POLICY REPORT

One Cheer for the Budget, but Improvement Needed

By Rea S. Hederman Jr., Greg R. Lawson, Tom Lampman, and Joe Nichols

Introduction

Governor Kasich introduced his biennial budget proposal on February 2, 2015. The budget document acknowledges that Ohio will continue its long-standing, multi-decade stagnation relative to the rest of the nation. In fiscal year (FY) 2017, Ohio's economy is projected to grow 2.2%, versus 2.9% for the U.S. economy, and Ohioans' personal income is projected to grow 4.4%, versus 5.4% nationally.[1] While the budget contains some positive, and long overdue, pro-growth reforms such as large reductions in the personal income tax; it has many elements that will not boost Ohio's growth as envisioned but will instead limit prosperity. These elements include a doubling down by the Governor on previously rejected tax increases such as on cigarettes, the oil and gas industry and the Commercial Activities Tax. They also are violations of principles of sound tax policy as The Buckeye Institute outlined in a recent report.

The following are several initial observations:

1) Efforts to continue reducing the personal income tax (PIT) should be applauded. A shift from income to consumption-based taxation should also be applauded from a long-term perspective. However, several of the mechanisms chosen to offset revenue losses will counter-act some of the positive impacts from the PIT reduction and violate the principle of tax equity. Additional government spending restraint should form the basis of eliminating the income tax prior to any other increases.

2) Education spending continues to grow at a rapid pace despite little academic evidence that vastly increased budgets benefiting bureaucracy yield significant academic gains.

3) Efforts to increase the Ohio severance tax will lead to less investment and violates the principle of tax equity by penalizing a single industry.

4) Medicaid continues to be what former Governor George Voinovich called the "Pac-Man" of the state budget, especially after the expansion. However, the Governor is wisely seeking to impose limited personal responsibility requirements on those over 100% of the Federal Poverty Level (FPL).

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1 Office of the Governor, "The State of Ohio Executive Budget, Fiscal Years 2016-2017," Table B-1: History and Global Insight Baseline Forecast, http://blueprint.ohio.gov/doc/budget/State_of_Ohio_Budget_Recommendations_FY-16-17.pdf (accessed February 3, 2015).

5) The state is wisely continuing a reduction in revenue sharing by further reducing reimbursements to local governments for tangible personal property and kilowatt-hour taxes.

6) Overall state spending is increasing faster than can be justified through either inflation or population growth. The largest increase comes from moving the Medicaid expansion costs back onto the General Revenue Fund (GRF) books. However, state-only GRF spending also eclipses inflation, albeit less than some previous budgets.

Overall Spending & Revenue

Under the proposed budget unveiled on February 2, government spending and revenues will increase. Although the All Funds budget would grow only 2 and 2.5% respectively over the biennium, growth in GRF expenditures is up due primarily to Medicaid expansion and continuing increases to K-12 education.

The proposed GRF expenditures for Fiscal Year 2016 (FY) are 12.5% over FY15, an increase of nearly $4 billion dollars. Much of this increase is predicated on a large influx of federal dollars due to the Governor's decision to expand Medicaid under Obamacare. Even excluding these new federal dollars, state spending has grown. The state's share of overall GRF expenditures has increased by $900 million, or about 4%. This is more than the increase required for Ohio's inflation rate and limited population growth.

Revenue has been shuffled between various taxes being raised and lowered; income tax revenue will decline by 21.7% while Commercial Activity Tax revenue will increase by more than 80%. The final effect is a 5.3% increase in state GRF tax revenue in FY 2016 over FY 2015. With unfavorable demographic trends in Ohio, Gross State Product growth of more than 2-3% annually may prove challenging, meaning an even greater share of Ohio's economic activity will go to feeding the tax burden.

Taxes

While the Kasich budget reduces income taxes with a focus on small businesses and tax rate reductions, the overall plan adversely affects Ohio businesses by shifting the tax burden from individuals to the business sector. Individual income taxes decline by a fifth in the next fiscal year, but the commercial activity tax increases by 80% and the sales tax increases by 15%. Though a net tax cut, it is more of a tax shift.

A tax shift that raises the impact on businesses violates the rule of creating a pro-growth tax policy. Governor Kasich is right to look at reducing individual taxes and helping small businesses, but tax shifting is not tax relief.

Governor Kasich's proposal of tax reform and CAT increases is an increase to the General Revenue Fund of $43 million in FY 2016 and a revenue reduction of $49 million in FY 2017 compared to current law baseline.

Governor Kasich does move in the right direction with significant cuts to individual income tax. By reducing income tax receipts by 15% in 2015 and 8% in 2016, Ohio workers and families will benefit greatly from tax savings.

Governor Kasich plans to increase the Commercial Activities Tax by .06 percentage points from .26 to .32%. The non-partisan Tax Foundation has called the Commercial Activities Tax "the worst part of Ohio's tax code." A higher CAT is not conducive to good tax policy or economic growth and violates the principle of equity, especially for businesses that are impacted more negatively by a gross receipts tax due to low profit margins.

The current proposal would raise the tax by $1 per pack, equalize the tax rate on other tobacco products with the cigarette tax rate, and again includes electronic vaporized tobacco products in the tax. The budget forecasts cigarette tax revenues increasing by almost 70% over baseline in one year. This forecast is dubious because a tax increase of the magnitude recommended in the budget is likely to drive tobacco users to purchase out of state or reduce smoking more than the current trend would forecast. The FY 2014-15 executive budget proposed raising the cigarette tax by 60 cents per pack. This tax is a violation of the principle of tax equity by singling out a particular class of taxpayer for a disproportionate burden.

