



**Tax
Committee**
November 3, 2011

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OMA Tax Committee Meeting Sponsor:

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OMA Tax Policy Committee
November 3, 2011

AGENDA

- | | |
|--|---|
| Welcome & Self-Introductions: | Tony Long of Honda of America Manufacturing,
Committee Chair |
| OMA Counsel Report | Mark Engel of Bricker & Eckler, OMA Tax Counsel |
| Ohio Third Frontier | <i>Revisions to Ohio's Economic Development
Investment Fund</i> |
| Legislative Report | Ryan Augsburger, OMA Staff
Don Mottley of Taft/ |
| Special Guest – Tax Study
Committee Findings
(Joining by Phone) | Honorable John Adams (R-Sidney)
House Majority Whip
Chairman, Ohio House Tax Study Committee |
| Special Report – Unemployment
Comp Tax Update | Bruce Madson, Ohio Dept. Jobs & Family Services
Dan Fitzpatrick, Ohio Dept. Jobs & Family Services |

SAVE THE DATE: 2012 Schedule

Thursday, February 16
Thursday, July 19
Thursday, November 15

Committee Meetings begin at 10:00 a.m. and conclude by 1:00 p.m. Lunch will be served.

Register for committee meetings online at www.ohiomfg.com, click on Events.

Additional committee meetings or teleconferences, if needed, will be scheduled at the call of the Chair.

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BRICKER & ECKLER LLP
9277 Centre Pointe Drive
Suite 100
West Chester, Ohio 45069-4891
MAIN: 513.870.6700
FAX: 513.870.6699

www.bricker.com
info@bricker.com

Mark A. Engel
513.870.6565
mengel@bricker.com

Ohio Manufacturers' Association
Tax Policy Committee Tax Counsel Report
November 3, 2011

By Mark A. Engel
Bricker & Eckler LLP

Administrative Actions:

Pursuant to uncodified section 757.42 of H.B. 153 (copy attached), a use tax amnesty for consumers use tax payers took effect October 1, 2011 and will last until May 1, 2013. Highlights of the program include:

- Taxpayer pays all taxes due after January 1, 2009; all criminal and civil penalties and interest are waived.
- A payment plan for up to 7 years is available.
- Any taxes previously assessed do not qualify.
- A person registered to pay use tax prior to January 1, 2011, remains liable for interest and penalty.
- A person who does not qualify for this amnesty may still qualify for relief under the voluntary disclosure program.

A rule has been proposed (O.A.C. 5703-9-69) governing the use tax amnesty payment plans. A copy is attached. A summary of the program in question and answer format has been issued by the Department; a copy is attached.

Legislative Actions:

See Mr. Augsburger's report.

Judicial Actions:

Ohio Supreme Court

In *WCI Steel, Inc. v. Testa*, 129 Ohio St. 3d 256, 2011-Ohio-3280, the Supreme Court ruled that a notice of appeal to the board of tax appeals sufficient specified error if it (i) states the taxpayer's objection to the commissioner's actions and (ii) identified the treatment that the commissioner should have applied. Moreover, the court recognized that since the BTA has a statutory duty to receive additional evidence, evidence that was not submitted to the Tax Commissioner may still be presented in the first instance to the BTA.

In *Plain Local Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, Slip Op. No. 2011-Ohio-3362, the Court held that the BOR and BTA may consider, as evidence, information contained in an appraisal report when the appraiser who prepared the report does not appear to testify before the BOR. In addition, it is also permissible to rely on evidence contained in an appraisal report that determines value for a date other than the tax lien date in issue. Such arguments go to the weight to be afforded to the evidence, rather than to its admissibility.

In *Maralgate, LLC v. Greene Cty. Bd. of Revision*, Slip Op. No. 2011-Ohio-5448, the Court held that a parcel of property that was originally part of a single parcel owned by a family farm and qualifying for CAUV could still qualify for CAUV after it was transferred to another family-owned entity. The parcel would not have qualified by itself, but since its use continued in conjunction with the rest of the land, the Court held that its status could be considered in conjunction with that of the rest of the property.

Ohio Court of Appeals

In *Middletown v. Myers*, 193 Ohio App. 3d 632, 2011-Ohio-2470, the Court of Appeals held that an individual who resided in Middletown and who failed to show that he had another permanent place of residence was domiciled in Middletown for municipal income tax purposes. “Domicil” is that place at which one makes a home for an indefinite period. The taxpayer resided in Middletown and failed to establish another place of residence, therefore, he was found to be domiciled within the city and subject to tax.

Ohio Board of Tax Appeals

No decisions of substance.

The BTA has implemented a small claims process.

Tax Commissioner Opinion

No opinions to report.

Ohio Third Frontier Program

For information about the Ohio Third Frontier Program, please see the attached summary.

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~~5743.026 of the Revised Code.~~

~~SECTION 757.41. Section 757.40 of this act is hereby repealed effective June 16, 2012. The repeal of Section 757.40 of this act does not affect, after the effective date of the repeal, the rights, remedies, or actions authorized under that section.~~

SECTION 757.42. (A) For the purposes of this section:

(1) "Use tax" means a tax levied under Chapter 5741. of the Revised Code.

(2) "Consumer" has the same meaning as defined in section 5741.01 of the Revised Code.

(3) "Audit" has the same meaning as defined in section 5703.50 of the Revised Code.

(B) The Tax Commissioner shall establish and administer a consumer use tax amnesty program independently from the amnesty program established in Section 757.40 of this act with respect to delinquent use taxes that are qualifying delinquent consumer taxes under that section. The program established under this section shall commence on October 1, 2011, and shall conclude on May 1, 2013. The Commissioner shall issue forms and instructions and take other actions necessary to implement the program and may adopt rules to administer the program. The Commissioner may contract with such parties as the Commissioner deems necessary for promotion, computer support, or administration of the program.

(C) If, during the program, a consumer pays the full amount of use tax for which the consumer has outstanding liability on or after January 1, 2009, that has accrued as a result of the consumer failing to pay those taxes in a timely fashion or a failure of the taxes to be remitted in a timely fashion, the Commissioner shall waive or abate all delinquent use tax owed by the consumer before January 1, 2009, and all applicable penalties and interest accrued before and after January 1, 2009. For any consumer that does not participate in the use tax amnesty program under this section, the Commissioner may audit and make an assessment against the consumer for all delinquent use tax due from that consumer on or after January 1, 2008, plus all applicable penalties and interest, as permitted by section 5703.58 of the Revised Code.

(D) As soon as practical after the effective date of this section, the Tax Commissioner shall implement and adopt rules to administer a payment plan program. Upon application by a consumer that participates in the use tax

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amnesty program under this section, the Commissioner may enter into a payment plan with the consumer allowing the participant to pay the amount of use tax owed by the consumer over a time period of up to seven years. If the consumer fails to remit the unpaid use tax or fails to comply with the terms of a payment plan, the consumer is liable for interest, computed at the rate per annum prescribed by section 5703.47 of the Revised Code, on the amount of use tax owed by the consumer and payable under the payment plan, and the Commissioner shall certify to the Attorney General any remaining unpaid amount, including the interest charge, in accordance with section 131.02 of the Revised Code.

(E) A consumer against which the Tax Commissioner has issued an assessment on or before the effective date of this section is not eligible to participate in the use tax amnesty program established under this section.

(F) The Tax Commissioner shall not waive any interest or penalties due on use tax paid as allowed under the amnesty program authorized by this section by a consumer that registered with the Commissioner for the use tax on or before June 1, 2011.

(G) A person who participates in the program and pays the required outstanding delinquent tax in accordance with this section shall not be subject to any criminal prosecution or any civil action with respect to that tax, and no assessment shall thereafter be issued against that person with respect to that tax.

(H) Taxes and interest collected under the program shall be credited to the General Revenue Fund, except that delinquent taxes levied under section 5741.021, 5741.022, or 5741.023 of the Revised Code shall be distributed to the appropriate counties and transit authorities in accordance with section 5741.03 of the Revised Code during the next distribution required under that section.

~~SECTION 757.50. All inheritance tax files that still remain open under temporary order, or otherwise, for which the "ultimate succession" pursuant to former sections 5731.28 and 5731.29 of the Revised Code as those sections existed before their repeal by S.B. 326 of the 107th General Assembly (effective July 1, 1968), relating to the inheritance tax, has not been finalized and have not been submitted to the Department of Taxation as explained below, shall be considered to be closed as of January 1, 2013.~~

~~Notwithstanding the former sections of the Revised Code constituting the Ohio Inheritance Tax as those sections existed before their repeal by that act, all claims and inquiries must be received by the Department of Taxation, or postmarked on or before, December 31, 2012.~~

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Consumer's use tax amnesty payment plan.

(A) House Bill ("H.B.") 153, 129th General Assembly, (uncodified section 757.42) authorizes the Tax Commissioner to enter into a no-interest payment plan with a qualifying taxpayer who elects to participate in the consumer's use tax amnesty established by H.B. 153.

(B) A taxpayer must satisfy the following conditions in order to qualify for a consumer's use tax amnesty payment plan:

(1) The taxpayer must not be registered with the Ohio Department of Taxation for consumer's use tax as of June 1, 2011.

(2) The amount of consumer's use tax due under the taxpayer's amnesty application must exceed \$1,000.

(3) At least one (1) corporate officer, LLC member, general partner or other guarantor ("Guarantor") of the taxpayer must agree to the terms of the payment plan on behalf of the taxpayer, and agree to accept personal liability for the entire debt.

(4) At least one (1) additional Guarantor must agree to accept personal liability for the entire debt. If the taxpayer is a single member LLC no additional Guarantor is required.

(5) Each Guarantor must provide his or her social security number to the Tax Commissioner.

(6) The Guarantor(s) must agree that the Tax Commissioner is not required to pursue the taxpayer for the unpaid balance, including interest and any additional fees, prior to seeking repayment by the Guarantor(s).

(7) The taxpayer must agree that the period in which the Tax Commissioner may assess unpaid consumer's use tax due under amnesty does not expire until six (6) months after the end of the payment plan.

(C) The consumer's use tax amnesty payment plan terms are as follows:

(1) The minimum monthly payment is \$1,000. The initial monthly payment must be submitted with the amnesty application.

(2) The maximum term of a consumer's use tax amnesty payment plan is seven (7) years (84 months).

(3) The taxpayer must return the fully executed consumer's use tax amnesty payment plan agreement to the Tax Commissioner within 15 days after receipt.

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(4) The taxpayer must make each payment due under the consumer's use tax amnesty payment plan on or before the first business day of each month.

(D) If the taxpayer misses a monthly payment, fails to return a fully executed copy of the consumer's use tax payment plan agreement, or fails to remain current with all Ohio tax obligations, the Tax Commissioner will notify the taxpayer of such default ("Default Notice") via U.S. mail or a similar method of delivery. The taxpayer will have 15 days from the date of the Default Notice to provide documentation establishing that the disputed payment was made, the fully executed Agreement has been returned, or that the taxpayer is current with all of its Ohio tax obligations. If within the 15-day period the taxpayer fails to provide such documentation, the Tax Commissioner may assess the taxpayer and each Guarantor for the entire outstanding consumer's use tax balance, including interest. Interest will be calculated from the date the tax was required to be paid. Any assessment issued for amounts due under consumer's use tax amnesty will be immediately certified to the Ohio Attorney General for collection and may be subject to any and all costs and additional fees assessed by the Attorney General.

(E) In the event that the taxpayer fails to comply fully with the terms of the consumer's use tax payment plan agreement, each Guarantor shall be personally liable for the unpaid balance, including interest and any additional fees that may be incurred as a result of the taxpayer's default.

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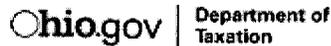
Effective:

R.C. 119.032 review dates: Exempt

Certification

Date

Promulgated Under: 5703.14
Statutory Authority: 5703.05
Rule Amplifies: none



1. [What is Consumer's Use Tax?](#)
 2. [What are the steps to request amnesty?](#)
 3. [What Consumer's Use Tax periods should be included in my amnesty application?](#)
 4. [What if I don't qualify for Consumer's Use Tax amnesty?](#)
 5. [What are the advantages of amnesty?](#)
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 8. [What happens if I apply for amnesty but don't qualify?](#)
 9. [Is there a payment plan available?](#)
 10. [Can you provide examples of how to calculate payments under the payment plan?](#)
-

General Information

1. What is Consumer's Use Tax?

Consumer's use tax must be paid on all taxable purchases of tangible personal property or services used, stored or otherwise consumed in Ohio unless Ohio sales tax has been paid to a vendor or the tax has been properly paid to another state. In general, if you have paid Ohio sales tax on the purchase of tangible personal property or a taxable service, you do not owe consumer's use tax on that transaction. Examples of tangible personal property subject to use tax are computer equipment, printers, fax machines, office supplies (paper, envelopes, folders, pens, paper clips, etc.), furniture and cleaning supplies (mops, brooms, cleaners, paper towels, etc.). Consumer's use tax is also due on the use of taxable services in Ohio. Examples of taxable services include, but are not limited to, installation, repair, employment services (temporary labor), automatic data processing, janitorial and maintenance services, storage services and maintenance contracts. The Ohio Department of Taxation ("ODT") has developed a series of fact sheets to further explain use tax and how use tax commonly applies to certain types of businesses such as construction contractors, manufacturing, retail and service-related enterprises. The fact sheets can be found at the bottom of this page.

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2. What are the steps to request amnesty?

Step-by-step guides to request amnesty:

- [If you were registered as of or prior to June 1, 2011](#)
- [If you were never registered or registered after June 1, 2011](#)

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3. What Consumer's Use Tax periods should be included in my amnesty application?

Consumer's use tax due on purchases made on or after January 1, 2009 should be included in your amnesty application. However, if you have been issued an assessment for consumer's use tax due for any period, you are not eligible for amnesty. You can apply for consumer's use tax amnesty only once during the program.

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4. What if I don't qualify for Consumer's Use Tax amnesty?

Taxpayers who do not qualify for consumer's use tax amnesty may still qualify for ODT's Voluntary Disclosure Program. For more information on voluntary disclosure, please scroll down to the bottom of this page. However, if you qualify for consumer's use tax amnesty, you are not eligible for voluntary disclosure for consumer's use tax.

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Qualifications

5. What are the advantages of amnesty?

The Tax Commissioner will waive all use tax liability that has not been assessed for any periods prior to January 1, 2009. Consumer's use tax paid under amnesty is not subject to interest or civil or criminal penalties. However, if you are registered for Ohio use tax as of or prior to June 1, 2011, you will be required to pay interest on any under-reported or unreported consumer's use tax.

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6. Am I required to pay tax for past periods?

Yes. You must make a nonrefundable payment of all consumer's use tax due on purchases made on or after January 1, 2009 through the last day of the month preceding the month in which you request amnesty. You will also be required to register for consumer's use tax and may be required to file returns on an ongoing basis. Even if you are not required to file use tax returns on a regular basis, you still must report and pay consumer's use tax on your annual personal income tax return (e.g., Schedule C filers), Form IT1040, or via a Use Tax Voluntary Payment Form VP-Use. Both forms are available on ODT's Web site.

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7. Is the information I submit under amnesty subject to review?

The Tax Commissioner reserves the right to review the documentation provided under amnesty and any other records that support the amnesty submission in order to confirm that the amount of the amnesty payment accurately reflects your consumer's use tax liability.

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8. What happens if I apply for amnesty but don't qualify?

If you apply for amnesty but ODT determines that you don't qualify because of a prior consumer's use tax assessment or prior consumer's use tax amnesty submission, ODT will issue an assessment for the balance of your consumer's use tax liability, plus interest. Any payment submitted with your application will be applied to your consumer's use tax liability. A payment plan is not available to consumers who do not qualify for amnesty.

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Payments / Refunds

9. Is there a payment plan available?

A no-interest payment plan is available to businesses that were not registered for consumer's use tax as of or prior to June 1, 2011. In order to qualify for a payment plan, the amount of consumer's use tax due under amnesty must exceed \$1,000. The length of the payment plan will be determined by the total consumer's use tax liability and the payment period cannot exceed 7 years (84 months). Further, a minimum payment of \$1,000 per month is required. If you request a payment plan:

1. At least one corporate officer, LLC member, general partner or other guarantor ("Guarantor") must agree to the terms of the payment plan on behalf of the business and agree to accept personal liability for the entire debt; and
2. One additional Guarantor must agree to accept personal liability for the entire debt. If the business is a single member LLC, no additional Guarantor is required. In lieu of Guarantor (s) a taxpayer may provide a surety bond, an irrevocable letter of credit or other security acceptable to the Tax Commissioner equal to the total consumer's use tax liability due under amnesty plus twenty percent (20%). The surety bond, irrevocable letter of credit or security must be in effect for the entire length of the payment plan.

Guarantors signing the payment plan agreement must provide his or her social security number on the payment plan agreement. Further, the business must waive the statute of limitations for assessment of the consumer's use tax due under the payment plan. The first month's payment must be remitted at the time you submit your amnesty application.

The proposed rule for the use tax amnesty payment plan has been filed with the Joint Committee on Agency Rule Review (JCARR). Comments on the rule can be submitted to Taxation via e-mail.

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Special Circumstances

10. Can you provide examples of how to calculate payments under the payment plan?

The formula for calculating the monthly payment under the payment plan is:

1. If amount due is \$1,000 or less—the full amount must be paid with the amnesty application.
2. If amount due is \$84,000 or more—Total Amount Due Under Amnesty/84 months; or
3. If amount due is more than \$1,000 and less than \$84,000—the monthly payment is \$1,000.

