Fiscal Note & Local Impact Statement

123 rd General Assembly of Ohio

BILL: **H.B. 374** DATE: **June 10, 1999**

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

LOCAL IMPACT STATEMENT REQUIRED: **Yes**

CONTENTS: **creates nonrefundable corporate franchise tax credits for job training and for research and development spending**

State Fiscal Highlights

STATE FUND	FY 2000	FY 2001	FUTURE YEARS
General Revenue Fund			
Revenues	- 0 -	- 0 -	Loss of $38.1 million beginning in FY 2003; larger in subsequent years.
Expenditures	- 0 -	- 0 -	Potential increase of $100,000 or more, beginning in FY 2002.

Note: The state fiscal year is July 1 through June 30. For example, FY 2000 is July 1, 1999 – June 30, 2000.

- LBO estimates that the R&D credit would cost about $35 million for FY 2003, the first year of the credit. The GRF share of the revenue loss would be $33.3 million. The credit is limited to C-corporations – pass-through entities are not eligible. Based on data from other states, LBO estimates that 125 to 150 Ohio corporations would claim the credit.

- LBO estimates that the worker training credit would cost about $5 million in FY 2003, the first year of the credit. The GRF share of the revenue loss would be $4.76 million. The credit is limited to C-corporations – pass-through entities are not eligible. Based on data from other states, LBO estimates that 200 to 250 Ohio corporations would claim the credit.

- LBO estimates that, starting in FY 2002, the Ohio Department of Taxation would face additional personnel costs of at least $100,000 in administering the credit, particularly in reviewing applications and estimating the economic impact of the training credits granted.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 1999	FY 2000	FUTURE YEARS
Counties, Municipalities, Townships, and Special Districts			
Revenues	- 0 -	- 0 -	Loss of $1.9 million beginning in FY 2003; larger in subsequent years.
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.

- Local governments would lose revenue through reduced allocations from the Local Government Fund (LGF), and from the Local Government Revenue Assistance Fund (LGRAF). LGF losses from both credits are estimated to be $1.7 million annually, starting in FY 2003. LGRAF losses from both credits are estimated to be $0.2 million annually, starting in FY 2003.

Detailed Fiscal Analysis

Summary

LBO estimates the overall impact of the bill to be a revenue loss of approximately $40 million in FY 2003, the first year of impact. The estimated loss is $35 million from the research and development (R&D) credit, and $5 million from the worker training credit. The worker training credit has the potential to grow significantly in subsequent years, up to the $20 million cap. Data from states with similar R&D credits to the one proposed in this bill show that there is the potential for significant growth in that credit also. Of the estimated $40 million revenue loss in FY 2003, the state GRF would bear $38.1 million, with the Local Government Fund (LGF) bearing $1.7 million and the Local Government Revenue Assistance Fund (LGRAF) bearing $0.2 million.

The Tax Commissioner is charged with a number of tasks in administering the worker training credit. LBO has not yet been able to attach a number to the additional costs that this will impose on the Department of Taxation, starting in FY 2002.

Research and Development Credit

The bill creates a research and development tax credit against the corporate franchise tax, in addition to the existing research and development credit available under the state sales and use tax. The credit is for 7% of qualified research expenses in Ohio, over and above average annual research expenses for the past three years. The credit may be carried forward for seven years. "Qualified research expenses" has the same meaning as in Section 41 of the Internal Revenue Code. The credit is first allowed in taxable year 2002, so that the first fiscal impact would be FY 2003.

LBO's estimates of the revenue impact of the credit are based on extrapolations from state data and from federal data. According to research by the Federal Reserve Bank of Dallas, 21 states currently provide research and development credits, with 18 of them linked to R&D spending levels.[1] The states vary in their application of the credit. Some have caps on the amount that any one firm can claim (e.g. $500,000). Some have caps on the total amount of credit statewide (Pennsylvania limits the credit to $15 million). Some have tiers of credit percentages (Minnesota allows 5% of the first $200 million of qualified spending and 2.5% of spending above $200 million). Finally, 11 states use a fixed base period of 1984-1988 for computing incremental research expenses, the same as for the federal credit.

LBO’s estimates use data from states that have similar credit provisions to those in this bill. Illinois and Missouri probably have the closest structures to Ohio's proposed credit. Both states allow a credit of 6.5% of qualified expenses (Missouri allows no credit for spending that is in excess of double the base amount). Both states use a base period of the 3 preceding years.

[1] Other sources have different tabulations of which states have an R&D credit. Testimony on the bill by a spokesperson for Abbot Labs/Ross Products also put the number of states with an R&D credit at 21, but the list of states was different.

Illinois companies claimed a credit of $35.2 million in FY 1998, while Missouri companies claimed a credit of $16.0 million. Translating these amounts into Ohio equivalents requires adjusting the credit percentage upward to 7%, and also adjusting the credit for the size of the state economy relative to Ohio. As Table 1 shows, if Missouri's experience is adjusted for the difference in credit rates (6.5% vs. 7.0%) and for the difference in size of the state economies, the FY 1998 revenue loss would have been $36.1 million. If Illinois's experience is adjusted for the difference in credit rates (6.5% vs. 7.0%) and for the difference in size of the state economies, the FY 1998 revenue loss would have been $31.1 million. The average of these two estimates is $33.6 million.

Adjusting the Illinois and Missouri information for differences in the size of the state economy, LBO estimates that 125 to 150 corporations would take advantage of the R&D credit.

