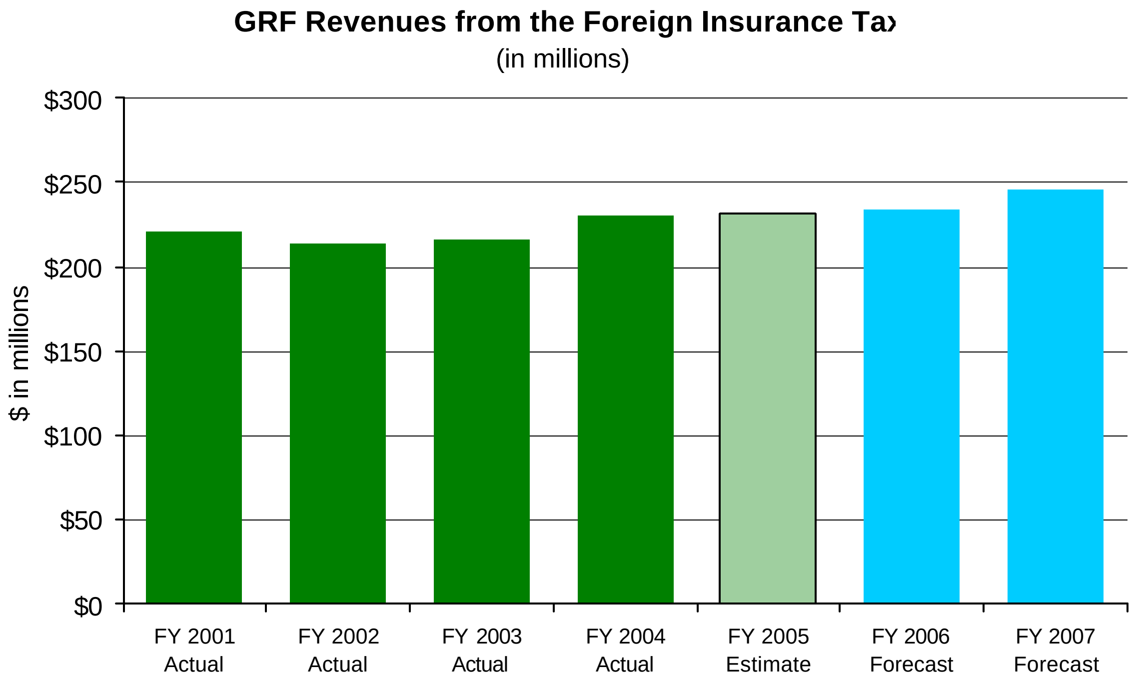
Foreign Insurance Tax



	FY 2001 Actual	FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005 Estimate	FY 2006 Forecast	FY 2007 Forecast
Revenue	$220.6	$214.3	$216.4	$230.5	$232.1	$233.8	$245.5
Growth	-12.6%	-2.8%	0.9%	6.5%	0.7%	0.7%	5.0%

A new tax structure, created by Am. Sub. H.B. 215 of the 122nd General Assembly, was implemented in FY 2003 after a five-year phase-in period. Under the new structure foreign insurance companies, i.e., insurance companies that are headquartered in a state other than Ohio, generally pay a tax of 1.4% of premiums. Foreign insurance companies that are health insuring corporations (HICs) pay a tax of 1.0% of premiums. The new tax structure is the same as the current structure under the domestic insurance tax.

The decreases in revenues from this tax in FY 2001 and FY 2002 are primarily due to the phase-in to the new tax structure. In FY 2002, foreign insurance companies paid a tax of 1.62% of premiums, so that the new rate of 1.4% of premiums represents a straightforward decrease in the tax rate. This decrease is partially offset by an increase in the retaliatory tax that some foreign insurance companies pay. This retaliatory tax rate applies instead of the normal 1.4% rate for any insurance company headquartered in a state that levies a tax rate on Ohio insurance companies higher than the 1.4% that Ohio otherwise imposes on foreign insurance companies. As Ohio lowered the tax rate applied to foreign insurance companies, more of those companies ended up paying the tax at the retaliatory rate. The retaliatory portion of this tax certified to the Treasurer of State increased from $72.4 million in FY 2001 to $112.5 million in FY 2002. This approximately $40 million increase in the retaliatory tax went a long way toward offsetting the reduction in the normal tax rate.

The forecast is based on a combination of regression analysis and trend analysis. Several regression specifications found that revenue under the tax is negatively related to short-term interest rates, specifically to six-month Treasury bill rates. These empirical results confirm the theoretical expectation that rising interest rates increase an insurance company's earnings on investing the premiums it collects, thus allowing the company to generate the same income on lower premium levels. This result is illustrated by recent experience: tax revenues grew at a rate significantly above the long-term growth rate, after adjusting for changes in tax rates, during FY 2002 through FY 2004. The average (adjusted) growth rate in tax revenues from FY 1992 to FY 2004 was 5.0% per year. Adjusted revenue growth in FY 2002 was 10.4%, in FY 2003 growth was 16.8%, and in FY 2004 it was 6.5%. During the corresponding period short-term interest rates fell from 3.3% to 1.1%. Short-term interest rates rose to 1.6% in 2004, and are widely predicted to continue rising in 2005 and 2006. Global Insight, an economic forecasting firm, projects that the six-month Treasury bill rate will rise from 1.6% in 2004 to 3.0% in 2005 and 3.5% in 2006.

Several regression specifications predicted negative growth in revenue under this tax due to the predicted rising interest rates. But aside from the negative growth that accompanied lowering tax rates from FY 1998 to FY 2003, falling revenue under this tax is rare: only two other years saw negative growth between FY 1976 and FY 2004. Due to this feature of historical experience with the tax, the growth rate for FY 2005 and FY 2006 is projected to equal the average growth rate under the tax during the last period of significantly rising interest rates (FYs 1996 - 1998): 0.7%. In FY 2007, as interest rates are predicted to rise more moderately, the growth rate for revenues under the tax is projected to return to its long run average rate of 5.0%.