Here are some examples:

Example 1—Total use tax liability is \$10,000. Since the minimum payment is \$1,000, the monthly payment is calculated by dividing \$10,000 by \$1,000, or \$1,000 per month for 10 months.

Example 2—Total use tax liability is \$126,000. Since the maximum payment period is 84 months, the monthly payment is calculated by dividing \$126,000 by 84 or \$1,500 per month for 84 months.

Example 3—Total use tax liability is \$1,000 or less. Since the minimum payment is \$1,000, the full amount due must be remitted with the amnesty application.

Example 4—Total use tax liability is \$1,700. The first payment is \$1,000 and second payment is \$700. For amounts not evenly divisible by 1,000, the final payment will be the remaining amount due.

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DRAFT- NOT FOR FILING

5717-1-25. Small claims division

(A) The following appeals shall be assigned to the small claims division:

(1) Appeals from a decision of a county board of revision involving real property that is not intended primarily for use in a business activity, that are commenced under section 5717.01 of the Revised Code and in which the property at issue qualifies for the partial tax exemption described in section 319.302 of the Revised Code;

(2) Appeals from a decision of a municipal board of appeal or from a final determination by the tax commissioner, if the amount in controversy as stated on the face of the notice of appeal does not exceed ten thousand dollars exclusive of interest and penalty, that are commenced under section 5717.011 or 5717.02 of the Revised Code.

(B) An appeal that is initially assigned to the small claims division shall be reassigned to the regular docket if either of the following applies:

_____ (1) A party requests the reassignment; or

_____ (2) The appeal presents a constitutional issue or an issue of public or great general interest.

(C) Proceedings in the small claims division shall be conducted in an informal manner and shall proceed on an expedited basis. Proceedings in the small claims division shall be governed by this chapter, except as follows:

_____ (1) No discovery under rule 5717-1-11 of the Administrative Code shall be permitted except by leave of the board;

_____ (2) No briefs may be submitted by any party except by leave of the board;

_____ (3) No case management schedules may be requested under rule 5717-1-07 of the Administrative Code.

(D) Appeals assigned to the small claims division may be resolved by mediation among the parties pursuant to rule 5717-1-21 of the Administrative Code.

Promulgated under: R.C. 5703.14

Statutory authority: R.C. 5703.14, 5703.02

JULY 2011

HB 153 Biennial Budget Bill (2012-2013) - Key Economic Development Budget Bill Provisions

H.B. 153, Ohio's budget bill for the 2012-2013 fiscal biennium, contains a number of statutory revisions that impact economic development. The bill creates new tax exemptions, credits and grant programs as well as extends some existing tax exemptions or credits, and enacts a number of new tax breaks. At the same time, the bill contains no tax rate increases. This bulletin will summarize the many substantive changes made by the bill that may impact economic development efforts in Ohio.

Grants & Credits

- **Section 122.171 – Expansion of the Refundable Job Retention Tax Credit Program.** Expands the refundable job retention tax credit program to include companies that employ at least 500 full-time equivalent employees and companies that have an annual payroll of at least \$35 million.
- **Section 122.171 – Expansion of a Non-Refundable Jobs Retention Tax Credit.** Expands the non-refundable jobs retention tax credit program to permit the Ohio Tax Credit Authority, between July 1, 2011, and December 31, 2013, to issue tax credits to businesses that (i) retain at least 500 full-time equivalent employees and an annual payroll of at least \$20 million, or (ii) maintain an annual payroll of \$30 million; (iii) that invest at least \$5 million at a project site in the same jurisdiction where its principal place of business is located during a period of three consecutive calendar years, including the calendar year that includes a day of the taxpayer's taxable year or tax period with respect to which the credit is granted, and (iv) that meet other existing requirements. The

aggregate amount of tax credits that may be issued between July 1, 2011 and June 30, 2013 cannot exceed \$25 million.

- **Section 122.175 – Creation of a Data Center Sales and Use Tax Exemption.** Creates a new sales tax exemption for equipment used in the operation of a computer data center business. The business must make a capital investment of at least \$100 million in Ohio, during a period of three consecutive calendar years, and must maintain annual payroll for employees involved in the investment project of at least \$5 million for the entire term of the credit. Application must be made to the tax credit authority, which may authorize a partial or full exemption (100%) for the project.
- **Section 122.76 – Removal of the Minimum Financial Institution Percentage from the Minority Business Loan Program.** Revises R.C. 122.76, which allows the director of development, with controlling board approval, to lend funds for the purpose of procuring or improving real or personal property to minority business enterprises, community improvement corporations, Ohio development corporations, minority contractors business assistance organizations and minority business supplier development councils that predominantly benefit minority business enterprises (or are located in a census tract that has a population that is sixty per cent or more minority), to remove the requirement of bank or governmental financing of at least 30% of the total project cost.
- **Sections 122.86 and 5747.81 – Creation of the InvestOhio Program.** Creates a non-refundable

Bricker & Eckler LLP
100 South Third Street
Columbus, Ohio 43215-4291

614.227.2300 Main
614.227.2390 Fax
www.bricker.com
info@bricker.com

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personal income tax credit program for persons investing in a small business enterprise with an operating presence in Ohio. A “small business enterprise” is one having assets of less than \$50 million, or annual sales less than \$10 million. Eligible investments must be made on or after July 1, 2011, must be used to acquire a direct or indirect equity interest in the enterprise, and must be held for at least 2 years if made before July 1, 2013, and 5 years if made after that date. The maximum an individual may invest in any fiscal biennium is \$10 million, and the credit is 10% of the amount invested. During any fiscal biennium, small business investment certificates cannot be issued by the Department of Development that would cause the credits claimed for any biennium to exceed \$100,000,000. Any unused credit may be carried forward seven taxable years.

- **Section 149.311 – Extension of the Ohio Historic Preservation Tax Credit Program.** The tax credit for the rehabilitation of an historic building, set to expire July 1, 2011, was made permanent. There is an aggregate limit of \$25 million for such credits during each fiscal biennium. Also, R.C. 5725.34 and 5729.17 were amended so that foreign and domestic insurance companies are added to the taxpayers eligible for the credit. The department of development may charge reasonable fees to administer the law and permits the director to rescind an application where the applicant has failed to obtain the necessary funding within 18 months of being approved for the credit. Recipients are required to repay amounts received if the project is not completed. Various other procedural changes are also made. The revisions to the Ohio Historic Preservation Tax Credit program have an immediate effective date.
- **Sections 5709.40, 5709.41, 5709.73, 5709.78, 5709.82, 5709.83 – Requirement for Compensation Payments to Joint Vocational School District for Tax Increment Financing Arrangement at Same Rate and Term as City, Local or Exempted Village School District.** Any municipality, county or township that implements a tax increment financing (TIF) program and enters into an agreement with the affected city, local, or exempted village school district to compensate that district for all or a portion of the tax revenue that such school district would have received, but for the TIF, must also compensate the affected joint vocational school district at the same rate and term. The affected joint vocational school district is also required to receive notice of the proposed TIF program in the same manner as the city, local, or exempted village school district.
- **Sections 5709.62, 5709.63, 5709.632 – Extension of the Enterprise Zone Program.** The enterprise zone (EZ) program, which was set to expire on October 15, 2011, was extended to October 15, 2012.
- **Section 5733.351 – Amends Definition of “Eligible Entities” for Purposes of the “Qualified Research Expenses Tax Credit Program” to Include Insurance Companies.** The corporation franchise tax credit for research expenses incurred by one or more members of an affiliated group was revised to permit the inclusion of an insurance company in the group, even though insurance companies are not subject to the franchise tax. Uncodified bill Section 757.93 states the change is a clarification of existing law.
- **Section 122.121 – Delays the Effective Date of the Sports Incentive Grant Program until July 1, 2013.** The Sports Incentive Grant Program allows a municipality or county to apply for a grant from the Ohio Department of Development of up to \$500,000 to utilize in the preparation for and presentation of specified sporting events and related activities, provided that the event is anticipated to generate in excess of \$250,000 in incremental sales tax revenue. The grant program has a yearly fiscal cap of \$1,000,000. The commencement of the program, which was scheduled to begin July 1, 2011, was delayed until July 1, 2013.
- **Section 122.861 – Creates a Diesel Emissions Reduction Grant and Revolving Loan Program.** For purposes of reducing emissions from diesel engines, R.C. 122.861 authorizes Ohio’s director of environmental protection to make grants and loans for projects relating to certified engine configurations and verified technologies in a manner consistent with the requirements of Section 793 of the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 841, et seq., and any regulations issued pursuant to that Section. The bill transfers

authority to administer the program from the Department of Development to the state Director of Environmental Protection.

Prevailing Wage

- **Section 166.02 – Removes Prevailing Wage Requirements for Guarantees and Loans in R.C. 166.06 and 166.07.** The Bill removes the requirement that projects utilizing financial assistance from programs created from R.C. 166.06 and 166.07 must pay laborers and mechanics employed on the project the prevailing rate of wages under Chapter 4115.
- **Section 1728.07 – Exempts a Community Urban Redevelopment Corporation (CURC) from the Prevailing Wage Requirement.** Community Urban Redevelopment Corporations are exempted from paying laborers and mechanics employed on the CURC projects the prevailing rate of wages under Chapter 4115.
- **Section 4115.04 – Exempts Public Improvements Undertaken by a Port Authority from Paying Prevailing Wages.** Port Authorities are exempt from the prevailing wage requirements of R.C. 4115.03 to 4115.16 for public improvements undertaken by, or under contract for, a port authority as defined in Section 4582.01 or 4582.21 of the Revised Code.
- **Section 4582.12 – Exempts a Port Authority Project from Paying Prevailing Wages.** Port Authorities are exempt from the prevailing wage requirements when the port authority elects to construct a port authority facility.

Tax Exemptions

- **Section 5727.75 – Extends the Date for Filing a Property Tax Exemption by a Qualified Energy Project until December 31, 2013.** The exemption for qualified alternative energy projects in R.C. 5727.75 was extended for two years. Application for exemption must be made by December 31, 2013; construction on the facility must begin before January 1, 2014, and the facility must be in operation by January 1, 2015.
- **Section 5751.01 – Exempts Uranium Enrichment from the Commercial Activity Tax.** An exclusion from “gross receipts” was added to the Commercial Activity Tax for receipts from transactions involving uranium in a designated uranium enrichment zone in Ohio. The owner or operator of the facility must apply for a certificate in order to claim the exclusion. If the application is denied, the denial may be appealed to the board of tax appeals, in which case the applicant must maintain certain tax records until the appeal is resolved.
- **Section 5731.02 – Repeal of the Estate Tax.** The Estate Tax was repealed for the estate of individuals dying on or after January 1, 2013.

The Ohio Historic Preservation Tax Credit provision is effective immediately. The remaining provisions become effective 90 days after the bill was signed by the Governor on June 30.

Please contact Mark Engel at mengel@bricker.com or 513.870.6565 if you have any questions or would like more details about these provisions.

THE BRICKER & ECKLER ECONOMIC DEVELOPMENT TEAM:

Attorneys:

John Caleb Bell
614.227.2384
jbelle@bricker.com

Mark A. Engel
513.870.6565
mengel@bricker.com

Price D. Finley
614.227.8897
pfinley@bricker.com

M. Shannon Martin
513.870.6692
smartin@bricker.com

Public Finance and Economic Development Specialist:

Quinten L. Harris
513.870.6574
qharris@bricker.com

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Ohio Third Frontier Program

Overview

Created in 2002, the Ohio Third Frontier is an unprecedented commitment to create new technology-based products, companies, industries and jobs. In May, the Ohio Third Frontier was extended through 2015

The \$2.3 billion initiative supports applied research and commercialization, entrepreneurial assistance, early-stage capital formation, and expansion of a skilled talent pool that can support technology-based economic growth. The Ohio Third Frontier's strategic intent is to create an "innovation ecosystem" that supports the efficient and seamless transition of great ideas from the laboratory to the marketplace.

The investment of Ohio Third Frontier resources is guided by the following strategic goals:

In targeted areas of technology, the Ohio Third Frontier is catalyzing the growth of existing and emerging industry clusters by:

- Increasing the quantity of high-quality research that has commercial relevance to Ohio companies
- Expanding access and availability of investment capital to create, grow, and attract technology-based enterprises
- Growing and nurturing an increasingly experienced pool of entrepreneurial management talent
- Addressing the technical needs of existing companies pursuing new products and production processes
- Contributing to the expansion of a technologically proficient workforce

The Ohio Third Frontier supports a comprehensive portfolio of program activities that include:

Value Chain Development

Advanced Energy Program to support R&D that addresses the technical and cost barriers to commercialization in Ohio of advanced energy components and systems, with preference to wind, biomass, and energy storage.

Advanced Materials Program to support R&D that addresses the technical and cost barriers to commercialization in Ohio of advanced materials products with preference to polymer and carbon nano-materials, liquid crystals, and bio-based materials.

Biomedical Program to support R&D that addresses the technical and cost barriers to commercialization in Ohio of biomedical products, with preference to cardiovascular, regenerative medicine, and orthopedics.

Fuel Cell Program to support R&D that addresses the technical and cost barriers to commercialization in Ohio of fuel cell and other advanced energy components and systems.

Innovation Ohio Loan Fund to assist Ohio companies in developing next generation products and services in targeted industry sectors by financing the acquisition, construction, and related costs of technology, facilities, and equipment.

Medical Imaging Program to support research and development that addresses the technical and cost barriers to commercialization in Ohio of medical imaging components and systems.

Ohio Research Commercialization Grant Program to support accelerated Ohio commercialization by small companies awarded selected federal R&D funding.

Photovoltaic Program to support R&D that addresses the technical and cost barriers to commercialization in Ohio of photovoltaic components and systems.

Sensors Program to support research and development that addresses the technical and cost barriers to commercialization in Ohio of sensors components and systems supporting key Ohio industries.

Targeted Industry Attraction Grants to focus resources and incentives on the attraction of companies that can help build critical mass in selected growth industries in Ohio.

(NEW) JobsOhio Network Program to support and leverage the retention, expansion and recruitment of businesses and industries with high potential for job and wealth creation in Ohio. Increase the technical capabilities and business competencies of Ohio value chains within key existing and emerging driver industries and pursue targeted attraction to fill gaps

(NEW) Commercial Acceleration Loan Program to increase the technical capabilities and business competencies of Ohio value chains within key existing and emerging driver industries and pursue targeted attraction to fill gaps.

- \$25 Million dollars
- Up to 50% of project cash costs;
- Deferred principal and/or interest options;
- Working capital eligible;
- For-profit companies in targeted industries;
- Different loans/terms for different opportunities;
- Validated market demand through IOLF, OTF Investment Forum, Battelle forums, staff survey;
- Invest in projects moving products/services into meaningful market entry:
 - Commercial scale demonstrations in market use conditions;
 - Manufacturing scale-up beyond pilot plant;
 - Final customer validation, product certification, and/or regulatory certification;
 - Acquisition of exclusive IP rights;
 - Launch of next generation of an existing product, service, or process;
 - Design engineering/packaging.
- **3 Commercial Acceleration Loan Funds:**

New Venture Loans - \$500k - \$1 M per loan

- Professional venture/smart money backed co.;
- Balloon loan w/ less than market rate interest;
- Warrant provision;
- 25% forgivable for successful completion and another 25% forgivable / sales of \$1 M and significant market entry.

Venture/Non-venture Loans - \$500k - \$2 M per loan

- Targeted to small, post revenue co. w/ existing product/service on market;
- Near to market project w/ high sales potential;
- Revenue participation note, deferred payments w/ min./max. payback;
- 25% forgivable w/ sales of \$1 M and another 25% forgivable w/ sales \$2 M+, and significant market entry at each milestone.

Non-venture Loans - \$500k - \$3 M per loan

- Targeted to small to established company w/existing product/service on market;
- Near to market project w/ strong financial backing;
- Loan will support up to 25% of the project;
- 5% annual interest, due monthly, principal deferred during project period.

Entrepreneurial Services

Entrepreneurial Signature Program to establish robust networks of entrepreneurial services and capital within six geographies to accelerate the growth of early-stage Ohio technology companies.

Capitalization Program (4 Stages):

(NEW) Micro Fund

- \$1 M dollars
- Up to \$100k per fund (non-profit);
- Investments from \$5k to \$25k;
- Non-profit organizations that have not received other state TBED assistance;
- Plan for sustainability including objectives and milestones;
- Incentive to encourage creative entrepreneurial efforts that are spontaneously arising at the community level.

Pre-Seed Fund Capitalization Program to increase the availability of professionally managed capital and associated services to accelerate the growth of early-stage Ohio technology companies.

- \$25 M dollars
- \$500K to \$2M per fund;
- Cash match 1:1.

Seed Fund Capitalization Program

- Investments from \$1M to \$4M

(NEW) Growth Fund

- \$10 M dollars
- \$5 M per fund;
- Private Cash Match 1:3;
- SBA Cash Match 1:8 (2x total fund);
- SBIC Impact Fund opportunity:
 - Invitation by SBA to participate;
 - \$200M per year available as fund leverage;
 - 2x leverage for total fund;
 - \$60M Fund:
 - \$5M State Investment;
 - \$15M Private Capital;
 - \$40M SBIC Leverage.

*SBIC Impact Fund targets energy, education and low to moderate income areas.

Funds must deploy 50% of capital to these targets.

Talent

Internship Program to provide Ohio businesses with technically trained students in targeted areas and allow students to explore career opportunities within Ohio.

