Fiscal Note & Local Impact Statement

122 nd General Assembly of Ohio

BILL: **H.B. 104** DATE: **April 10, 1997**

STATUS: **As Introduced** SPONSOR: **Rep. Hodges**

LOCAL IMPACT STATEMENT REQUIRED: **Yes**

CONTENTS: **Reduces the assessment rate on tangible property held in inventory**

State Fiscal Highlights

STATE FUND	FY 2000	FY 2001	FUTURE YEARS*
General Revenue Fund			
Revenues	- 0 -	- 0 -	- 0 -
Expenditures	$8.5 million increase	$17.6 million increase	$27.5 million to $90.4 million increase

*Increases from $27.5 million in FY 2002 to $90.4 million in FY 2010 and thereafter.

- To the extent that the assessment percentage reductions reduce the value of tangible property, the policy will result in higher state aid to local school districts.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 1998	FY 1999	FUTURE YEARS
School districts			
Revenues	$2.8 million loss	$22 million loss	$34.6 million loss in FY 2000 to $171.9 million loss in FY 2009 and decreasing thereafter
Expenditures	- 0 -	- 0 -	- 0 -
Other local governments			
Revenues	$8.1 million loss	$17.0 million loss	$26.9 million loss in FY 2000 to $128.1 million loss in FY 2009 and increasing thereafter
Expenditures	- 0 -	- 0 -	- 0 -

- Decreases in the assessment percentages on tangible property will reduce property tax revenue to local governments.

- School districts will lose approximately 70 percent of the property tax revenue; however, a portion of those losses will be replaced by increased basic aid payments.

Detailed Fiscal Analysis

The bill reduces the assessment percentages on tangible personal property classified as inventory by one percentage point per year beginning in calendar year 1998. The reductions continue until the year 2007, when the assessment rate will be 15 percent.

This bill basically follows one of the recommendations of the Commission to Study the Ohio Economy and Tax Structure. In its draft report of September 24-25, 1994, *Ohio Tangible Business Personal Property: Property Taxation (Staff Report Number 8b),*the Commission staff makes the following point:

> In spite of the sizable revenue loss for Ohio, it is in the economic interest of the state to consider dropping commercial and industrial inventory from the personal property tax base. Only nine states continue to tax inventory. Ohio is out-of-line with most states. Commercial and industrial inventories are by their very nature very mobile. A state which places a tax on such factors will always be at a competitive disadvantage when compared to surrounding states. Keeping the tax provides a strong incentive for existing firms which maintain a high level of inventory to expand to other states where inventory is not taxed and for new firms to select other states when considering location. (P. 70)

The chief problem with eliminating the tax is that it is an important source of revenue for local governments, and most of the alternatives for replacing the lost revenue considered by the Commission and others involves state rather than local sources of revenue. Phasing out the tax, while not eliminating Ohio's disadvantage vis-a-vis other states, does provide time to deal with state and local funding issues.

Background

The tangible personal property tax is a tax levied on personal property used in business in Ohio. It is a local tax levied at the local level to support local services. Approximately 70 percent of the revenues go to school districts to support education services. The tax is levied on the assessed (or "taxable") value of personal property. The taxable value is found by multiplying the "true value" of personal property (generally the depreciated book value of machinery and fixtures and the acquisition cost of inventories) by an assessment percentage which is given in section 5711.22 of the Ohio Revised Code.

The assessment percentage reductions will mainly affect local governments and school districts. However, to the extent that the assessment percentage reductions reduce the value of taxable property, the policy will also result in higher state aid to local school districts. Essentially, schools receive some State GRF money via the foundation formula. The foundation formula provides funding to school districts based on the extent to which the value of taxable property in each district falls short of the amount that would be required to provide an adequate level of funding per pupil in that district. About 95 percent of the districts have property valued at less than the state support level. Since the assessment percentage reductions will further reduce the value of taxable property, lower taxable values will enter into the equation for these school districts, necessitating higher levels of state aid.