Table 1 - R&D Credits in Other States as Estimators for Ohio Credit
amounts in millions of $

State	Year Effective	Type	% of expense	Base Period	Data from	Credit Amount	Amount @ 7% credit	State Economy, Relative to Ohio	Ohio Estimate
Illinois	1990	Incremental	6.5%	3 preceding years	FY 1998	$35.2	$37.9	1.22	$31.1
Missouri	1994	Incremental	6.5%	3 preceding years	FY 1998	$16.0	$17.2	0.48	$36.1

LBO also used federal tax data for corporate returns in taxable years 1994 and 1995. This data is not available on a state basis. Instead, the IRS provides data on the amount of the R&D credit claimed nationwide in those taxable years. Since the federal credit is 20% of qualified expenses, LBO worked backward from the credit amount claimed to the amount of qualifying expenses. Allocating a percentage of these expenses to Ohio and applying the 7% credit resulted in an estimated revenue loss of anywhere from $20 million to $34 million. This estimate, of course, could well be somewhat low given that R&D expenditure has grown since 1994-1995.

Based on a combination of the federal and state data, LBO estimates that the tax credit will cost about $35 million annually in lost revenue, beginning in FY 2003. The credit could be bigger, since data from other states suggest that if there had been an Ohio credit in FY 1998 it would have cost around $34 million, and by FY 2003 R&D expenses probably will have grown 15% or more. (The federal data suggest a credit of around $27 million back in FY 1995-1996.) One factor that may limit the revenue loss from the credit is that it is restricted to C-corporations. Another factor is that some corporations that would claim the R&D credit may already be using up most or all of their liability with the existing investment tax credit.

The annual revenue loss of $35 million would be divided as follows:

State GRF - $33.3 million
LGF - $ 1.5 million
LGRAF - $ 0.2 million

Worker Training Tax Credit

The bill creates a non-refundable job training tax credit against the corporate franchise tax. The credit is equal to one-half of the incremental training cost. The incremental cost is defined as the training cost over and above the average training cost for the previous three years. There are several caps on the credit amount. For any corporate taxpayer, the credit is capped at five hundred dollars times the number of employees trained. Furthermore, the credit cannot exceed the lesser of one hundred thousand dollars or one-half of the taxpayer's corporate franchise tax liability. Finally, the statewide credit amount cannot exceed $20 million in any one calendar year, with manufacturing corporations receiving no more than $10 million in credits. At least $5 million in credits must be set aside each year for non-manufacturing corporations with fewer than 500 employees. The first year that the credit would be available is taxable year 2002, so that the revenue impact would not be felt until FY 2003.

The credit is limited to five particular SIC codes or divisions: manufacturing; finance, insurance, and real estate; business services; legal services; and various technical services (SIC Group 87).

LBO's estimate of the revenue impact of the credit is based on extrapolations from data on training credits in other states. Currently, at least ten states offer working training credits. The amount of the credit varies among states. Unfortunately, no other state with available data has a credit that is a close match. Alabama offers a credit of up to $1,000 for training new employees in new skills. Illinois provides a credit of 1.6 percent of worker training cost. Rhode Island offers a credit of 50 percent of training cost that cannot exceed $5,000 per worker in any three years. Many of the programs were enacted in the last few years and data has not been released.

Rhode Island's program cost was $450,000 in its second year (CY97). Ohio's economy (as measured by GSP) is roughly 12 times the size of Rhode Island's. If Rhode Island can be used as a guide, Ohio's new training credit would have an annual cost of about $5 million in its early years. This amount is expected to grow as more companies take advantage of it. LBO estimates that in the early years, 200 to 250 corporations would take advantage of the credit. The $5 million loss in FY 2003 would be divided as follows:

State GRF	- $ 4.76 million
LGF	- $ 0.21million
LGRAF	- $ 0.03 million

Illinois's worker training tax credit currently costs $17.7 million, with about 3,750 corporations taking advantage of it (an average of about $4,700 per participating corporation). It is difficult to compare the proposed Ohio credit with the Illinois credit because the Illinois credit is not incremental. That is, the Illinois credit does not require that training expenses exceed some baseline amount. LBO compared the Illinois and Ohio credits for various hypothetical scenarios. For companies that are increasing their training expenditures, the Ohio credit is more generous than the Illinois credit. Thus, it seems reasonable to assume that if the Ohio credit is successful in encouraging more firms to provide training, or encouraging firms to increase their training budgets, the size of the Ohio credit will eventually approach or exceed the Illinois credit, and bump up against the $20 million cap.

<u>Administrative Costs</u>

The Tax Commissioner is charged with a number of tasks in administering the new worker training tax credit. The Commissioner must prescribe a form for applications, and then review the applications to check the following:

(i) Whether the taxpayer's primary business activity falls into one of the five SIC groupings listed in the preceding section;
(ii) Whether the proposed training program is an eligible training program – does it correct skill deficiencies, does it exclude management, executive, and other prohibited training programs, etc.;
(iii) Whether the proposed training program strengthens the Ohio economy and improves its workforce skills;
(iv) Whether the tax credit is a major factor in the taxpayer's decision to carry out the training program;
(v) Whether the limitations on aggregate credits granted are met.

The Tax Commissioner must also adopt rules to implement the tax credit, and submit a report by March 31st of each year to the Governor, President of the Senate, and Speaker of the House on the status of the training tax credit program for the preceding calendar year. Among other things, the report is to contain an estimate of the impact of the tax credits granted on the Ohio economy.

LBO has not had an opportunity to garner information from the Ohio Department of Taxation in order to estimate the cost of these additional administrative activities. It seems reasonable to assume that three or more additional staffers would be needed to review applications and estimate the economic impacts for the annual report. This means that additional pay and benefit costs would be at least $100,000 per year, and perhaps significantly more.

While the tax credits would not have a revenue impact until FY 2003, since the first taxable year is 2002, the cost increases would first be felt in FY 2002, although there might be only a half-year impact that year.

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