- \$3 M
- Up to \$3,000 per internship;
- For-profit companies;
- Deployed through seven regional non-profit partners.

**Reorganized program began deploying FY 2011 funding of \$2.25 beginning in summer quarter 2011*

**FY 2012 funding will be awarded for deployment well before the summer internship season 2012*

(NEW) The ONE Fund aims to aggressively recruit young entrepreneurs to Ohio to work under the guidance of seasoned entrepreneurs, industry experts, and investors to launch a new business venture.

- Attract and retain entrepreneurial talent in Ohio by directing resources to accelerate the formation and development of companies;
- Assist young companies in attracting follow-on investment;
- Foster a culture of entrepreneurship, and raise visibility and excitement about entrepreneurship in Ohio.

Pilot Accelerator

Collaboration with OSU Center for Entrepreneurship 10-Xelerator (10x) for pilot accelerator:

- First 10x class graduated on September 1, 2011 with "Showcase Day".

- Second 10x class starting in winter 2012.

ONE Fund Accelerators:

\$1.6 M

Funding for up to 4 Accelerators;

12 Statements of Interest received to date.

ONE Fund Start-Up Events:

\$0.1 M

- 5-10 Start-Up Events;
- Sponsor high-profile prize-based start-up weekends and other events;
- Bring together broad range of new and established entrepreneurs, industry professionals, students and investors.

Open Innovation

Industrial Research and Development Center Program to make Ohio organizations more competitive for the attraction of major corporate, non-profit or federal research and Development centers.

Innovation Platform Fund to support near term commercialization projects requiring major capital acquisitions and improvements at Ohio higher education institutions and nonprofit research organizations with a secondary benefit to support technical workforce training. This Program is formerly known as the Wright Projects Program.

Ohio Technology Validation and Start-up Fund to create greater economic growth in Ohio based on start-up companies that commercialize technologies developed by Ohio institutions of higher education.

Ohio Research Scholars Program, in partnership with the Ohio Board of Regents, to attract leading research talent that can contribute to the growth of research centers of excellence within Ohio's academic institutions that support economic development priorities of the state.

Research and Commercialization Program to advance scientifically unique applied research projects that can sustain the development of new, innovative products within three years.

Wright Centers of Innovation to establish large-scale, world-class research and technology development centers designed to accelerate the pace of Ohio commercialization.

Leading Industry Sectors:

Based on a Battelle Study, these are the leading and emerging areas that the 3rd Frontier Board and Commission will focus their time, effort and resources promoting:

- **Advanced Materials**
- **Software Applications for Business and Healthcare**
- **Fuel Cells and Energy Storage**
- **Medical Technology**
- **Aero-Propulsion Power Management**
- **Sensing & Automation Technologies**
- **Situational Awareness and Surveillance Systems**
- **Solar Photovoltaics**

The Future Direction of the Ohio 3rd Frontier Program:

- A portfolio of activities that emphasizes economic outcomes in the 3-5 year timeframe;
- Updated assessment of major Ohio market opportunities and sharper focus on six key industries in which significant growth can be catalyzed with OTF investments, integrated with state's overall economic development strategy;
- Identification of some potential large game-changing investments that can be pursued in the next five years;
- Explore funding alternatives [to grants] that shift more risk to award recipients and generate some direct return back to OTF for future investments;
- Metrics that improve ability to make ROI-based decisions and track success in those terms.

Pursued Outcomes of the 3rd Frontier Program:

- Produce a high level of economic return for the state in quality jobs, company growth, and wealth creation;
- Attract companies, talent and capital to Ohio;
- Create sustainable engines of economic development activity in key areas of technology and industry strengths;
- Reduce the risk of pursuing entrepreneurial, innovation and development activities in Ohio;
- Sustain best practices and relationships that lead to efficient commercialization;
- Increase the visibility and reputation of Ohio as an innovation and entrepreneurial destination.

3rd Frontier Financial Resources over the next several years:

- All OTF program funding from a single source, Third Frontier Research and Development Fund (voter-approved bonds):

Appropriation Amounts			
FY 12	FY 13	FY 14	FY 15
\$225 M*	\$175 M	\$175 M	\$175 M

*\$200 M available for new program awards in 2012

- 2012's Budget is \$200 million and will be disbursed in the following manner (with \$14.4 million unallocated):

Entrepreneurial Support	Value Chain Development	Open Innovation	Talent	Total
\$77.7 M	\$39.9 M	\$65 M*	\$3 M	\$185.6M
42%	21%	35%	2%	100%

*Includes \$8 M Research Incentive budget item

Public Policy Report**PUBLIC POLICY REPORT – Tax Policy**

TO: OMA Tax Policy Committee
FROM: Ryan Augsburger, OMA Staff
DATE: November, 2011
SUBJECT: TAX POLICY HIGHLIGHTS

Overview

Following completion of the main operating budget in June, only a House legislative study committee has been active. The November 8 General Election has dominated statehouse activity since last meeting.

State Issue 2 addresses state and local government service labor contracts and if not approved by voters may force budget corrections. A few bills are being considered, mostly in the House.

State Budget and Financial Condition

Tax and other revenue collection was \$19.5 million or 0.8% above estimates in September. State revenue collection is down \$36 million or 0.5% year to date. While collections are running at estimated levels, year to date figures are nearly 10% better than 2010. The largest contributions to this year-over-year growth were non-auto sales tax, personal income tax, and the commercial activities tax.

Administration officials have hinted that Governor Kasich may want to revise the budget (mid-term) to institute another rounds of cuts.

Estate Tax Repeal

The Estate Tax was repealed as a rider to the state budget with a 2013 effective date so it will not shortchange revenue collection in the FY12, FY13 biennium. The OMA advocated in support of repeal. See enclosed Wall Street Journal column referencing OMA member Summitville Tiles, Inc.

House Study Committee

Beginning in late August a legislative study committee met numerous times to hear learn about tax policy. OMA Tax Counsel Mark Engel of Bricker & Eckler appeared before the panel on behalf of the OMA (see testimony included in packet). He focused comments on the importance of the package of reforms, enacted in 2005. Most state representatives were not in the General Assembly during the reforms. Mark cautioned lawmakers about the importance of maintaining a broad base, in order to maintain the low rate. The committee is charged with looking at the CAT, considering the sales and use tax, and considering tax expenditures.

Over a dozen industries or companies have appeared before the committee asking for special treatment (exemption) from the CAT. A number of local government leaders are also appearing to express opposition to a rumored legislative proposal to consolidate municipal tax collection at the state level. Also see study committee presentation materials by Department of Taxation Deputy Director, Fred Church.

Unemployment Compensation

Like many states, Ohio's fund to pay unemployment compensation claims was depleted in early 2010. The state has borrowed federal funds (\$2.3 billion) that will need to be paid back. States are required to begin paying interest by September 2011 (nearly \$300 in interest alone in the 2012/13 biennial budget).

The OMA has signed on with other business groups in urging the federal government to provide greater flexibility for states to repay the debt. Eventually Ohio employers could see a premium increase to repay the federal loans and restore the state fund, probably coupled with benefit cuts. In the short term, the state budget appropriated funds to meet the interest payments that come due on Sept 30. This is a positive development for employers. See enclosed report by the tax foundation.

JobsOhio and Third Frontier

House Bill 1 / Senate Bill 1 created a non-profit corporation called JobsOhio to coordinate state economic development activity. The corporation is headed by a board of directors and chaired by the Governor. A series of informational presentations was held around the state recently. Also impacted was the eligibility criteria for popular Third Frontier Funds. See enclosed information on Third Frontier.

Tax Management

Businesses Face Higher Unemployment Taxes

In a background paper on unemployment insurance, the Tax Foundation studied states like Ohio that have exhausted their funds for paying unemployment benefits and "may soon face a financial crisis without significant reform to the system."

Their study, **Unemployment Insurance Taxes: Option for Program Design and Insolvent Trust Funds**, serves as a primer for an important but complex system and as a roadmap for how to improve it. The study includes state-by-state rankings on unemployment insurance program structure, funding, and other metrics. Ohio's outstanding federal loans as of September, stood at \$2.61 billion.

10/21/2011

OMA To Lawmakers: Preserve Tax Reform

OMA Tax Counsel **Mark Engel** of Bricker & Eckler LLC this week told a panel in the Ohio House of Representatives to hold the line on the broad-base, low-rate commercial activity tax (CAT). Dozens of other business interests have told the lawmakers that their business or industry is harmed by the CAT and are seeking exemption. Pharmaceutical distributors, retailers, grain elevator operators, and gas stations are among the parties protesting the "unfair" burden imposed on them by the CAT.

In his **testimony** on behalf of the OMA, Engel said, "The solution isn't a tax system made of Swiss cheese; we tried that already, and it didn't work. Hold fast to a broad-based, low-rate tax that is simple to enforce and simple to follow, and that treats all taxpayers the same."

Last week, Cleveland State University Dean Edward "Ned" Hill made a presentation to the committee on the economic benefits of the tax reforms enacted in 2005.

09/23/2011

More Small Business Loans Available

The federal government recently approved the next wave of funds, \$767 million, to community banks for making commercial and industrial loans. The development is part of the Small Business Jobs Act enacted last year which set aside \$30 billion for this purpose. Manufacturers worked in support of the creation of this program.

Read more in the **PMA / NTMA One Voice**.

09/16/2011

OMA Recognized for Estate Tax Repeal

Earlier this year, state leaders repealed Ohio's estate tax as an amendment to state budget legislation. Abolishing the tax had been an OMA priority for many years because the tax served as a deterrent to necessary re-investment by family-owned businesses. **The Wall Street Journal** chronicled the historic development. The OMA worked together with



other supporter organizations including Citizens United to End Ohio's Estate Tax.

Pictured is the OMA's Ryan Augsburger, Ron Alban and Jack Boyle of Citizens Untied to End Ohio's Estate Tax, and OMA President Eric Burkland.

09/09/2011

House Panel Considers State Tax Policy

The Ohio House of Representatives this week began a series of "study committees" with a panel to examine the state's tax structure.

Deputy Ohio Tax Commissioner Fred Church said the goal of the tax reform of 2005 was to create a broad-based, low-rate business tax to replace the corporate franchise and tangible personal property taxes and to lower the personal income tax rate. Church testified that the new "tax was designed to benefit

manufacturing, creating a favorable 'platform for production' in Ohio."

"Fred's **presentation** described accurately how the significant tax reforms have dramatically improved Ohio's tax climate," commented the OMA's Ryan Augsburger.

A threat to Ohio's manufacturing-friendly state tax policy is special interest lobbying to obtain tax exemptions, which erode the tax base. A witness representing gas station/convenience store operators testified that the industry should be exempted from the tax. There'll be more of this coming from other groups as the study committee continues its hearings.

08/26/2011

State Outlines New Economic Development Apparatus

The Kasich administration this week **unveiled details** about the state's new way of working with businesses to promote their growth and attract new investment in Ohio. To date, the functions of economic development have been shepherded by the Ohio Department of Development; however, with the passage of the JobsOhio bill (House Bill 1), Governor Kasich was authorized to form a nonprofit corporation which is responsible for economic development, job creation, job retention and the recruitment of businesses to Ohio.

The **full report** details which functions should remain within the state agency structure and which functions should transfer to JobsOhio.

Officials responsible for the new structure are holding **six regional meetings** to discuss Ohio's new economic development strategy. The meetings are intended to describe the role of the Ohio Department of Development and its relationship with JobsOhio and the JobsOhio Network partners.

"This new approach, which has a regional focus, represents perhaps the most sweeping reform ever of Ohio's economic development strategy," commented the OMA's Ryan Augsburger, who will be monitoring the developments and

reporting them to members via this publication and to the OMA Tax Policy Committee. Manufacturers are invited to attend the regional events and to view a **presentation** the state is using to describe JobsOhio.

08/19/2011

Ohio GrowNOW Program Reduces Interest Rates on New or Existing Small Business Loans

State Treasurer Josh Mandel has created the **GrowNOW** program to make financing more affordable for small business owners.

Qualifying businesses can receive a three percentage point interest rate reduction on new or existing small business loans for two years with the opportunity for renewal.

The program is a partnership between eligible banks and the Ohio Treasury. Small business owners must commit to the creation or retention of at least one full-time job or two part-time jobs in the state of Ohio for every \$50,000 borrowed, up to \$400,000. GrowNOW broadly serves as a catalyst for Ohio's economic development by supporting the small businesses that drive it.

07/29/2011

Taxation Legislation
Prepared by: The Ohio Manufacturers' Association
Report created on October 31, 2011

- HB1** **JOBSONIO (DUFFEY M)** To authorize the Governor to create JobsOhio, a nonprofit economic development corporation.
Current Status: 2/18/2011 - **SIGNED BY GOVERNOR**; Eff. 2/18/2011
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_1
- HB3** **REPEAL ESTATE TAX (GROSSMAN C, HOTTINGER J)** To repeal the estate tax for the estates of individuals dying on or after January 1, 2011.
Current Status: 2/16/2011 - **REPORTED OUT**, House Ways and Means, (Fourth Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_3
- HB8** **TAX PROMPT REMITTANCE DISCOUNT (BLAIR T)** To increase the sales and use tax prompt remittance discount and to authorize a discount for prompt remittance of income tax withholding.
Current Status: 1/11/2011 - Referred to Committee House Ways and Means
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_8
- HB10** **REMEDIATION OF CONTAMINATED SITE (SEARS B)** To authorize refundable tax credits for the completion of a voluntary action to remediate a contaminated site and for the return of such sites to productive use, and to exempt persons through 2017 who have issued covenants not to sue under the Voluntary Action Program from certain fees and penalties for one year after the issuance of such a covenant.
Current Status: 3/2/2011 - House Ways and Means, (Fifth Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_10
- HB17** **TAX CREDIT FOR HIRING UNEMPLOYED (BAKER N)** To authorize a \$2,400 income tax withholding credit for an employer that hires and employs a previously unemployed individual.
Current Status: 1/11/2011 - Referred to Committee House Ways and Means
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_17
- HB18** **TAX CREDIT - EXPANDING BUSINESSES (BAKER N)** To authorize a nonrefundable tax credit for a business that increases payroll and expands into a vacant facility.
Current Status: 2/23/2011 - House Ways and Means, (Fifth Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_18
- HB43** **OHIO VENTURE CAPITAL AUTHORITY (GOYAL J, WILLIAMS S)** To increase the annual and aggregate limit on the amount of tax credits the Ohio Venture Capital Authority may authorize.
Current Status: 1/26/2011 - Referred to Committee House Economic and Small Business Development
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_43
- HB44** **SMALL BUSINESS WORKING CAPITAL LOAN PROGRAM (GOYAL J, GARLAND N)** To create the Small Business Working Capitol Loan Program.
Current Status: 1/26/2011 - Referred to Committee House Economic and Small Business Development
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_44
- HB58** **INTERNAL REVENUE CODE (BECK P)** To expressly incorporate changes in the Internal Revenue Code since December 15, 2010, into Ohio law.
Current Status: 3/7/2011 - **SIGNED BY GOVERNOR**; eff. 3/7/2011
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_58
- HB81** **PERFORMANCE BUDGETING (SNITCHLER T)** To require performance budgeting by most state agencies.

Current Status: 2/22/2011 - House State Government and Elections, (Second Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_81

- HB98 INCOME TAX RATE FOR 70 1/2 YEARS OR OLDER (HOLLINGTON R)** To reduce the maximum effective income tax rate applicable to unearned income of persons age 70 1/2 years or older to 1% beginning in 2013.
Current Status: 3/30/2011 - House Ways and Means, (Fourth Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_98
- HB101 JOB CREATION/RETENTION CREDITS (WILLIAMS S)** To provide for a six-year trial period in which taxpayers may include a limited number of the taxpayer's employees who work from home and whose rate of pay is at least three times the federal minimum wage as employees employed in the project for purposes of the job creation and retention credits if the recipient of the credit provides a specified level of capital investment, and to require the Director of Development to issue a report at the end of the six-year period.
Current Status: 6/1/2011 - House Ways and Means, (First Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_101
- HB111 TAX DEDUCTION-SMALL BUSINESS (WILLIAMS S)** To authorize an income tax deduction for small business owners' reinvestment of undistributed profits in business property, employee training, or research and development.
Current Status: 5/11/2011 - House Ways and Means, (First Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_111
- HB114 TRANSPORTATION BUDGET (MCGREGOR R)** To make appropriations for programs related to transportation and public safety for the biennium beginning July 1, 2011, and ending June 30, 2013, and to provide authorization and conditions for the operation of those programs.
Current Status: 7/13/2011 - HB114 had a provision amended by SB187
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_114
- HB134 CAPITAL GAINS INVESTMENTS (SCHURING K)** To reduce the income tax rate on capital gains reinvested in Ohio-based investments.
Current Status: 6/1/2011 - House Ways and Means, (Fourth Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_134
- HB153 BIENNIAL BUDGET (AMSTUTZ R)** To make operating appropriations for the biennium beginning July 1, 2011, and ending June 30, 2013, and to provide authorization and conditions for the operation of state programs.
Current Status: 6/30/2011 - **SIGNED BY GOVERNOR**; Effective 6/30/2011; some sections different dates, 7 line item vetos
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_153
- HB198 PROPERTY TAX COMPLAINTS (COLEY II W)** To permit property tax complaints to be initiated only by the property owner.
Current Status: 5/12/2011 - House Financial Institutions, Housing and Urban Development, (Second Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_198
- HB220 CAT TAX CREDIT INVESTMENT LOSSES (BECK P, BAKER N)** To allow a refundable commercial activity tax credit for investment losses recognized by foreign entrepreneur investors who invest in certain projects in Ohio.
Current Status: 6/23/2011 - House Economic and Small Business Development, (Sixth Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_200
- HB258 APPRENTICESHIP PROGRAMS (GROSSMAN C, DOVILLA M)** To exempt from taxation for five years the earned income of an individual who obtains journeyman status or a baccalaureate degree

and works in Ohio; and to prohibit the Apprenticeship Council from adopting standards for apprenticeship ratios that are stricter than those requirements specified in the federal regulations governing apprenticeship programs and from discriminating against open or merit shops.