For the purpose of calculating the fiscal impact of this bill, it is assumed that changes in the assessment percentage do not affect the total amount of tangible property in the state. It also assumes that changes in the assessment percentage do not affect the average tax rate on tangible property. These assumptions are briefly addressed at the end of this note.

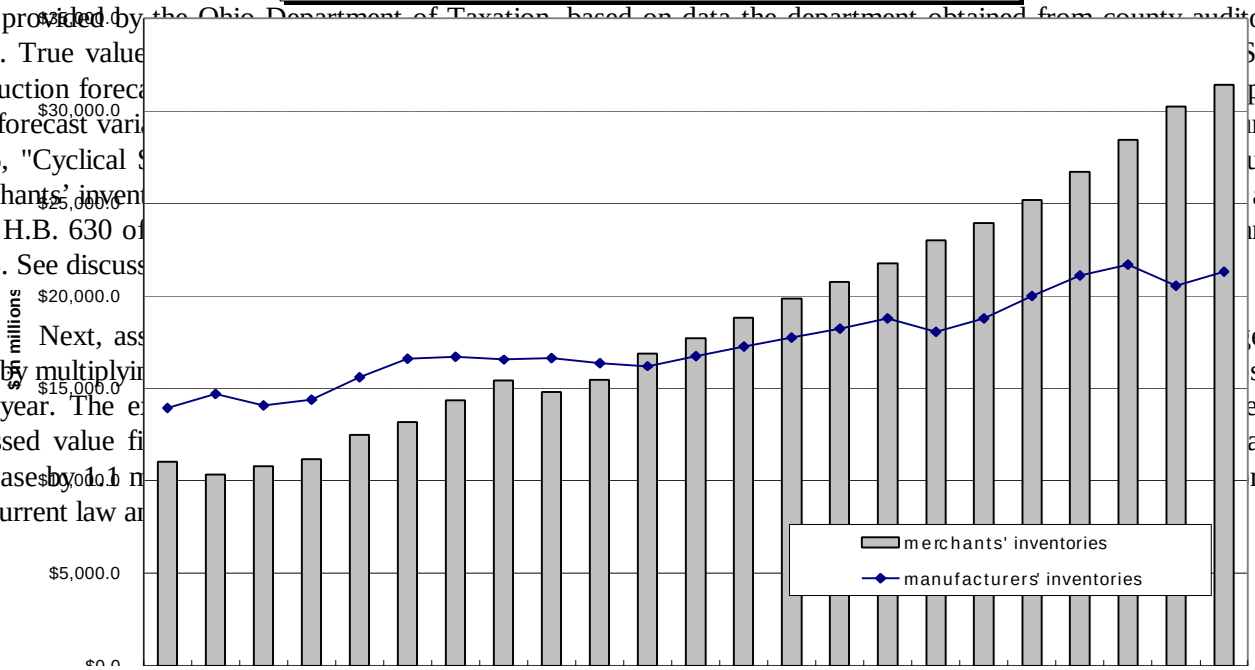
Method of Calculating Cost

The cost is calculated as the reduction in taxes due in any given year when the same statewide average tax rate is applied to the same tangible property; the only variation in the calculations being the proportion of the property's true value that is assessed for taxation. The annual (cumulative) costs are summarized in **Table 1**, below. "Total cost" here is equal to the difference between the projected revenues at a 25 percent assessment rate and the projected revenues at the new lower rate as set forth in the bill (and given in column B of the table). As indicated in column D, the total cost (i.e., revenue loss) of this bill is estimated at $26.9 million in CY 1998, increasing to $426.9 million in CY 2007 and continuing annually, thereafter.