A positive inclusion in the budget plan is the creation of a committee to review tax expenditures and consider whether to close them. This is a policy that The Buckeye Institute along with several other state-based think tanks have long called for as a way to clean up and modernize the tax code while opening the door to overall rate reductions. This committee could facilitate Ohio shifting to a simpler tax code that comports with one of The Buckeye Institute's tax principles.

Another positive move are further re-allocations of state revenue sharing with local governments, thus furthering the goal of driving local spending back down to local decision-makers.

Education

The budget continues increasing spending on K-12 education. The estimated FY14-15 budget increased state spending on education (GRF and State Lottery) by over $1.5 billion over the FY12-13 budget. The proposed FY16-17 budget is $1.8 billion over that amount and includes a total of $700 million more than in FY15.

The idea that this record level of state spending on education will improve outcomes is questionable given the lack of evidence that increased spending leads to better academic outcomes. The state should continue embracing school choice to empower parents and limit the growth of K-12 spending rather than increasing it and allowing it to be diverted by the existing education bureaucracy.

The Kasich Administration focuses on school choice by continuing to expand vouchers and seeking to expand upon high-performing charter schools.

Energy

Governor Kasich again proposed raising the severance tax for oil and natural gas as an income tax cut "pay-for" in his fiscal year (FY) 2016-17 budget. Raising taxes on oil and gas producers is poor policy because it increases the cost—and thus reduces the incentive—to drill in Ohio while also violating the tax principle of equity. It is an especially bad time to increase the severance tax because falling oil prices are squeezing margins for extractors and reducing their ability to drill new wells. Ohio Department of Job and Family Services reports that shale drilling employment nearly doubled from 2011 to 2014 and pays 58% higher wages than the Ohio average. A higher severance tax would likely shift this valuable economic activity to other states.

Current law assesses the tax on natural gas at 2.5 cents per thousand cubic feet (mcf), and oil at 10 cents per barrel. The proposed FY 2014-15 budget proposed a complex severance tax structure that assessed a variable rate based on whether the well produced oil or natural gas, was vertically or horizontally drilled, and the quantity of Btu's per Mcf produced, topping out at a 4% rate. This budget proposes raising the severance tax on only horizontally-drilled oil and natural gas to 6.5% of the spot market value of each respective commodity, and to 4.5% of spot market value for natural gas liquids like ethane and butane.

In FY 2013, oil and natural gas drillers paid approximately $2.8 million in severance tax to Ohio. The FY 2014-15 proposal would have increased their burden to $45 million in 2014 and $155 million in 2015. This proposal would raise their tax burden to $76.5 million in FY 2016 and $183.4 million FY 2017.

Medicaid

The fiscal year (FY) 2016-17 budget again proposes to increase the total GRF appropriation for Medicaid, from $15.2 billion in fiscal year (FY) 2015 to $18.5 billion in FY 2016 (a 21.4% increase, or 7.4% when including the expansion appropriation in FY 2015), and to $19.6 billion in FY 2017. Medicaid is by far the single largest item in the budget, taking up 49% of the total GRF appropriation in FY 2015 and growing to 52% in 2016. The state's share excluding federal dollars would grow from $5.7 billion in FY 2015 to almost $6 billion, or 26% of the state-source budget, in FY 2016. This is far higher than the FY 2014 50-state average, which according to the National Association of State Budget Officers was 25.8% of total budgets and 15.3% of state-source budgets in FY 2014. Uncontrollable Medicaid spending curtails economic growth by growing government and taxes, and will eventually crowd out other budget priorities such as education.

Choosing to continue the current Medicaid expansion under the ACA will only exacerbate this problem. As the Legislative Service Commission reports, "For the first half of FY 2015, all-funds expenditures for ACA Expansion totaled $1.56 billion, $537.7 million (52.6%) above estimate. This positive variance was due to higher than expected caseload and per person costs." The future is even darker because the federal matching rate for the expansion population will begin declining in FY 2017, increasing the state's share of expansion costs, and because changes to federal funding law may outlaw a sales tax on Medicaid premiums that provides critical revenues that are relied upon by the Kasich administration to keep the system solvent.

One silver lining in the Governor's budget on Medicaid is an effort to impose a sliding-scale co-payment on those recipients above 100% of the FPL. This is a limited, but necessary, step in the direction of requiring greater personal responsibility by those in the Medicaid expansion population.

Conclusion

The Kasich Administration's biennial budget proposal is an impressive piece of work showcasing pro-growth instincts relative to the PIT reductions and the long-term shift to a consumption tax that does not penalize work and investment. It also continues to embrace school choice and begins the needed steps to assure greater self-sufficiency by those currently receiving public assistance.

However, the proposal needs improvement. Even after these reforms, Ohio's tax code will continue to run afoul of numerous principles previously outlined by The Buckeye Institute for sound tax policy. Unwise tax increases in order to offset revenue losses will put a damper on the effectiveness of the PIT reductions. Tax reform should be initiated, but the first step should be constraining the growth of government spending, not raising other taxes.

The Buckeye Institute looks forward to working with both the Kasich Administration and the General Assembly to improve upon the proposed budget. With the right policies, Ohio can throw off its historical economically lagging status and see its prosperity reach new heights.

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Founded in 1989, The Buckeye Institute for Public Policy Solutions is an independent research and educational institution—a think tank—whose mission is to advance free-market public policy.

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