Current Status: 9/27/2011 - House Ways and Means, (Second Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_258

- HB261** **ALTERNATIVE FUEL FACILITY** (MCGREGOR R) To allow a credit against the personal income tax or commercial activity tax for the installation of an alternative fuel facility.
Current Status: 9/21/2011 - House Ways and Means, (Second Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_261
- HB310** **ELECTRIC VEHICLE SALES TAX REDUCTION** (GOODWIN B) To reduce the amount of sales tax due on the purchase or lease of a qualifying electric vehicle by up to \$2,000.
Current Status: 9/21/2011 - House Ways and Means, (First Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_310
- HB327** **JOB CREATION-RETENTION TAX CREDIT** (GONZALES A) To provide for a six-year trial period in which taxpayers may receive a job creation or job retention tax credit for the employment of home-based employees and to require the Director of Development to issue a report at the end of the six-year period.
Current Status: 9/22/2011 - House Economic and Small Business Development, (First Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_327
- SB1** **JOB SOHIO** (WAGONER M) To authorize the creation of JobsOhio, the non-profit economic development corporation.
Current Status: 2/2/2011 - Referred to Committee Senate Finance
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_1
- SB4** **PERFORMANCE AUDITS OF STATE AGENCIES** (SCHAFFER T) To require the Auditor of State to conduct performance audits of certain state agencies.
Current Status: 4/5/2011 - **SIGNED BY GOVERNOR**; Eff. 4/5/2011
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_4
- SB5** **COLLECTIVE BARGAINING REFORM** (JONES S) To make changes to Ohio's Collective Bargaining Law, which was first enacted in 1983.
Current Status: 3/31/2011 - **SIGNED BY GOVERNOR**; Eff. 7/01/11
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_5
- SB6** **JOB RETENTION TAX CREDIT** (PATTON T) To authorize a refundable job retention tax credit.
Current Status: 2/22/2011 - SB6 became part of HB58
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_6
- SB7** **IRS TAX CHANGES** (OBHOF L) To expressly incorporate changes in the Internal Revenue Code since December 15, 2010, into Ohio law, and to declare an emergency.
Current Status: 2/17/2011 - Senate Ways & Means & Economic Development, (Second Hearing)
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_7
- SB12** **SMALL BUSINESS SET ASIDE** (KEARNEY E) To generally require that state agencies set aside a certain amount of purchases for which only small business enterprises may compete.
Current Status: 2/2/2011 - Referred to Committee Senate State & Local Government & Veterans Affairs
More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_12
- SB13** **UNEMPLOYMENT MODERNIZATION TASK FORCE** (SCHIAVONI J) To allow an individual to

receive unemployment compensation benefits for unemployment related to domestic abuse or compelling family circumstances, to allow an individual to receive unemployment training extension benefits under specified conditions, and to create the Unemployment Modernization Review Task Force.

Current Status: 3/22/2011 - Senate Insurance, Commerce & Labor, (First Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_13

SB47 **CAT TAX CREDIT GROCERY STORES** (KEARNEY E) To authorize a commercial activity tax credit for underserved community grocery stores.

Current Status: 2/17/2011 - Senate Ways & Means & Economic Development, (First Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_47

SB58 **TAX CREDIT EMPLOYMENT CONVICTED FELONS** (TAVARES C) To create a tax credit for the employment of individuals who have been convicted of felonies.

Current Status: 2/10/2011 - Senate Ways & Means & Economic Development, (First Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_58

SB90 **ESTATE TAX** (JORDAN K) To repeal the estate tax for the estates of individuals dying on or after January 1, 2011.

Current Status: 4/14/2011 - **REPORTED OUT AS AMENDED**, Senate Ways & Means & Economic Development, (Fifth Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_90

SB115 **PROPERTY SALE GAINS** (KEARNEY E) To exempt from income taxation any gains from the sale of Ohio property used in a trade or business and held for at least two years.

Current Status: 3/24/2011 - Senate Ways & Means & Economic Development, (First Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_115

SB188 **ALTERNATIVE FUEL FACILITY** (PATTON T) To allow a credit against the personal income tax or commercial activity tax for the installation of an alternative fuel facility.

Current Status: 9/22/2011 - Senate Ways & Means & Economic Development, (First Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_188

SB200 **EDISON JOBS DEVELOPMENT PROGRAM** (HUGHES J) To create the Edison Jobs Development Program within the Department of Development and to make an appropriation.

Current Status: 9/20/2011 - Referred to Committee Senate Finance

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_200

SB206 **TAX CREDIT-TEMP EMPLOYMENT AGENCY HIRES** (SCHAFER T) To allow taxpayers to count employees employed through a temporary or professional employment agency toward the payroll and income tax withholding requirements of the job creation and job retention tax credits.

Current Status: 9/20/2011 - Referred to Committee Senate Ways & Means & Economic Development

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_206

SB209 **ELECTRIC VEHICLE SALES TAX REDUCTION** (HITE C, TURNER N) To reduce the amount of sales tax due on the purchase or lease of a qualifying electric vehicle by up to \$2,000.

Current Status: 9/22/2011 - Senate Ways & Means & Economic Development, (First Hearing)

More Information: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_209

THE WALL STREET JOURNAL.

SATURDAY, JULY 2, 2011

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Ohio Shows the Way on Death Tax Repeal

By **BILL BATCHELDER,**
JACK BOYLE AND DICK PATTEN

Ohio Gov. John Kasich made good on a major campaign promise Thursday, killing the state's estate tax in the process of enacting the 2012-13 budget. He also managed to kill off an \$8 billion deficit without raising taxes -- a model for fiscally squeezed states nationwide.

The end of the death tax, which goes into effect on Jan. 1, 2013, will help stop the hemorrhaging of small businesses and jobs from the Buckeye State. Ohioans had suffered long enough with the levy on inheritances, with a 6% tax on personal and business assets above the \$338,333 exemption, up to \$500,000, and a 7% tax on assets above \$500,000. The death tax was a major reason that business, jobs and capital have fled the state.

Ohio's nearly 200,000 small businesses employ some 2.3 million people -- about half the civilian labor force -- and support annual payrolls exceeding \$77 billion. But businesses and jobs have been leaving Ohio for years, many to the 28 states without a death tax.

The stampede for the exits comes as no surprise: Dying in Ohio was expensive. When federal (35% on all assets exceeding \$5 million) and state taxes are combined, an Ohio family with a successful business could lose up to 40% of everything they had worked for.

While some opponents of repeal defend the death tax on the grounds that the state, like the federal government, needs the revenue, the truth is it yielded little revenue -- around 2% of the average local jurisdiction's revenues in Ohio, less than two-tenths of 1% for Columbus, and around 1% for Washington.

What estate taxes do produce is flight. Business owners flee high-tax states for low-tax or no-tax states, and wealthy people dodge the entire matter by hiring expensive lawyers who establish trusts, foundations

and other devices that protect them from the tax man.

The owners of family businesses and family farms typically can't afford such games. For all practical purposes, they're cash-poor, with most of their capital -- and net worth -- tied up in land, buildings, equipment, inventory and payroll.

The story of Dave Johnson -- president of the 100-year-old, fourth-generation family-owned business, Summitville Tiles, Inc. (a ceramic tile and brick manufacturer whose products festoon both the roof of the White House and the floors of McDonald's restaurants around the world) -- is typical.

Mr. Johnson, like many other small to mid-sized manufacturers, struggles to keep his business competitive in the face of the construction-industry meltdown. It hasn't been easy. And the estate tax is another worry. If he didn't have to contend with it, he could invest in more machinery, technology and employees -- confident that the business would endure into the next generation.

It's much the same elsewhere. A 2008 study by the Connecticut Department of Revenue Services, for example, named the estate tax the primary reason wealthy residents left the state and, in many cases, took their businesses with them. The study also showed, if further confirmation were needed, that the economies of states without estate taxes grew 50% faster, and created nearly twice as many jobs, than states with death taxes.

Against this backdrop, a two-year volunteer grass-roots campaign took hold in Ohio, garnering 85,000 petition signers for repeal of the estate tax and uniting a coalition that called on Ohio lawmakers to end the destructive tax. With this support and a state legislature committed to increasing jobs and local revenues over the long haul, the failed status quo was defeated.

Not surprisingly, public officials in some of Ohio's wealthiest cities were the most vocal

opponents of repeal. Because a portion of Ohio's estate tax revenue goes to the locality where the decedent lived, wealthier jurisdictions received the bulk of the revenue. The estate tax might seem a boon for rich communities that want a new park or pool, but it offered little to poorer jurisdictions.

What most of the critics don't understand is that repeal of the estate tax ultimately means more tax dollars, not fewer. A 2009 Duquesne University study found that state and local governments lost some \$3 in non-estate tax revenues for every \$1 increase in federal estate tax revenue. Overall, the study calculated, eliminating the federal estate tax would boost state and local tax revenues by approximately \$9.3 billion annually. With Ohio business owners now able to focus their energy and resources on growth and success, rather than on the survival of their businesses after they die, we can expect them to invest more money in those 200,000 businesses, hire more workers, and increase purchases -- all of which will help increase the tax base.

Ohio's repeal of its estate tax, after nearly 120 years, may not lead to an avalanche of repeal activities around the country, but it's already having a positive effect. Last month, for example, Maine lawmakers doubled their estate tax exemption to \$2 million from \$1 million. Oregon lawmakers rejected a proposal to increase their estate tax, as did North Carolina. Momentum is moving in the right direction.

State governments may need tax revenue, but they don't need taxes that destroy wealth and drive away job-creating business owners.

Mr. Batchelder is speaker of the Ohio House of Representatives. Mr. Boyle is the co-founder of Citizens United to End Ohio's Estate Tax. Mr. Patten is president of the American Family Business Institute in Washington, D.C.

Citizens United to End Ohio's Estate Tax

To learn about our successful campaign, contact: Ron Alban (ralban@alban-invest.com), Jack Boyle (jackboyle@ohioprosperityinitiative.org), or Dan Regenold (dregenold@frameusa.com).

Paid for by Citizens United to End Ohio's Estate Tax.
William Curfis, Treasurer, 865 Macon Alley, Columbus, OH 43206

BACKGROUND PAPER

October 2011, Number 61

Unemployment Insurance Taxes: Options for Program Design and Insolvent Trust Funds

Businesses Face Higher Taxes as States Exhaust Trust Funds and Incur Interest Payments

By
Joseph D. Henchman

Key Findings

- *Unemployment insurance (UI) is a social insurance program jointly operated by the federal and state government. Employers pay federal and state UI taxes that fund benefits, with employers paying different tax rates based on their layoff history (“experience rating”).*
- *High rates of unemployment and benefits lasting up to 99 weeks have led 34 states to borrow over \$37 billion from the federal government to pay benefits. States are not expected to repay these amounts for some time and must begin paying interest on their balances in 2011.*
- *Businesses are in danger of facing higher UI taxes at a time when private sector hiring is already at a low level. Some states are already reducing UI benefits or raising taxes.*
- *States routinely cut UI taxes in good economic times and raise them in bad economic times, undermining the argument that the program is countercyclical.*
- *Modest UI reforms should be considered, including eliminating the “firewall” between administrative costs and benefits, reducing cross-subsidies to high-layoff employers, and relying more on face-to-face training and advising. More significant reforms that could be considered include adopting elements of state workers’ compensation programs and experimenting with individual accounts.*
- *Economic evidence suggests that extending unemployment benefits increases unemployment by encouraging “excessive search.”*
- *States should be sure that their UI tax systems are not overly complex and burdensome, particularly to new employers. States should also balance the goal of spreading the costs of unemployment to all employers with the danger of overly subsidizing high-turnover employers. Finally, states should resist efforts to introduce need-based features into UI.*

Joseph Henchman is the Vice President of Legal & State Projects at the Tax Foundation. He would like to thank Dr. William Conerly for his prior work on the subject and his advice, as well as Elsie Watters, the author of our 1981 study on unemployment insurance. He would also like to acknowledge the valuable research assistance of Sarah Hyon and Frederick Hubach.

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Introduction

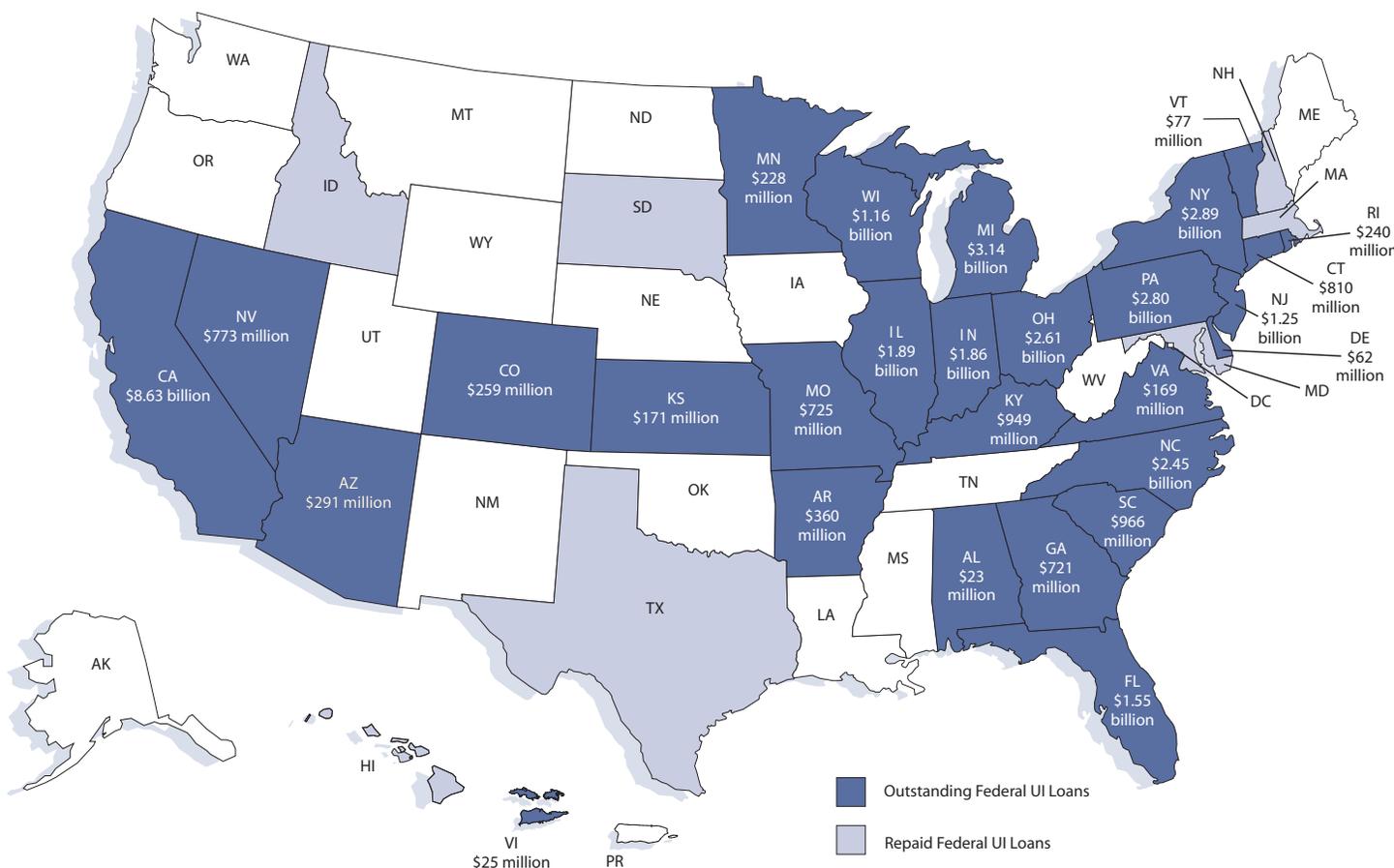
Record high levels of unemployment and record low reserve funds have placed great pressure on the federal-state unemployment insurance (UI) tax and benefit system. Between 2008 and 2011, \$174 billion was paid in unemployment taxes while \$450 billion was paid out in benefits, a gap of \$276 billion.¹ In 2011 alone, employers and employees are projected to pay \$51.8 billion in taxes, while \$131.4 billion is projected to be paid out in benefits for workers recently unemployed.² Benefits are drawn for an average of 18 weeks, with many claimants receiving the maximum 99 weeks of benefits.

Over the past two years, 34 states and the U.S. Virgin Islands exhausted their unemployment insurance trust funds and have had to borrow from the federal government to pay unemployment benefits; 27 states have outstanding balances

(see Figure 1). While 4 million new hires are made each month, the unemployment rate has stood above 9 percent and the number of unemployed per job opening remains high (see Figures 2 and 3). While some states have repaid their balances and others are no longer borrowing additional amounts, the current outstanding balance of loans is \$37.3 billion. States are not expected to repay their loans fully for several years.