Table 1
Cost of Reducing Assessment Percentage on Tangible Property Held as Inventories

Column A Calendar Year	Column B Proposed Assessment Percentage	Column C Projected average effective millage rate	Column D Projected cost (Total Revenue Lost - in million dollars)
1998	24%	72.9	$26.9
1999	23%	74.0	$56.7
2000	22%	75.1	$89.7
2001	21%	76.2	$122.8
2002	20%	77.3	$161.8
2003	19%	78.4	$208.2
2004	18%	79.5	$260.7
2005	17%	80.6	$316.4
2006	16%	81.7	$365.4
2007	15%	82.8	$426.9

The first step in dete ntories for 1996 through 2007. True value estimates for man h 1996 were constructed from data provided by the Ohio Department of Taxation, based on data the department obtained from county auditors and tax filers. True value S. industrial production foreca projections. The forecast vari rth Quarter 1996, "Cyclical S ue value of merchants' inven accordance with H.B. 630 of ning in CY 1995. See discuss



Next, ass es for each year by multiplyin sed rate for that year. The e each of the assessed value fi assumed to increase by 1.1 n ries at both the current law ar

Table 2 shows - on a calendar year basis - how the total cost of the assessment percentage reductions are divided among three main groups: school districts, other local government units, and the State General Revenue Fund (GRF). Since school districts typically receive approximately 70 percent of tangible property tax revenues, approximately 70 percent of this lost revenue was attributable to them. This figure, $18.9 million in 1998 and $39.7 million in 1999, etc., is given in column C. (These numbers in column C differ from those presented at the front of this note under "Local Fiscal Highlights School Districts," since those are presented on a fiscal year basis.) The remaining 30 percent, given in column D ($8.1 million in CY 1998), is a cost to other local taxing districts (counties, municipalities, townships, and special districts). Columns E and F divide the cost to school districts between the added GRF expenditures (column E) and net revenue losses to school districts (column F) after added GRF payments are taken into account, i.e., column F = column C - column E. (Again, the figures in column E differ from those given at the front of this note under State Fiscal Highlights, since those are presented on a fiscal year basis.) In CY 1999, the $39.7 million revenue loss to school districts would be partially offset by up to $4.2 million in State Foundation Aid (resulting from the CY 1998 assessment percentage reductions), bringing the net loss to school districts to about $35.4 million in CY 1999. The effect of the assessment percentage reductions on school districts is discussed in some detail in the next section.

