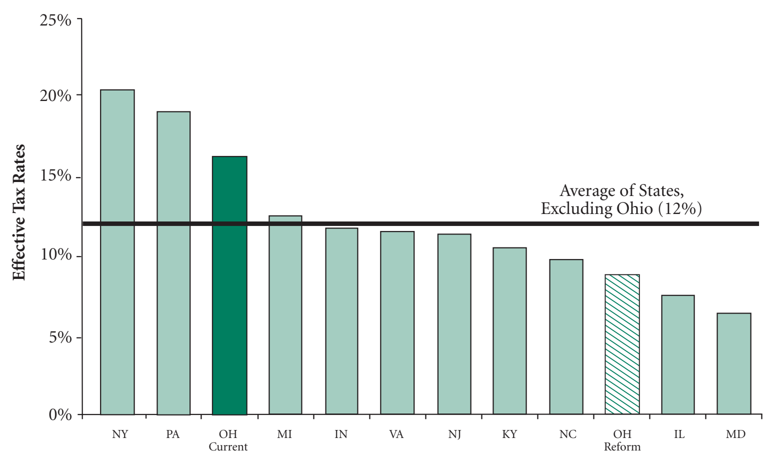

Chart 3 shows the dramatic improvement in Ohio's economic competitiveness under the tax reform package. Based on the average tax burden for the industries included in Chart 2, the business tax reforms move Ohio from third-highest to third-lowest for the comparison states, slightly below North Carolina.

The tax reform package will yield all of these benefits while also providing sufficient revenue to state government in the coming biennium to balance the budget. Looking beyond 2006-07, by FY 2010 the reforms will grow Ohio's economy by increasing Gross State Product by **$6.1 billion**, increasing personal income by **$3.9 billion**, creating **82,000 new jobs,** injecting an additional **$6.4 billion** in new capital investment into the economy. At the same time, state and local taxes are **reduced** by **$7.9 billion** from FY06 through FY10. All of these benefits will send a clear message to the investment community that **"Ohio means business."**

Thank You

Tax reform was a collective endeavor through the leadership and support of countless individuals and organizations across our great state. In a word, the effort exemplified "best-in-class" of the public-private partnership.

At the outset, the Ohio Business Roundtable wishes to acknowledge the bold and spirited leadership of Governor Bob Taft, Lieutenant Governor Bruce Johnson, Senate President Bill Harris and House Speaker Jon Husted. Each of these state leaders was assisted by a team of outstanding public servants whose dedication to true tax reform is appreciated – State Tax Commissioner Bill Wilkins, Director of Budget and Management Tom Johnson, Senate President Pro Tempore Jeff Jacobson, Senate Finance Committee Chairman John Carey, Senate Ways and Means Committee Chairman Ron Amstutz, House Speaker Pro Tempore Chuck Blasdel, House Finance and Appropriations Committee Chairman Chuck Calvert, House Ways and Means Committee Chairman Sally Conway Kilbane and all members of the legislature who supported Am Sub HB 66. We also acknowledge the guidance provided by Jon Allison, Mike Suver, Teri Geiger and Scott Borgemenke, chiefs of staffs respectively to the Governor, Lt. Governor, Senate President and Speaker – and the staffs of the Governor's office, Ohio Departments of Taxation and Development, the Ohio General Assembly and the Legislative Service Commission.

We are indebted to so many individuals from the business community – government relations professionals, corporate tax executives, and directors of business associations, including: Ted Adams and Scott Kriss of Limited Brands, Dave Adler of Deloitte & Touche, Barbara Benham and Ed Kane of Huntington Bancshares, Phil Blandford of The Andersons, Bob Blazer of SBC, Eric Burkland and Ryan Augsburger of The Ohio Manufacturers' Association, Ernie Cade of Key Corp, Ed Claggett of Scotts Miracle-Gro, Dennis Cocco of PolyOne, Marino Colatruglio of Cardinal Health, Chuck Dylag of PolyOne, Rick Fearon of Eaton, Jack Fisher and Rocky Black of the Ohio Farm Bureau Federation, Michael Fisher of the Cincinnati USA Regional Chamber, Jim Haas and Tom Ruebel of Fifth Third, Louise Hughes and Debbie Snellgrove of Procter & Gamble, Scott Hunter of Diebold, Bill Konstantacos and Caroline Ramsey of Honda, Bob Lapp of The Timken Company, Greg Lashutka and Alan Todryk of Nationwide, Vince Magnacca of Goodyear, Bruce McCrodden of National City, Bob Milbourne of the Columbus Partnership, Tom Mischell of American Financial, Scott Roberti of General Electric, Joe Roman and Carol Caruso of the Greater Cleveland Partnership, John Schloss of STERIS, Rick Shapiro of AEP, Gene Sitarz of FirstEnergy, Tim Timmerman of Ford, and Mike Watts of Big Lots. Three organizations, among many across the state, stand out for their extraordinary, above-and-beyond leadership in this all-hands effort – the Greater Cleveland Partnership, The Ohio Manufacturers' Association and the Ohio Farm Bureau Federation. We value our partnership with them.

The Roundtable benefited from the wise counsel of former Ohio House Speaker Jo Ann Davidson who skillfully guided our coalition-building efforts. Yet, at the end of the day, this project succeeded because a project team of dedicated professionals working day and night for almost two years was singularly focused on providing our members and state policy leaders with hard data, sophisticated modeling and penetrating analysis to drive the reform effort. Chairman John Barrett and the Executive Committee of the Ohio Business Roundtable commend and are deeply appreciative of the inspired work of Steve Starbuck, Bob Cline, Tim Kimmel, Andrew Phillips and Lori Maite of Ernst & Young, Tom Zaino and Steve Hall of McDonald Hopkins, Dick Taulbee, Ed Babbitt and Michael Marchese of Western & Southern Financial Group, Nick Lashutka and Jackie Swick of the Ohio Business Roundtable, and Roundtable President Richard Stoff, who served as overall project director.

OHIO BUSINESS ROUNDTABLE

The Ohio Business Roundtable is an independent, nonpartisan organization of the chief executive officers of the state's major business enterprises. Established in 1992, the BRT was created in the belief that business leaders in a pluralistic society should have an active and effective role in the formulation and evaluation of public policy. The BRT's mission is to apply the knowledge, experience and insight of its CEO members, working in partnership with public leaders, to solve complex problems affecting Ohio's overall social and economic vitality. The principal strength of the Roundtable is the extent of participation of the CEOs of the member firms – working together on specific issues where their business experience can make a significant contribution in effecting innovative change. In an effort to provide a broad base of information for the decision-making process, membership is diversified by industry sector and geographic location. Thus the CEOs, representing some eighty companies in all fields, can present a cross-section of thinking on critical statewide issues. The Ohio Business Roundtable is highly selective in the issues it addresses; a principal criterion is the impact on global competitiveness. The chief executives are committed to advocating public policies that foster vigorous, sustained economic growth and an improved standard of living for all Ohioans.

Ohio Business Roundtable, Inc.
John F. Barrett, Chairman • Richard A. Stoff, President
41 S. High Street • Columbus, Ohio 43215 • 614-469-1044