Beginning on September 30, 2011, states must pay approximately \$1.3 billion in interest on those outstanding balances; in many cases, businesses and employees in those states will also face increases in federal unemployment insurance tax rates as a result of those federal loan balances. These new interest obligations and tax increases, if they ultimately occur, come at a time when private sector hiring is already at a low level and states are under significant fiscal pressure. These unemployment insurance fiscal policies may exacerbate

Figure 1
Federal Loans to States to Pay Unemployment Benefits



Source: US Department of Labor Employment & Training Administration, as of September 2011

1 Office of Management and Budget, Budget of the U.S. Government Fiscal Year 2012: Historical Tables (Feb. 14, 2011), <http://www.gpoaccess.gov/usbudget/fy12/pdf/BUDGET-2012-TAB.pdf>.

2 *Id.*

negative job growth and tax trends, instead of operating countercyclically as the program was intended.

Consequently, this may be an appropriate time for the federal government and the states to contemplate significant changes to the structure of unemployment insurance taxation and benefits. Program design alternatives could offer more innovative and more sustainable methods to find jobs for the short-term and long-term unemployed while preserving benefits to support them in the meantime. These options include eliminating the firewall between administrative costs and benefits, reducing cross-subsidies through greater use of experience ratings, relying more on face-to-face training and advising, adopting elements of state workers' compensation programs, and experimenting with individual accounts to encourage saving. These changes can enhance the program's ultimate goal of ensuring a viable safety net for transition periods between employment.

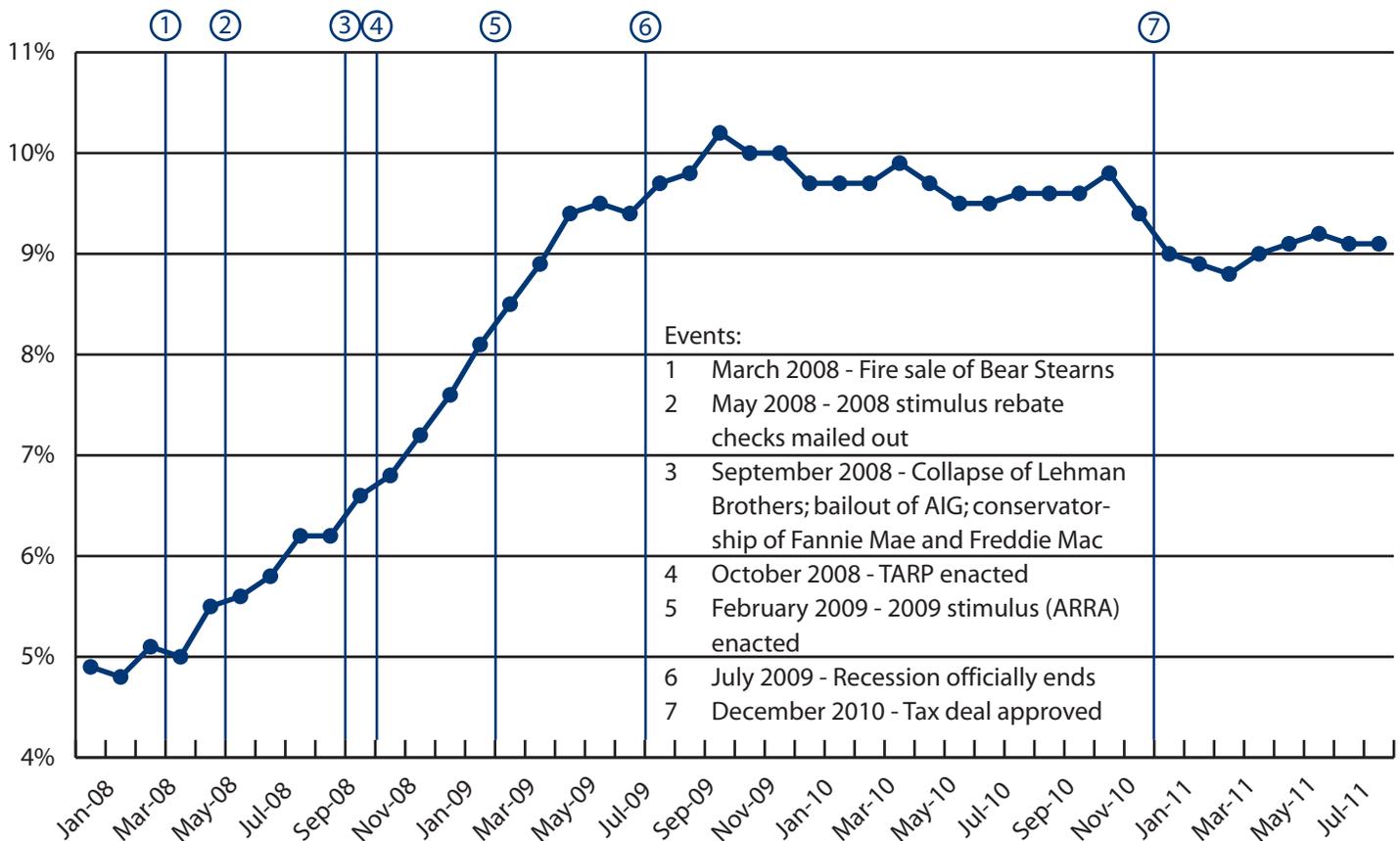
How the Unemployment Insurance System Works

Unemployment insurance is a social insurance program jointly operated by the federal and state governments.³ Employers and employees pay taxes to the federal and state governments, while state governments administer the program and the federal government reimburses the states for administrative expenses. In times of high unemployment, benefits are extended in time and states unable to pay benefits out of accumulated trust fund reserves may borrow from the federal government for that purpose.

History and Goals of Unemployment Insurance

Enacted in 1935 as part of the Social Security Act, the federal unemployment insurance program was modeled after similar programs implemented in

Figure 2
U.S. Unemployment Rate and Key Events Since 2008



Source: U.S. Department of Labor.

³ In addition to the 50 states, other participants in the program include the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

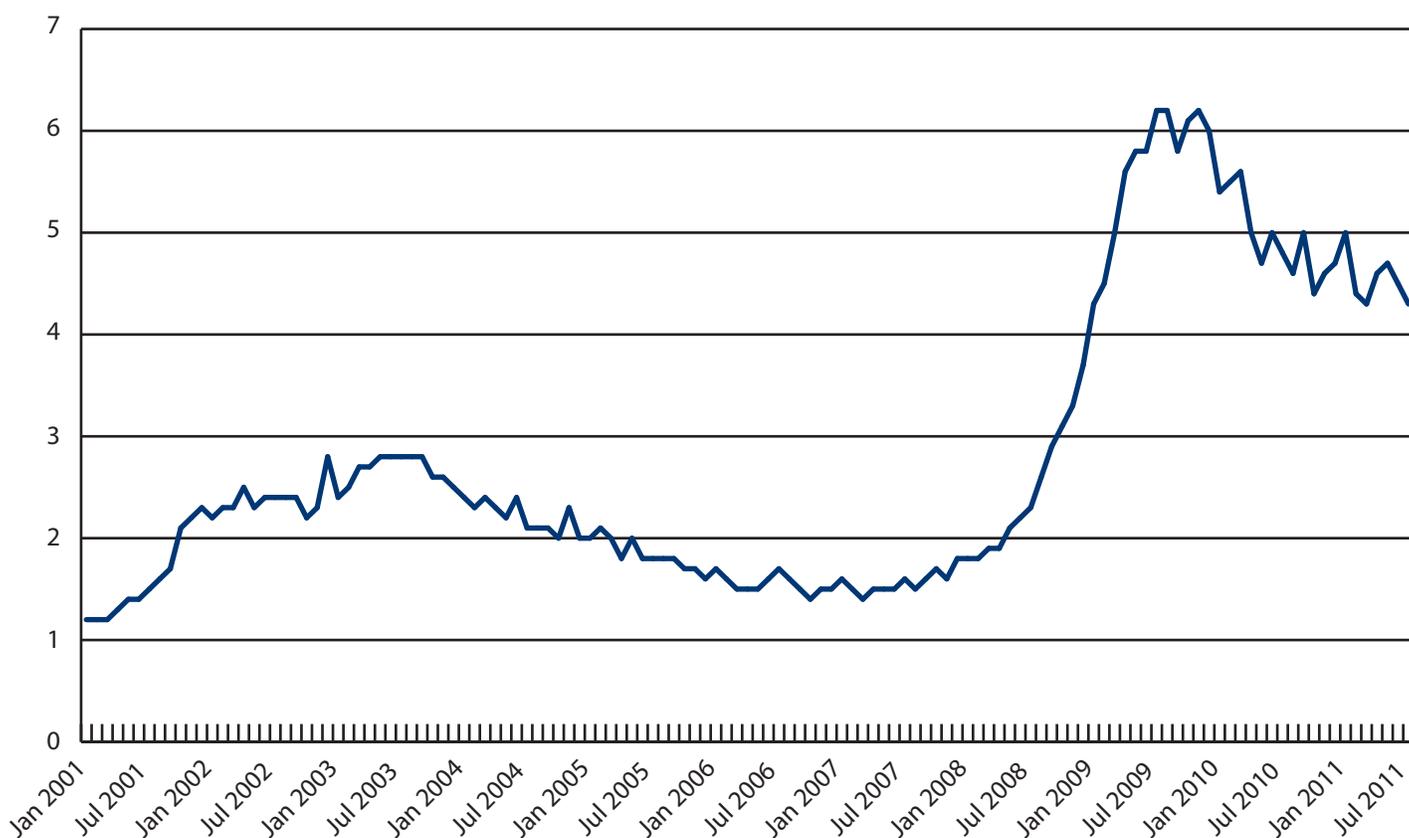
Britain (adopted 1911, expanded to entire workforce in 1920), Italy (1919), Germany (1927), and 18 other countries.⁴ Unemployment insurance itself dates to a city plan in Switzerland in 1789 and union-administered and company-administered plans going back as far as 1831, although they covered only a small number of workers.⁵ The first bill to create a state-level compulsory unemployment insurance program was introduced in Massachusetts in 1916, and a number of states considered such laws in subsequent years but none passed.⁶

At the time, unemployment was viewed as a problem to be addressed by the workers themselves, their unions, and perhaps the states; at most, the federal government would hold a

hearing or a conference but further action was considered undesirable and even unconstitutional.⁷ Ideas for combatting unemployment included providing free transportation to the West for the unemployed (1870s Greenback Party platform), immigration restrictions, public works jobs, currency and tariff reform, shorter work days, and better education. “In general, the emphasis lay on prevention of unemployment more than on amelioration of the problems of the worker without a job.”⁸

Modern observers may be surprised that organized labor was a key opponent of compulsory state unemployment insurance. Samuel Gompers, the long-time head of the American Federation of Labor, argued that compulsory unemployment in-

Figure 3
Unemployed Persons per Job Opening



Source: Bureau of Labor Statistics, Job Openings and Labor Turnover Survey (JOLTS).

4 See Chris Edwards & George Leef, *Failures of the Unemployment Insurance System*, Cato Institute (2011), <http://www.downsizinggovernment.org/labor/failures-of-unemployment-insurance>; Elsie M. Watters, *Unemployment Insurance: Trends and Issues*, Tax Foundation Research Publication No. 35 (1982), <http://www.taxfoundation.org/news/show/2022.html>.

5 See U.S. Social Security Board, *Unemployment Compensation: What and Why?* (1937). At least one scholar posits that states prohibited the creation of extensive private unemployment insurance schemes by insurance companies so as to protect union-administered plans from competition. See Michael B. Rappaport, *The Private Provision of Unemployment Insurance*, 1992 Wisconsin L. Rev. 61 (Jan.-Feb. 1992.)

6 See U.S. Social Security Board, *supra* note 5.

7 See Watters, *supra* note 4, at at 3-4 (citing the Wagner Committee report that preferred federal tax credits to businesses that purchase private unemployment insurance and rejected a federal system, and a 1921 conference on unemployment presided over by then-Secretary of Commerce Herbert Hoover.)

8 *Id.* at 2.

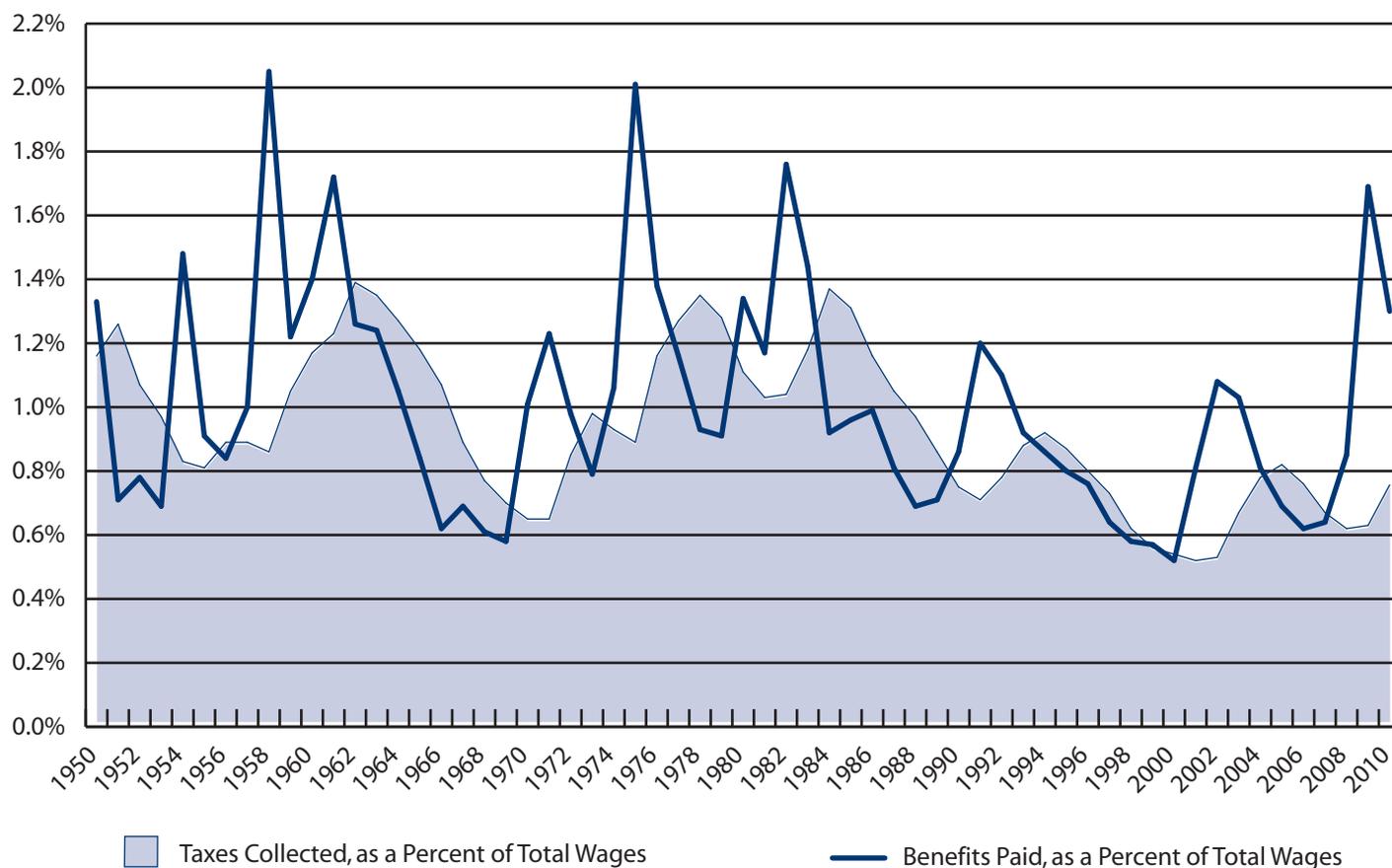
surance would substitute government dependency for benefits administered by unions themselves, and was pushed by supporters “who know nothing of the hopes and aspirations of labor which desires opportunities for work, not for compulsory unemployment insurance.”⁹ A government program, aside from public works jobs, “was regarded as interference and a threat to union independence.”¹⁰

The Great Depression of the 1930s, with unemployment levels reaching 25 percent, changed these public attitudes. Wisconsin was the first state to adopt a compulsory program, in 1932.¹¹ Although a number of states expressed interest in adopting a state-level program, no others did so; one state reported that the competitive advantage of its employers and employees not having to pay taxes for a program outweighed the program’s benefits.¹² Proponents argued that compulsory unemployment insurance could provide a financial safety net to discharged employees, might discour-

age employers from adding to unemployment by increasing their costs for doing so, and counter economic cycles by encouraging saving in good times and paying out benefits in times of slow aggregate demand. After vetoing legislation that would have authorized private insurance companies to offer unemployment insurance, then-New York Governor Franklin Roosevelt assembled a six-state commission to develop recommendations for unemployment insurance programs.

This commission recommended a federal-state cooperative system that would allow a nationwide pooling of risk, prevent interstate competition by requiring all states to participate, and leave administration and benefit design to the states (“uniformity where essential and diversity where desired”).¹³ The states were left free to determine the taxable wage base (so long as it was at or above the federal minimum), experience-rating methods, tax rates, eligibility and

Figure 4
Unemployment Taxes and Benefits as a Percent of Wages over Time



9 *Id.* at 2-3; Aaron Steelman, *If Only Samuel Gompers Were Alive Today*, Cato Institute (Oct. 1996), http://www.cato.org/pub_display.php?pub_id=6274; Samuel Gompers, *American Federationist: Promises and Performances* at 680-81 (Jul. 1916).