Table 2

Cost of Assessment Percentage Reductions by Source and Destination of Funds

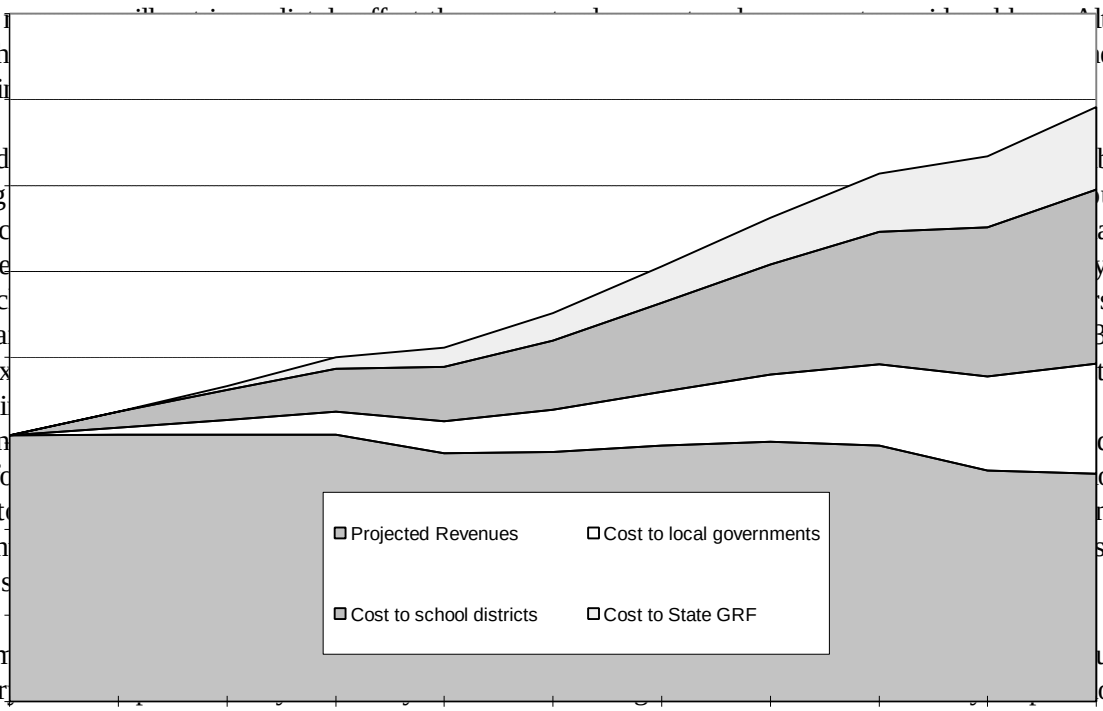
A	B	C	D	E	F
	Personal Property Tax Revenue Loss			Added GRF Expenditures	
Calendar year	Total Cost	Cost to Schools	Cost to Other Local Governments	Foundation Aid Payments	Net Cost to Schools
1998	($26.9)	($18.9)	($8.1)	$0.0	($18.9)
1999	($56.7)	($39.7)	($17.0)	$4.2	($35.4)
2000	($89.7)	($62.8)	($26.9)	$13.1	($49.8)
2001	($122.8)	($86.0)	($36.8)	$22.5	($63.4)
2002	($161.8)	($113.3)	($48.5)	$32.3	($81.0)
2003	($208.2)	($145.8)	($62.5)	$42.6	($103.2)
2004	($260.7)	($182.5)	($78.2)	$54.6	($127.9)
2005	($316.7)	($221.7)	($95.0)	$68.3	($153.4)
2006	($365.4)	($255.8)	($109.6)	$82.9	($172.9)
2007	($426.9)	($298.8)	($128.1)	$96.6	($202.2)
2008	($492.9)	($345.0)	($147.9)	$110.7	($234.3)
2009	($562.0)	($393.4)	($168.6)	$126.6	($266.8)

Effects of Assessment Percentage Reductions on School Districts and the State Formula

In Ohio, school districts are guaranteed a certain per pupil amount, known as the "formula." To the extent that a 23 mill rate on taxable property in any school district fails to generate this guaranteed "formula" amount, the state's School Foundation Basic Allowance program will make up the difference. Total payments for this program come from the state GRF and are referred to as "Foundation Aid." (Under the March 1, 1998, Supreme Court decision, as long as tangible property taxes remain part of the local property tax base; the formula is likely to work in much the same way to make up part of the local loss. It may, however, cover either more or less mills than the current system.)

State aid to education may be based on either the "foundation formula" or a "guaranteed" amount. The guaranteed amount is equal to at least [illegible] In any year, school districts will receive the greater of the two amounts. The calculation of the "guarantee" is subject to change in H.B. 117. In any case, changes in local [illegible] although many districts go on th[illegible] their long-term aid level determin[illegible]

Chart 3: Effect of Reducing Assessment Percentages on Inventories



Reduced [illegible] ble property, thereby reducing [illegible] undation Aid payments to reac[illegible] at proportion 23 mills is of the [illegible] y tax receipts attributable to sc[illegible] rst 23 mills of school district ta[illegible] 3 mills would represent approx[illegible] ttributable to school districts i[illegible] $8.5 million. Assuming that in[illegible] d to generate the foundation fo[illegible] ost revenues, implying a cost t[illegible] million - $8.5 million) represen[illegible] s complicates this calculation, s[illegible]

The reim[illegible] urns are filed between Februar[illegible] ons must pay one-half of their liability at this time, as well. The second half of their liability, along with the total liability of intercounty corporations, must be paid by September 20 of the same calendar year. Approximately 70 percent of the liability is owed by intercounty corporations, with the remaining 30 percent owed by all other businesses. Therefore, 15 percent of tangible property taxes is paid in February through April, and 85 percent is paid in September and October.