10 Watters, *supra* note 4, at 3.

11 See *id.*

12 See Report of the Ohio Commission on Unemployment Insurance (1932).

13 See U.S. Social Security Board, *supra* note 5.

disqualification rules, and benefit amounts and duration.¹⁴ Additionally, the program would not be need-based, providing “no more than a subsistence income” as “a uniform percentage of former full-time wages,” and be funded entirely by taxes on employers and employees.¹⁵ These goals informed the federal legislation (the Federal Unemployment Tax Act, or FUTA) that was attached to the Social Security Act and signed into law by President Roosevelt in 1935.

Modern observers may be surprised that organized labor was a key opponent of compulsory state unemployment insurance. Samuel Gompers ... argued that compulsory unemployment insurance would substitute government dependency for benefits administered by unions themselves.

Federal Unemployment Insurance Tax and Employer Credits

A federal tax of 6.0 percent is ostensibly levied on the first \$7,000 of each worker’s earnings to finance the UI program.¹⁶ However, if a state has adopted a UI program that meets federal guidelines, employers in the state can credit state UI taxes against up to 90 percent of their federal UI tax, on a dollar-for-dollar basis. Thus, when a state UI program meets all federal requirements, employers in the state pay a federal tax rate of 0.6 percent plus state UI taxes.¹⁷ The tax-and-credit-offset feature of the program, designed by then-Supreme Court Justice Louis Brandeis, was designed to avoid constitutional concerns and ensure that all states set up UI programs after the federal law was enacted.¹⁸

Revenue from the federal tax is used to pay federal and state administrative costs of the UI program,

Table 1
Minimum Rates, Maximum Rates, New Employer Rates, Taxable Wage Base by State

State	Minimum Tax Rate	Maximum Tax Rate	New Employer Rate	Taxable Wage Base
Alabama	0.6%	6.7%	2.7%	\$8,000
Alaska	1.0%	5.4%	3.4%	\$34,600
Arizona	0.0%	5.9%	2.0%	\$7,000
Arkansas	1.0%	6.9%	3.8%	\$12,000
California	1.5%	6.2%	3.4%	\$7,000
Colorado	1.0%	5.4%	1.7%	\$10,000
Connecticut	1.9%	6.8%	3.7%	\$15,000
Delaware	0.1%	8.0%	2.6%	\$10,500
Florida	1.0%	5.4%	2.7%	\$7,000
Georgia	0.0%	5.4%	2.6%	\$8,500
Hawaii	1.2%	5.4%	4.0%	\$34,200
Idaho	1.0%	6.8%	3.4%	\$33,300
Illinois	0.7%	8.4%	3.8%	\$12,740
Indiana	0.7%	9.5%	2.5%	\$9,500
Iowa	0.0%	9.0%	1.9%	\$24,700
Kansas	0.1%	7.4%	4.0%	\$8,000
Kentucky	1.0%	10.0%	2.7%	\$8,000
Louisiana	0.1%	6.2%	Industry Average	\$7,700
Maine	0.9%	8.0%	3.0%	\$12,000
Maryland	2.2%	13.5%	2.6%	\$8,500
Massachusetts	1.3%	12.3%	2.8%	\$14,000
Michigan	0.1%	10.3%	2.7%	\$9,000
Minnesota	0.5%	9.4%	2.9%	\$27,000
Mississippi	0.9%	5.4%	2.7%	\$14,000
Missouri	0.0%	9.8%	3.5%	\$13,000
Montana	0.8%	6.1%	Industry Average	\$26,300
Nebraska	0.0%	8.7%	2.5%	\$9,000
Nevada	0.3%	5.4%	3.0%	\$26,600
New Hampshire	0.0%	7.0%	3.7%	\$12,000
New Jersey	0.5%	5.8%	2.8%	\$29,600
New Mexico	0.1%	5.4%	2.0%	\$21,900
New York	1.5%	9.9%	4.1%	\$8,500
North Carolina	0.2%	6.8%	1.2%	\$19,700
North Dakota	0.2%	10.0%	1.4%	\$25,500
Ohio	0.7%	9.6%	2.7%	\$9,000
Oklahoma	0.3%	7.5%	1.0%	\$18,600
Oregon	2.2%	5.4%	3.3%	\$32,300
Pennsylvania	2.7%	10.8%	3.7%	\$8,000
Rhode Island	1.7%	9.8%	2.5%	\$19,000
South Carolina	0.1%	11.3%	2.9%	\$10,000
South Dakota	0.0%	9.5%	1.2%	\$11,000
Tennessee	0.5%	10.0%	2.7%	\$9,000
Texas	0.8%	8.3%	2.7%	\$9,000
Utah	0.4%	9.4%	Industry Average	\$28,600
Vermont	1.3%	8.4%	1.0%	\$13,000
Virginia	0.8%	6.9%	3.2%	\$8,000
Washington	0.5%	6.0%	Industry Average	\$37,300
West Virginia	1.5%	7.5%	2.7%	\$12,000
Wisconsin	0.3%	9.8%	3.6%	\$13,000
Wyoming	0.7%	10.0%	Industry Average	\$22,300
District of Columbia	1.6%	7.0%	2.7%	\$9,000

Source: U.S. Department of Labor

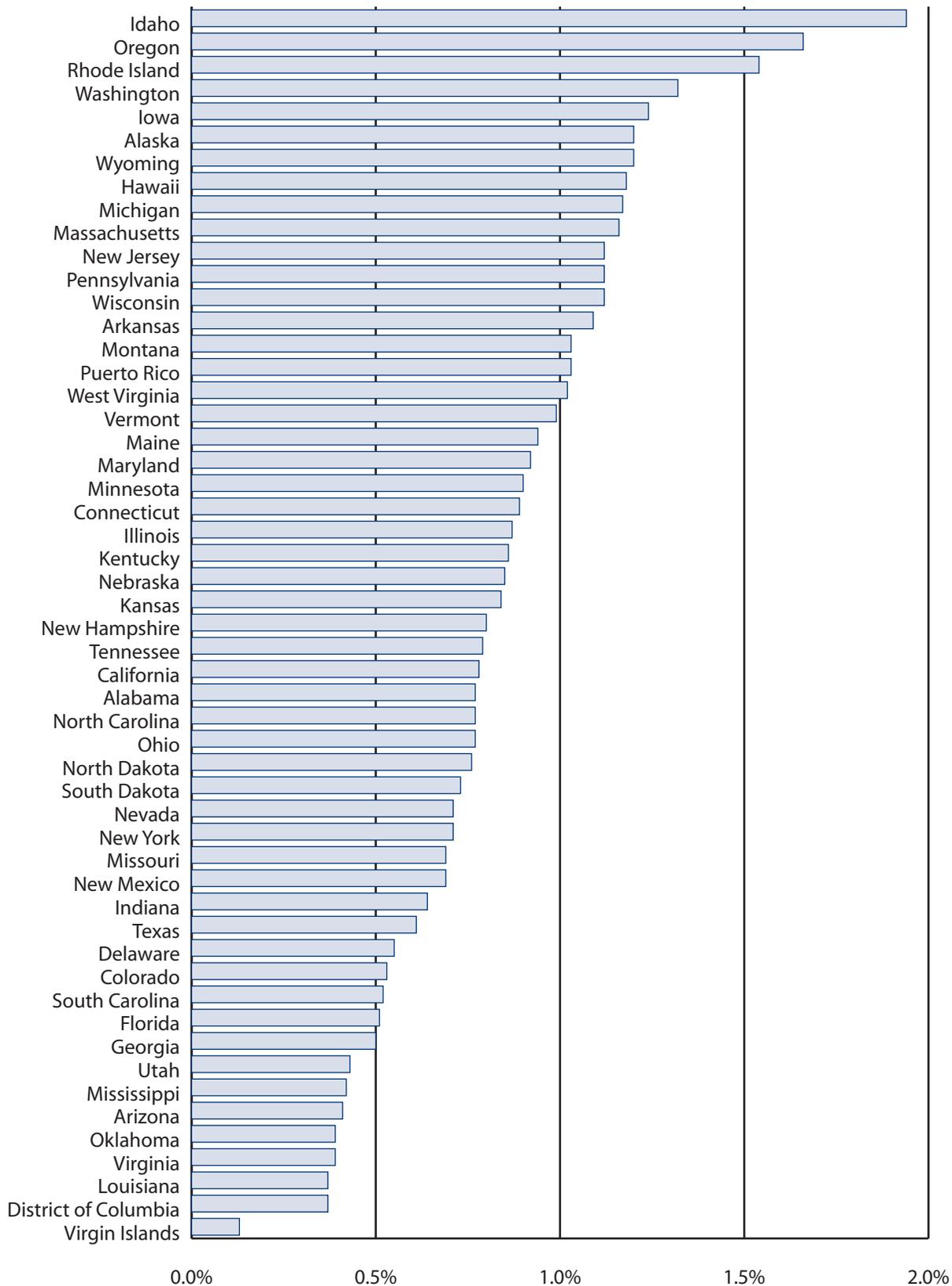
¹⁴ See Watters, supra note 4, at 23.

¹⁵ See U.S. Social Security Board, supra note 5.

¹⁶ From 1985 to June 30, 2011, the federal UI tax was 6.2 percent. A 0.2 percent “temporary” surtax was enacted in 1976 to reimburse the federal government for extended and supplemental benefits paid during that decade’s recessions. The surtax was repeatedly extended even after repayment was completed in 1987, but finally expired in 2011. See U.S. Government Accountability Office, Unemployment Insurance: States’ Tax Financing Systems Allow Costs to Be Shared among Industries, (Jul. 2006), at 5 n.2; Shalleen Mayes, *FUTA Surtax Set to Expire, Adding Confusion for Payroll Managers*, (June 30, 2011), <http://www.patriotsoftware.com/Employer-Training-Blog/bid/39474/FUTA-Surtax-Set-to-Expire-Adding-Confusion-for-Payroll-Managers>. President Obama’s budget proposed making the surtax permanent.

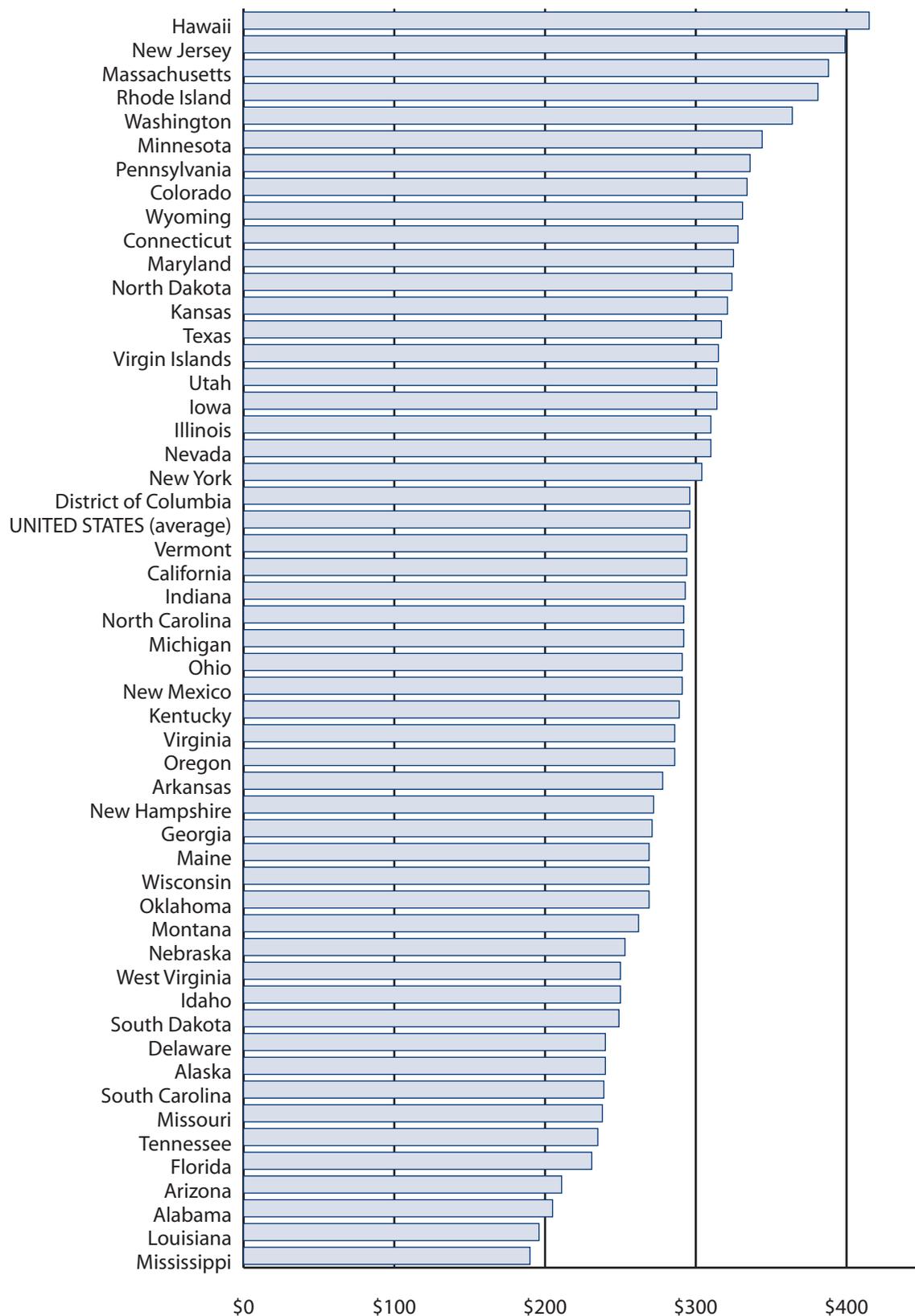
¹⁷ In all but three states, the legal incidence of UI taxes falls on employers. The three states where the legal incidence is on employees are Alaska, New Jersey, and Pennsylvania.

Figure 5
Average Unemployment Tax Rate by State
UI Tax Collections as a Percent of All Wages, 2010



Source: U.S. Department of Labor

Figure 6
Average Weekly Unemployment Insurance Benefit by State



Source: U.S. Department of Labor

Table 2
Weeks of Unemployment Benefits by State

State	State Benefits	EUC			SEB	SEB-2/ HEB	Total
		Tier 1 and 2	EUC Tier 3	EUC Tier 4			
Alabama	26	34	13	6	13	7	99
Alaska	26	34	13				73
Arizona	26	34	13	6			79
Arkansas	25	34	13				72
California	26	34	13	6	13	7	99
Colorado	26	34	13	6	13	7	99
Connecticut	26	34	13	6	13	7	99
Delaware	26	34	13		13	7	93
Florida	26	34	13	6	13	7	99
Georgia	26	34	13	6	13	7	99
Hawaii	26	34	13				73
Idaho	26	34	13	6	13	7	99
Illinois	26	34	13	6	13	7	99
Indiana	26	34	13		13	7	93
Iowa	26	34	13				73
Kansas	26	34	13		13		86
Kentucky	26	34	13	6	13	7	99
Louisiana	26	34	13				73
Maine	26	34	13		13		86
Maryland	26	34	13				73
Massachusetts	30	34	13		13		90
Michigan	26	34	13	6	13	7	99
Minnesota	26	34	13		13		86
Mississippi	26	34	13	6			79
Missouri	20	34	13	6	13	7	93
Montana	28	34	13				75
Nebraska	26	34					60
Nevada	26	34	13	6	13	7	99
New Hampshire	26	34					60
New Jersey	26	34	13	6	13	7	99
New Mexico	26	34	13		13		86
New York	26	34	13		13		86
North Carolina	26	34	13	6	13	7	99
North Dakota	26	34					60
Ohio	26	34	13	6	13	7	99
Oklahoma	26	34					60
Oregon	26	34	13	6	13	7	99
Pennsylvania	26	34	13		13		86
Rhode Island	26	34	13	6	13	7	99
South Carolina	20	34	13	6	13	7	93
South Dakota	26	34					60
Tennessee	26	34	13	6	13	7	99
Texas	26	34	13		13	7	93
Utah	26	34	13				73
Vermont	26	34					60
Virginia	26	34	13				73
Washington	26	34	13	6	13	7	99
West Virginia	26	34	13		13	7	93
Wisconsin	26	34	13		13		86
Wyoming	26	34					60
District of Columbia	26	34	13	6	13	7	99
Puerto Rico	26	34	13	6			79
Virgin Islands	26	34	13				73

Note: As of August 2011

Source: Tax Foundation compilation of state data sources

18 See Watters, *supra* note 4, at 1-4. The tax began at 3.0 percent (0.3 percent after credits) in 1939; in 1983, it stood at 6.2 percent (0.8 percent after credits), due to the 0.2 percent federal surcharge that existed between 1985 and June 2011.

19 U.S. Department of Labor, *Comparison of State Unemployment Insurance Laws* (Chapter 2) (2011), <http://workforcesecurity.doleta.gov/unemploy/comparison2011.asp>.

20 U.S. Government Accountability Office, *supra* note 16, at 1.

21 The federal minimum taxable wage base was originally \$3,000; it rose to \$4,200 in 1972; \$6,000 in 1978; and \$7,000 in 1983. In 1938, 98 percent of total wages were under the UI tax ceiling; by 1972 it was 52 percent and by 1983 it was 43 percent. Today, it is less than 30 percent.

the federal share of Extended Unemployment Compensation (EUC) benefits during times of high unemployment, loans to states to pay their share of UI benefits, and some labor information programs.¹⁹

State UI Tax Rates and Taxable Wage Bases

State UI taxes are based on schedules of minimum and maximum rates on a set taxable wage base. The rate employers pay depends on their “experience rating,” a risk-based continuum that varies rates “according to how much or how little their workers received unemployment benefits.”²⁰

Employers with a history of laying off many workers are subject to the maximum rate schedule; employers who have laid off fewer workers are subject to the minimum rate schedule. Minimum rates range from zero (six states) to 2.237 percent (Pennsylvania); maximum rates range from 5.4 percent (11 states) to 13.5576 percent (Pennsylvania). New employers generally pay a fixed rate until they qualify for an experience rating schedule. See Table 1 for minimum rates, maximum rates, and new employer rates by state.