For the purposes of calculating state aid payments for a given fiscal year, the Tax Department certifies in the preceding June the taxable value of property in each school district for the previous calendar year. Consequently, the value of tangible property in CY 1998 is used (in June 1999) to calculate foundation aid payments for FY 2000. Therefore, the $8.5 million cost to the GRF resulting from the assessment percentage reductions in CY 1998 would be incurred in FY 2000. (See State Fiscal Impact at the top of this note. As shown in **Table 2**, half would be incurred in CY 1999 and half in CY 2000). Since not all school districts receive funds based on the formula, the costs to the GRF are overstated by this method. The total costs to school districts are, however, understated by the same amount. The cost figures in the table should, therefore, be regarded as upper limits for increased GRF expenditures and lower limits for local school district revenue losses.

Reductions in taxable values, in any case, reduce local tax collections to school districts. To the extent that these losses are covered, in part, by increased state aid, the net cost to the district is reduced; but in cases where state aid does not increase as a result of the revenue loss, the school district incurs a greater part of the loss. Overall, the cost to the local school districts of the assessment percentage reduction increases relative to the cost to the GRF because of statewide increases in local property tax rates. Twenty-three mills - the GRF portion of school district costs for FY 1997 and beyond - is a smaller and smaller proportion of the rising average tax rate. See **Chart 3**, above, for how the revenue loss is apportioned among school districts, local governments and the GRF over time.

Impact of Assessment Percentage Reductions on tax treatment of inventory held for storage only

H.B. 630 of the 120th General Assembly (effective 7/22/94) phases out the tax on certain merchandise held in Ohio for storage only. Beginning in 1995, it reduces the assessment percentage on such inventory by 5 percent per year until the assessment percentage is equal to zero (most likely in 1999). These reductions are to be triggered annually by growth in the revenue from all taxable property. (In order to trigger the reduction, the tax revenue growth must at least equal the greater of 4 percent or the consumer price index.) This bill contains a provision that precludes the assessment percentage reductions it calls for from inhibiting the trigger. Basically, in calculating the tax revenue growth, the Tax Department is required to calculate the revenue from inventories as if they were assessed at 25 percent.

The assessment percentage reductions should not have a significant impact on the overall growth of property tax revenues, so that this provision is probably unnecessary. (Real property tax revenues constitute the largest portion of local property tax revenues, accounting for 77 percent in 1993. Furthermore, they have grown at a rate of 8 percent per year from 1985 through 1992.) In any case, the provision will only apply to the first two years of the assessment rate reduction. LBO does not anticipate either high inflation or a recession during this time period.

Impact of Assessment Percentage reductions on tax rates and inventories

This analysis assumed that assessment percentage reductions would not affect either tax rates or the amount of tangible personal property. It is possible, however, that the assessment percentage reductions could affect either. It is certainly likely that past assessment percentage reductions have contributed to both higher property tax rates, as well as to greater investment in tangible property.

The higher property taxes are a result of real property tax laws, specifically the H.B. 920 reductions, which appear as credits on real property tax bills. As a result of H.B. 920 of the 111th General Assembly, total tax collections on real property remain constant in any district in the absence of either voted tax increases or new construction of or additions to real property. Consequently, as real property appreciates in value, the effective tax rate on it falls. At the same time, as the costs of government services (specifically schools) increase, real property tax revenues do not similarly increase. In order to cover these increasing costs, voters are regularly asked to support property tax increases. The tax rate applied to tangible property in any district (including that applied to public utility tangible property) is the same that is applied to real property before credits and rollbacks. While the H.B. 920 reductions or "credits" do not apply to tangible personal property, any voted tax increase does apply to it.

For new and old debt service levies and for emergency levies, the proposed tax rates are driven by the total dollars required. Thus, with no assessment percentage reductions on tangible property, the property would have had a higher valuation; lower tax rates would have been required. On operating levies, the same principle generally applies: A particular revenue production is selected. If tangible valuation were higher, a lower tax rate would result. Thus, the higher tax rates compensate, in part, for the lower

assessments. The lower assessment on business tangible property essentially shifts the tax to other taxpayers - e.g., public utilities.

It is also unlikely that the true value of tangible personal property has been unaffected by previous assessment percentage reductions. The assessment percentage may be regarded as part of the "price" of Ohio tangible personal property. A reduction in assessment percentages would therefore have an impact similar to that of a price reduction: it would increase the net incomes of businesses and could lead to increased purchases of tangible personal property, causing an increase in the true value of tangible personal property, over and above the increase resulting from economic growth factors. The increase in tangible property could result both from existing companies increasing their investment in Ohio and from more companies forming in the state. Both of these scenarios would increase the aggregate value of all types of both real and tangible property in the state.

The more "sensitive" or "responsive" expenditures on tangible personal property are to changes in the assessment percentage, the lower is the relative cost of the assessment percentage reduction. While all categories of tangible property experienced the same reductions in assessment percentage between 1984 and 1993 and all are currently assessed at the same percentage of true value, the analysis to date suggests that some are more sensitive to changes in the assessment percentages than others. In other words, reductions in the assessment percentage lead to greater percentage increases in some types of property than others. Inventories, for example, are generally more responsive to lowered assessment rates than are furniture and fixtures. Therefore, the "cost" of a given reduction of the assessment rate on inventories may not have been as great as similar reduction applied to furniture and fixtures. However, it is also possible that this same rate reduction on inventories, while substantial in the 1970's or 1980's, will be relatively unimportant with respect to future assessment rate reductions. "Responsiveness" tends to fall as the price - in this case the assessment rate - falls.

Other developments have also reduced the potential "responsiveness" of inventories to additional assessment percentage reductions. For instance, the relatively slow growth of manufacturers' inventories projected in this analysis (see **Chart 1**) is a continuation of a national trend to streamline the manufacturing process. The trend began in the late 1970's and early 1980' in response to the high interest rates at that time. While interest rates have subsequently fallen in recent years, it is unlikely that manufacturers will revert to the old processes. Furthermore, many manufacturers have been able to take advantage of enterprise zones and foreign trade zones to reduce their tax burden associated with inventories. Consequently, lower assessment percentages on manufacturers' inventories may not have much of a stimulative effect, either on manufacturing or on the true value of manufacturers' inventories. On the other hand, merchants, who were also plagued by the high interest rates, were generally not able to economize on inventories in the same way. (Many reduced employment, instead.) The lower assessment percentages may, as a result have a more significant impact on their operations. On the other hand, the lower assessment percentages may make it easier for new manufacturing concerns to become established in the state (especially those which would not have been in the position to obtain lucrative enterprise zone agreements). In those cases, manufacturing firms would benefit from reduced assessment percentages on inventories as much as wholesale and retail merchants. Moreover, since manufacturing firms have more discretion over location than do *most* wholesale and retail establishments, this point is not insignificant.