The tax rates are applied to a taxable wage base, or ceiling, set by each state. Six states use a taxable wage base of \$7,000, the minimum for employers to receive federal credits.²¹ The highest wage base is in Washington State, at \$36,800. See Table 1 for taxable wage base by state.

The interaction of maximum rates, minimum rates, and taxable wage base results in different tax burdens on employers in each state. Additionally, in times when unemployment fund reserves are low, states may move all employers to a higher schedule of rates. Figure 5 shows the average UI tax rate paid by employers in each state in 2010, as a percentage of all wages (including those above the UI tax ceilings).

Other Taxes

Other state UI taxes include targeted fund-building or social cost surtaxes (including some that reduce tax rates for low-turnover employers), rate reductions for employers who make voluntary contributions, taxes to repay bonds or interest on

federal loans, and taxes for job training and placement programs.²²

Payment and Duration of Benefits

When an individual applies for unemployment benefits, states determine a weekly benefit amount and duration of benefits. The weekly benefit amount is generally calculated as a percentage of previously earned wages during a designated period of time.²³ In 2011, the average weekly benefit is \$296, or about 36 percent of the average weekly wage. Weekly benefits range from \$190 in Mississippi to \$415 in Hawaii. Figure 6 shows the average weekly benefit by state.

The duration of state-provided benefits has grown over time, rising from 15-16 weeks in the 1930s to generally up to 26 weeks today.²⁴ In addition, beginning in 1958, Congress has often enacted temporary programs providing special extended benefits during periods of high unemployment. For example, in the 1958-59 recession, Congress enacted the Temporary Unemployment Compensation (TUC) program that provided up to an additional 13 weeks of benefits.²⁵

Presently, unemployed persons can under certain circumstances receive up to 99 weeks of benefits. As an individual exhausts each tier of benefits, he moves to the next tier. If the program expires while an individual is in a tier, he continues collecting the remaining benefits in that tier but cannot advance to the next tier. These benefits consist of:

- Up to **26 weeks** of regular **state unemployment benefits** funded by state UI taxes (fewer weeks in some states)
- Up to **53 weeks** from the temporary **Emergency Unemployment Compensation (EUC-08)** program set up in 2008 and funded by federal UI taxes:
 - Up to 20 weeks for EUC Tier 1, in all states
 - Up to 14 weeks for EUC Tier 2, in all states
 - Up to 13 weeks for EUC Tier 3, in states with an unemployment rate of at least 6 percent (currently 43 states, the District

of Columbia, Puerto Rico, and the Virgin Islands)²⁶

- Up to six weeks for EUC Tier 4, in states with an unemployment rate of at least 8.5 percent (currently 22 states, the District of Columbia, and Puerto Rico)²⁷
- Up to **20 weeks** of benefits from the **Extended Benefits (EB)** program with funding shared between federal and state UI sources:
 - Up to 13 weeks in State Extended Benefits (SEB), in states with an unemployment rate of at least 6.5 percent (currently 32 states and the District of Columbia)
 - Up to seven weeks in State Extended Benefits-2/High Extended Benefits, in states with an unemployment rate of at least 8 percent (currently 24 states and the District of Columbia)

Table 3
States Facing Tax Credit Reductions

State	Reduction for 2010	Potential Reduction for 2011
Alabama		0.3%
Arkansas		0.3%
California		0.3%
Connecticut		0.3%
Florida		0.3%
Georgia		0.3%
Idaho		0.3%
Illinois		0.3%
Indiana	0.3%	0.6%
Kentucky		0.3%
Michigan	0.6%	0.9%
Minnesota		0.3%
Missouri		0.3%
North Carolina		0.3%
New Jersey		0.3%
Nevada		0.3%
New York		0.3%
Ohio		0.3%
Pennsylvania		0.3%
Rhode Island		0.3%
South Carolina	0.3%	0.6%
Virginia		0.3%
Wisconsin		0.3%
Virgin Islands		0.3%

Source: U.S. Department of Labor.

Note: 2011 reductions assume each state has a loan balance and no changes are made to avoid the reduction.

As of February 2011

22 See U.S. Department of Labor, *supra* note 19 at Chapter 2; Kail Padgitt, *2011 State Business Tax Climate Index*, Tax Foundation Background Paper No. 60 at 56 (2010).

23 For details about state benefit calculation methods, See U.S. Department of Labor, *supra* note 19 at Chapter 3.

24 Massachusetts offers 30 weeks; Montana offers 28 weeks in some situations. Six states have reduced maximum weeks below 26 weeks in the past two years.

25 Social Security Administration, Bulletin (Aug. 1959), <http://www.ssa.gov/policy/docs/ssb/v22n8/v22n8p16.pdf>.

26 As averaged over the previous three months. Alternatively, the tier applies when a state's insured unemployment rate is at least 4 percent.

27 As averaged over the previous three months. Alternatively, the tier applies when a state's insured unemployment rate is at least 6 percent.

Table 4
State UI Changes to Qualify for Federal Stimulus Funds

State	Change Base Period to Include Most Recent Quarter	Payments to Those Seeking Part-Time Work	Allow UI Benefits to Separations Due to Family Reasons	Additional 26 Weeks of Benefits for Training	Dependent Allowances of at Least \$15 Per Week
Alabama					
Alaska	X		X		X
Arizona					
Arkansas	X	X	X		
California	X	X	X		
Colorado	X	X	X		
Connecticut	X		X		X
Delaware	X	X	X		
Florida					
Georgia	X	X		X	
Hawaii	X	X	X		
Idaho	X	X		X	
Illinois	X		X		X
Indiana					
Iowa	X	X		X	
Kansas	X	X		X	
Kentucky					
Louisiana					
Maine	X	X	X	X	
Maryland	X	X		X	
Massachusetts	X			X	X
Michigan	X				
Minnesota	X	X	X		
Mississippi					
Missouri					
Montana	X	X		X	
Nebraska	X	X		X	
Nevada	X	X	X		
New Hampshire	X	X	X		
New Jersey	X	X		X	
New Mexico	X	X			X
New York	X	X	X		
North Carolina	X	X	X		
North Dakota					
Ohio	X				
Oklahoma	X	X	X		
Oregon	X		X	X	
Pennsylvania					
Rhode Island	X		X		X
South Carolina	X	X	X		
South Dakota	X	X		X	
Tennessee	X	X			X
Texas					
Utah	X				
Vermont	X				
Virginia	X				
Washington	X		X	X	
West Virginia	X				
Wisconsin	X		X	X	
Wyoming					
District of Columbia	X	X		X	
Puerto Rico					
Virgin Islands	X	X	X		
No. of States	38	24	20	14	7

Federal law was amended during the current recession to provide for complete federal funding of the EB program through 2011. Some states also offer additional benefits for special circumstances.²⁸

While some states have adopted a number of UI reforms, it is unlikely that a considerable number of states will repay their federal UI loan balances by the deadline. Employers in many states thus could face growing federal UI tax increases.

The EUC program of additional benefits is temporary and has faced several reauthorizations, most recently in late 2010 as part of an agreement that extended the 2001-03 tax cuts.²⁹ That agreement included an extension of the EUC until January 3, 2012; this does not add additional weeks of benefits, but rather preserves the current structure of benefits through 2011. Current beneficiaries would be able to draw benefits in EUC or EB until June 2012.

In times of low unemployment, generally between 2 and 3 million individuals are drawing unemployment benefits at any given time. As of June 2011, 3.6 million individuals were drawing state UI benefits, 3.2 million individuals were drawing EUC benefits, and 0.6 million were drawing EB program benefits, for a total of 7.5 million recipients out of an estimated 14.5 million unemployed.³⁰ Total recipients peaked at 12.1 million in January 2010.³¹

The UI System in the Economic Downturn

Insolvent States Face Higher Federal UI Taxes and Interest Payments

Because unemployment benefits are an entitlement program and must be paid even if the state trust fund is insolvent, states must then either

28 See U.S. Department of Labor, *supra* note 19 at Chapter 4.

29 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (H.R. 4853) (enacted Dec. 17, 2010).

30 See U.S. Department of Labor, *Weekly Continuing Claims*, <http://ows.dolera.gov/unemploy/docs/persons.xls>.

31 See *id.*

raise the money themselves or borrow from the federal government's share of UI tax revenues.³² Before 1982, these loans were permanently interest-free; that year, federal law was amended to require interest payments each October 1 for the preceding year. Hence, the first set of interest payments is due by October 1, 2011.

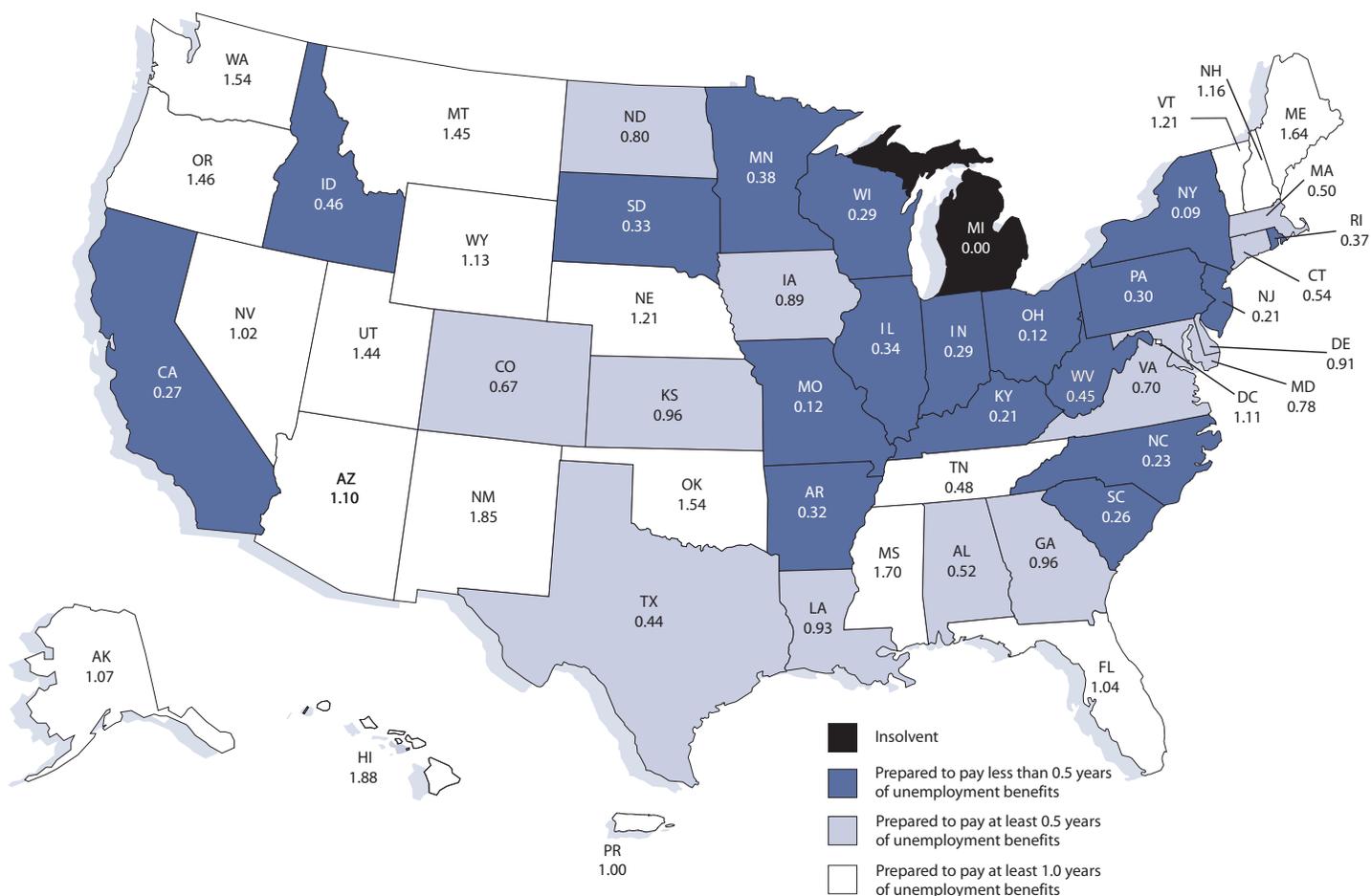
As of September 2011, 34 states had borrowed from the federal government to pay UI benefits. Seven states have repaid their loans in full either through general fund spending or state-based borrowing from the private sector: Hawaii, Idaho, Maryland, Massachusetts, New Hampshire, South Dakota, and Texas.

If a state's UI program is less solvent than it was three years previously, and if the state has not

in the past year begun repaying federal loan balances, employers in the state see their maximum FUTA credits reduced by 0.3 percent per year until the loans are repaid. This higher federal tax is thus a mechanism of automatically repaying those loans. Three states are currently so designated and thus face higher federal UI taxes than 0.8 percent: Indiana (1.1 percent FUTA tax), Michigan (1.4 percent FUTA tax), and South Carolina (1.1 percent FUTA tax).³³

Absent state action to repay federal loan balances or federal action to modify the obligation, 23 states and the U.S. Virgin Islands have been flagged by the Secretary of Labor as likely to see credit reductions this fall, retroactive to January 1, 2011 (see Table 3).³⁴ The Secretary of Labor is

Figure 7
How Prepared Were State Unemployment Fund Reserves at the Beginning of the Current Economic Downturn? Years of Benefits States Prepared to Pay as of First Quarter 2008



Source: National Association of State Workforce Agencies

Note: Number for each state is the Average High Cost Multiple (AHCM), an official estimate of how many years of high benefit pay-outs a state's trust fund can support.

³² Six states are authorized by their state's laws to issue bonds to pay unemployment insurance, which are then repaid over time. Those states are Colorado, Connecticut, Louisiana, Missouri, Texas, and West Virginia.

³³ U.S. Department of Labor, *Reduced FUTA Tax Credits for Tax Year 2010*, http://workforcesecurity.doleta.gov/unemploy/content/reduced_futa.asp.

required to make the determination by November 10 of each year.³⁵ Eventually, a state's employers could lose all of their 5.4 percent in employer tax credits if no part of the interest is paid.

If a state has not made progress toward repaying its loans after three years, an additional credit reduction occurs on top of the 0.3 percent credit reductions, known as the "2.7 add-on."³⁶ This formula reduces credits for employers in states with effective UI tax rates of less than approximately 0.4 percent.³⁷ After five years of non-repayment, the "BCR" credit reduction formula is used instead, which reduces credits for employers in states with high benefit costs relative to taxable wages.³⁸

States can avoid credit reductions by repaying loans at least equal to the amount employers would pay through credit reductions, increasing the solvency of their system by an amount equal

to the credit reductions, repaying any advances in the past year through November 9, and not borrowing between November 1 and January 31 of the following year.³⁹

While some states have adopted a number of UI reforms, it is unlikely that a considerable number of states will repay their federal UI loan balances by the deadline. Employers in many states thus could face growing federal UI tax increases. The author attended the summer 2011 working session on the topic at the National Conference of State Legislatures (NCSL), a gathering of state legislators from around the country, and there was still wide belief that the federal government will either forgive the loan balances or otherwise relieve them by preventing the scheduled tax increases.

Figure 8
Unemployment Insurance Trust Fund Reserves



Source: U.S. Department of Labor.

34 See U.S. Department of Labor, *States with Potential 2011 FUTA Credit Reductions*, http://workforcesecurity.doleta.gov/unemploy/.../reduced_credit_states_2011.xls.

35 See 26 U.S.C. § 2406(f).

36 See 26 U.S.C. § 3302(c)(2)(B).

37 The formula is $[(2.7\% \times 7000 / \text{Avg. U.S. Wage}) - \text{State Effective UI Rate on Total Wages}] \times (\text{State Annual Average Wage} / 7000)$.

38 The Base Credit Reduction (BCR) formula replaces the 2.7% in the above formula if $[\text{Five Year State Average Cost} / \text{Taxable Wages}]$ is higher.

39 Ron Wilus, *Trust Fund Loans: Interest Charges and Payment Options*, U.S. Department of Labor, http://www.workforceatm.com/sections/pdf/2010/Peretto_MI_ui75_2010.pdf?CFID=1978765&CFTOKEN=90708802.