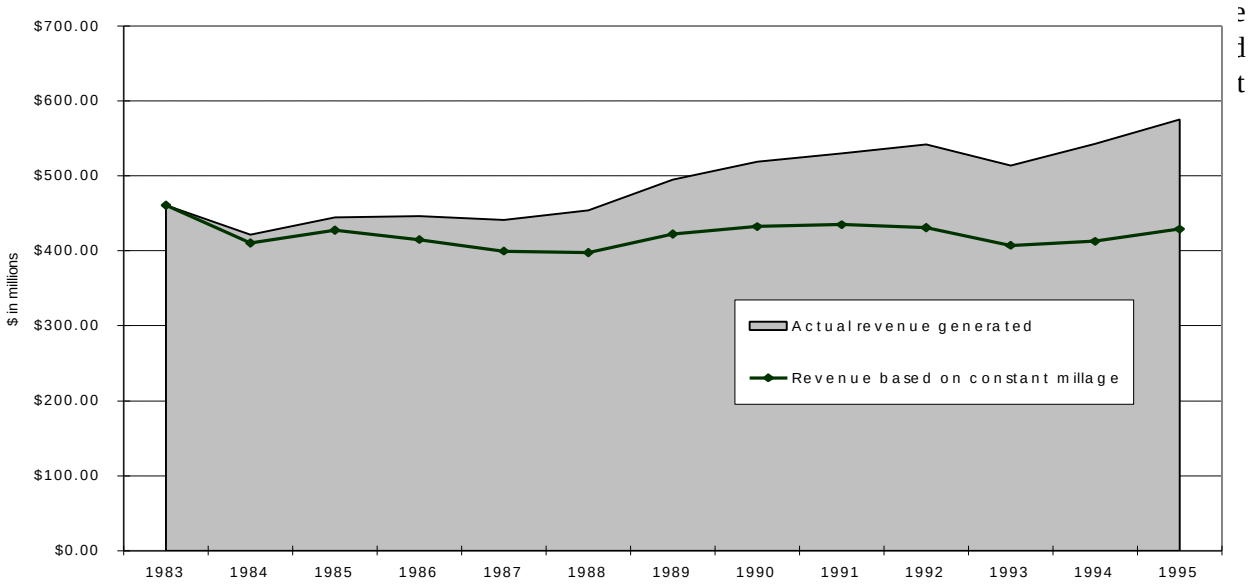
The projected costs of the assessment percentage reductions presented at the beginning of this note are based on a relatively low incremental tax rate. Since inventory only and not other tangible property is to be subject to the proposed assessment rate reductions, the reductions are not likely to put as much upward pressure on tax rates as they might have in the past. (In 1995, inventories accounted for only 44 percent of all business tangible property.) The low incremental tax rate used reduces the apparent cost of the assessment rate reductions, as it dampens the growth of the estimated revenue foregone. The amount of tax shifted to other taxpayers is also reduced. However, to the extent that the assessment percentage reductions

may be expected to increase the growth of all types of tangible property in the state - especially that which is not subject to the assessment rate reductions, the cost of the reductions is somewhat overstated by the projections at the top of this note.

APPENDIX

From tax year 1984 through 1993 the assessment percentage on all tangible property was decreased by 1 percent per year (dropping from 35 percent in tax year 1983 to 25 percent in tax year 1993). During this time, tangible tax revenue grew by an annual average of 3.2 percent. Revenue growth was partly the result of an increase in the underlying true value of property (the taxable base) and partly the result of increases in tangible millage. Specifically, LBO has calculated that revenue growth with constant millage would have averaged about 0.5 percent annually; the other 2.9 percent in growth came from increases in local millage. **Chart A** has a graphic depiction of the division of revenue growth into base growth and millage growth over the 1984-1995 period.

Chart A: Revenues from Personal Property Tax on Inventories 1984 - 1995



While the total assessed value of inventories grew by just 0.6 percent annually over the 1984-1995 period (see above), the total obscures the differences in the components. The assessed value of merchants' inventories grew by about 2.2 percent annually, while the assessed value of manufacturers' inventories **fell** by about 0.7 percent annually. We can hypothesize that the decrease in manufacturing inventories was driven in part by changes in the production process (e.g. "just-in-time" inventory management). It is also possible that manufacturers were more able to take advantage of enterprise zones and foreign trade zones to avoid taxes on tangible property generally, and thus also on inventory.

Chart B: Assessed Value of Inventories 1973 - 1995

❑ *LBO staff: Doris X. Mahaffey, Senior Economist*