Stimulus Package Suspended Interest Payments but Encouraged States to Expand Benefits

The American Recovery and Reinvestment Act of 2009 (ARRA) signed into law in February 2009, also known as the stimulus package, contained several elements that affect unemployment insurance programs.⁴⁰ Chief among these was an extension of the EUC program through the end of 2009; EUC has subsequently been extended to early 2012. Other key provisions:⁴¹

- **Suspended states' requirement to pay interest** on outstanding federal loan balances through 2010. Consequently, beginning on October 1, 2011, states with outstanding federal loan balances must begin paying interest on those balances.
- **Increased weekly benefits** by \$25 per week; this \$12.1 billion in additional benefits was funded entirely by the federal government. This provision expired in late 2010.
- **Exempted the first \$2,400 of unemployment benefits from federal individual income tax** for 2009 only.
- **Expanded to 100 percent** the federal government share for the EB program through early 2012.
- **Provided \$7 billion in UI "modernization incentive payments"** for states that expand UI benefits. To receive a share of the funds, a state must include the most recent quarter of an applicant's earnings in its calculation of benefits, and additionally adopt into law at least two of the following:
 - Pay benefits to those seeking only part-time work
 - Expand UI eligibility to those who leave their job for family reasons (*i.e.*, domestic violence, spousal relocation, caring for a family member)
 - Provide an additional 26 weeks of benefits to those in certain training programs
 - Provide a dependents' allowance of at least \$15 per week

More than half the states received some of the incentive payments, with 34 states receiving full payments. (See Table 4.) As noted by the

U.S. Government Accountability Office (GAO), "changes that states make to state unemployment programs as a result of ARRA's modernization provisions must be permanent, and thus could increase funding challenges for states in the future."⁴² However, the stimulus act does not provide for reclaiming funds from a state if the state subsequently repeals any of the expansion provisions.

President Obama's 2011 Budget Proposal Seeks to Encourage "Forward Funding"

In his February 2011 budget proposal, President Obama advocated a number of UI reforms that would encourage states to better "forward fund" UI liabilities during times of low unemployment.⁴³ The proposal notes that states are not accumulating sufficient UI reserves to withstand recession-level benefits, zeroing in on low taxable wage bases as the key culprit.

The President's proposal would:

- Extend the 0.2 percent federal UI tax surcharge through 2013 (resulting in a 0.8 percent federal UI tax rate after credits). The rate would drop to 0.38 percent in 2014.
- Increase the minimum federal taxable wage base from the current \$7,000 to \$15,000 in 2014, then indexing it to wage growth. Currently, 33 states have taxable wage bases lower than that level, and these would need to be raised.
- Extend the moratorium on state interest payments by two years.
- Delay credit reductions to borrowing states by two years.

The designers of the federal-state unemployment insurance system intended for revenues to exceed expenses during times of low employment, which would enable the accumulation of a large trust fund reserve that could then be drawn down during times of high unemployment. However, over the years states have steadily reduced the amount of reserves built up in good times.⁴⁴

One commonly cited reason is that officials fear that sizeable unemployment reserves will lead to pressure to increase benefits, which in turn

⁴⁰ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (enacted Feb. 17, 2009).

⁴¹ See U.S. Government Accountability Office, Unemployment Insurance Trust Funds: Long-standing State Financing Policies Have Increased Risk of Insolvency, No. GAO-10-440 at 34-35 (Apr. 2010).

⁴² Id.

⁴³ See Office of Management and Budget, *supra* note 1, at 111, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/labor.pdf>; U.S. Department of Labor Employment & Training Division, UI Outlook, (Mar. 2011), http://www.ows.doleta.gov/unemploy/content/prez_budget.asp.

would harm the state's ability to pay benefits during times of high unemployment. Consequently, in years leading up to the recession, states have reduced UI taxes and not accumulated reserves during times of low unemployment. For example, between 1995 and 2005, 31 states reduced UI taxes by at least 20 percent.⁴⁵

One measure of trust fund solvency is the "average high cost multiple" (AHCM), which estimates how many years of high benefit pay-outs a state's trust fund can support. For example, a state with an AHCM of 1.0 could support 12 months of historically high benefits. All state reserves had an AHCM of between 1.5 and 2.0 during the 1960s, approximately 1.0 during the late 1990s, and approximately 0.5 just prior to the present recession. In the first quarter of 2008, only 17 states, the District of Columbia, and Puerto Rico were ready to pay one year of high-cost benefits. 20 states had not prepared sufficient reserves to pay even a half year of benefits. (See Figure 7.)

Thus when UI regular and extended benefits rose from \$40.7 billion in 2008 to \$85.8 billion in 2009, built-up state trust fund reserves were not sizeable enough and many states became incapable of paying promised benefits.⁴⁶ Overall UI reserves have fallen steadily over the decades. (See Figure 8.)

If enacted, President Obama's proposal would likely lead to additional money flowing into state UI trust funds while easing obligations in the near term for insolvent states. However, given the proven reluctance of states to accumulate high levels of reserves during times of low unemployment, the proposal may not succeed in its goal of ensuring that UI trust fund reserves are large enough to handle the next recession.

Some States Reducing Benefits or Raising Taxes

Many states have altered UI benefit formulas and eligibility requirements during 2010 and 2011. Six states (Arkansas, Florida, Illinois, Michigan, Missouri, and South Carolina) have reduced the maximum period of state benefits below the previously-universal 26 weeks. Three states (Flor-

ida, Rhode Island, and South Carolina) adopted significant packages of UI reforms.

Florida Reduces Benefit Weeks and Tightens Eligibility Requirements

In June, Florida adopted legislation that makes a number of significant changes to its UI system⁴⁷:

- Benefits are changed from a flat 26 weeks to a sliding scale based on the state's unemployment level. When unemployment is 5 percent or less, recipients can receive up to 12 weeks of benefits. Each 0.5 percent increase in the rate adds another week of benefits, up to a maximum of 23 weeks when unemployment is 10.5 percent or higher (as it is now). This change takes effect January 1, 2012.
- The definition of misconduct, and thus ineligibility for benefits, has been broadened to include specific workplace violations and misconduct outside of working hours.
- Claimants must now provide officials each week with details about at least five prospective employers or a visit to a career center. Claimants must also complete an online skills assessment. This provision is effective August 1, 2011.
- Prisoners are no longer eligible for benefits, as of August 1, 2011.
- Individuals who receive severance pay are no longer eligible for benefits, effective August 1, 2011.
- Appeals officers can now consider certain types of hearsay evidence about claimants, and a rule requiring doubtful cases to be decided in favor of claimants has been repealed.

Rhode Island Reduces Average Weekly Benefit and Tightens Eligibility Requirements

Rhode Island adopted a series of changes that will take effect in July 2012.⁴⁸ The average weekly benefit is expected to drop from approximately \$390 to \$298 through four changes:

44 See Daniel L. Smith & Jeffrey B. Wenger, *If You Build It: State Unemployment Trust Solvency and Benefit Generosity*, Allied Social Science Associations (Jan. 2011), <http://www.martin.uky.edu/workshops/papers/Wenger0126.pdf>. They found only seven states increased their average reserve ratio: Alaska, Delaware, Hawaii, New Jersey, Oklahoma, Oregon, and Vermont. See also Dennis Cauchon, "States Running Out of Money in Jobless Funds," *USA Today* (Sep. 9, 2008).

45 Dale Ziegler, *Introduction to State Unemployment Insurance Trust Fund Solvency*, U.S. Department of Labor (Mar. 19, 2010), <http://www.workforceatm.org/sections/pdf/2010/SolvencyWebinarSlides.pdf?CFID=1970346&CFTOKEN=76052797>.

46 See U.S. Government Accountability Office, *supra* note 41, at 13. Michigan began borrowing in 2006, and Indiana and South Carolina in 2008. New Hampshire did not begin borrowing until 2011.

47 See Florida H.B. 7005 (2011 Leg.).

48 See Rhode Island Laws Ch. 11-151 (11-H 5894A).

- Reducing the maximum weekly rate from 67 percent of average wages to 57.5 percent
- Calculating benefits as replacing 50 percent of lost wages rather than 60 percent (phased in over three years)
- Averaging the two highest quarters in determining a claimants' benefits, rather than using only the highest quarter
- Capping claimants' maximum benefits at 33 percent of all base period wages, rather than 36 percent

Claimants will be disqualified if they are terminated for misconduct, refuse to accept suitable work, quit without good cause, or have not worked at least eight weeks earning at least the benefit rate. Claimants who received severance pay will be disqualified for up to 26 weeks.

Rhode Island also will increase its taxable wage base in 2012 to be indexed to 46.5 percent of the state's average base, resulting in an immediate increase from \$19,000 to \$19,600. High-layoff employers will pay taxes on a higher wage base.⁴⁹

South Carolina Dramatically Expands Experience Rating and Disqualifies Seasonal Employees

A new tier system took effect in 2011 placing employers in one of 20 tiers (up from 15) based on benefit ratio and unemployment claims over the previous seven years. 53 percent of South Carolina businesses have had zero unemployment claims and are in Tier 1 (\$10 per employee per year), a dramatic tax reduction. Businesses with the most unemployment claims are in Tier 20 (\$1,127 per employee per year). Some 30 percent of employers thus saw an increase in UI taxes of 100 percent to 600 percent. New employers are placed in Tier 12 for their first year of operation.

The state will reduce the maximum length of benefits from 26 weeks to 20 weeks, beginning in July 2012. The definition of seasonal employees (ineligible during the off-season) is changed as of January 2012 to regularly recurring periods of 36 consecutive weeks, the longest period used for such a definition. The state also increases the tax-

able wage base from \$7,000 to \$10,000 in 2011, \$12,000 in 2012, and \$14,000 in 2015.

These changes will allow South Carolina to pay back its federal loan and cease additional borrowing. However, critics point to the suddenness of the tax increase and the job reduction impacts for high-turnover employers (hiring freezes, capital investment freezes, layoffs, and threats to move to other states).⁵⁰ The state is also considering reducing benefits for those receiving severance, disqualifying applicants who fail drug tests, and requiring employee contributions.

Reductions in Weeks of Benefits

For the first time in decades, six states cut the maximum length of benefits for qualified claimants to below 26 weeks:

- Arkansas (25 weeks, effective March 2011)
- Florida (a sliding scale of 12 to 23 weeks, effective January 2012)
- Illinois (25 weeks, effective January 2012)
- Michigan (20 weeks, effective January 2012)
- Missouri (20 weeks, effective April 2011)
- South Carolina (20 weeks, effective June 2011)

Other Changes

25 states increased their taxable wage base; the average base in the United States has risen each year: \$11,696 in 2008, \$12,241 in 2009, \$12,970 in 2010, and \$13,451 in 2011. A number of states have also increased minimum and maximum tax rates (20 states in 2010), increased rates for new employers (13 states in 2010), imposed surcharges on all employers (11 states in 2010), and changed maximum and minimum benefits.

Indiana, Georgia, Massachusetts, New Jersey, and South Carolina passed bills canceling or delaying scheduled UI tax increases.⁵¹ Idaho and Texas have borrowed from private sources to pay benefits rather than from the federal government, "replac[ing] federal borrowing costs with (potentially lower) costs of the private bond market, but...not address[ing] structural financing issues."⁵²

49 Id.

50 See Sen. Paul G. Campbell, Jr., *South Carolina: State Unemployment Tax Relief*, Presentation to the National Conference on State Legislatures (Aug. 8, 2011).

51 Indiana House Enrolled Act No. 1450, 117th General Assembly; Georgia Act 95, 2011-2012 Regular Session; Massachusetts Chapter 2 of the Acts of 2011; New Jersey Public Law 2011, Chapter 81; South Carolina Act No. 63, 119th Session.

Issues Associated with the Current Unemployment Insurance Tax System

Experience Rating: Balancing Dual Objectives of Spreading Costs to All Employers and Imposing Costs on High-Turnover Employers

Firms pay higher or lower UI taxes based on their layoff history, known as their **experience rating**. Social insurance programs differ from private insurance in three ways: (1) participation is mandatory, assuring continual new entrants; (2) government operation makes program termina-

tion unlikely, no matter what the actuarial status; (3) taxes, premiums, and benefits can be changed by statute without participants' consent.⁵³ While social insurance programs "may increase somewhat with increased contributions or with increased participation," generally "benefits need not bear a direct relationship to individual contributions."⁵⁴

The UI program thus is a benefit to high-turnover employers, as it enables them to avoid paying higher wages to attract workers who value job stability. Adopting an experience rating formula allows states to claw back some of this benefit, requiring high-turnover firms to bear some of the costs associated with higher benefit payouts to their former workers. Employers with a high experience rating (high turnover and/or large numbers of former employees collecting benefits) must usually pay the maximum state UI tax rate, although these are generally not high enough to cover all the costs. These unrecovered costs "become the common burden of all employers, and for this reason can be referred to as shared costs."⁵⁸ Experience rating has two major goals:

- Use lower taxes to encourage employers to stabilize employment or prevent unemployment
- More accurately distribute the costs of UI benefits to those who impose the costs on society.

There are three types of shared or "socialized" costs. **Ineffective charges** are benefits paid to an employer's former employees in excess of the employer's tax payments, totaling approximately 18 percent of benefits paid in 2009.⁵⁹ **Inactive charges** are "benefits paid to unemployed workers whose former employer has gone out of business,"⁶⁰ totaling 6 percent of benefits paid.⁶¹ **Noncharged benefits** are benefits paid in situations where it is determined that the former employer should not be held responsible, such as where the benefit award is reversed or in some circumstances where the end of employment was due to personal reasons.⁶² Noncharged benefits total 15 percent of benefits paid.⁶³

CALCULATING EACH EMPLOYER'S EXPERIENCE RATING

Four different methods of experience rating (imposing higher UI taxes on employers more likely to impose UI costs on the system) are used by the 53 state and territorial unemployment insurance systems in the United States.

Reserve Ratio, used by 33 systems, accounts for each employer the taxes paid by the employer and the benefits paid to the firm's former employees.⁵⁵ Balances are carried forward and each year, the firm's reserve balance is divided by its wages (usually an average of three years' wages) to calculate its experience rating.

Benefit Ratio, used by 17 systems, divides benefits to a firm's former employees by its wages to calculate its experience rating.⁵⁶ Tax payments by the employer are not considered.

Benefit-Wage Ratio, used by Delaware and Oklahoma, calculates experience rating based on the proportion of the firm's payroll paid to workers who separate during a base period. The higher the ratio, the higher the tax rate. Duration of benefits is thus not a factor in this approach.⁵⁷

Payroll Variation, used by Alaska, bases experience rating on changes to a firm's payroll. Firms with recent layoff activity pay higher rates while firms with no layoffs in the past three years pay the lowest rate.

52 Claire McKenna and George Wentworth, *Unraveling the Unemployment Insurance Lifeline: Responding to Insolvency, States Begin Reducing Benefits and Restricting Eligibility in 2011*, National Employment Law Project Legislative Update at 2 (Aug. 2011), http://nelp.3cdn.net/833c7eeb782f18bdb3_a5m6b0wvp.pdf.

53 See Actuarial Standards Board, *Social Insurance*, Actuarial Standard of Practice No. 32 at 10 (Jan. 1998), http://www.actuarialstandardsboard.org/pdf/asops/asop032_062.pdf.

54 Id.

55 Arizona, Arkansas, California, Colorado, Georgia, Hawaii, Idaho, Indiana, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Rhode Island, South Dakota, Tennessee, West Virginia, Wisconsin, and the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

56 Alabama, Connecticut, Florida, Illinois, Iowa, Maryland, Michigan, Minnesota, Mississippi, Oregon, Pennsylvania, South Carolina, Texas, Utah, Vermont, Virginia, Washington, and Wyoming.

57 See Kevin B. Kerr, *Unemployment Insurance Financing: Selected Issues*, Government of Canada Depository Services Program (Oct. 1994), <http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/BP/bp389-e.htm>.

58 U.S. Government Accountability Office, *supra* note 16, at 15.

59 National Foundation for Unemployment Compensation & Workers' Compensation, *Fiscal Data for State Unemployment Insurance Systems, 2000-2009* (Oct. 2010) (Table 11).

The United States is the only country that bases its unemployment insurance program on experience ratings.⁶⁴ However, state-set maximum tax rates are generally too low to ensure that experience ratings fully impose on high-turnover employers the cost of benefits to their former employees. Therefore, some cross-subsidization happens in all state systems, just as private insurance usually involves a larger pool of non-claimants paying the costs of providing benefits to the small number of claimants.

Social insurance by definition means shifting the costs of some employers onto all employers as a whole, and experience rating can be an effective tool for this. States should also be cautious about being at either extreme in relying on experience rating:

- Relying too little on experience rating means society is heavily subsidizing employers with highly volatile employment practices, by allowing them to be cost-competitive with more stable employers. The GAO, studying industries in Washington State, found that finance, services, and retailers are likely subsidizing agriculture, fishing, mining, and construction.⁶⁷
- Relying too heavily on experience rating undermines the UI system's objective of spreading the costs of unemployment beyond high-turnover workers. In its 1996 report, the Advisory Council on Unemployment Compensation noted that experience ratings can discourage temporary layoffs, but worried that "such a system often imposes costs on firms precisely when they are in the weakest economic position."⁶⁸ In other words, "some employers—especially small ones—that need to lay off workers may find that their tax rates increase so dramatically as a result of those layoffs that that [sic] additional layoffs become necessary."⁶⁹

The U.S. Department of Labor developed an "Experience Rating Index" (ERI) to calculate to what extent experience rating drives a state's UI system, by calculating the percentage of benefits that are financed out of UI taxes paid by their former employers.⁷⁰ A state with a low ERI (such as Hawaii, Maine, Nevada, South Carolina, and Vermont) means more costs of unemployment

must be shouldered by low-turnover employers and society in general. A state with a high ERI (such as Colorado, Illinois, Minnesota, New York, and North Dakota) puts much of the burden of unemployment on employers who have a history of layoffs. States with an ERI in the middle balance these objectives.

While the Department of Labor ceased calculating ERI in 2005, the National Foundation for Unemployment Compensation & Workers' Compensation (NF/UC/WC) continues to do so. During the period 2000 to 2009, NF/UC/WC calculated overall ERI at between 49 and 64, meaning that between 49 percent and 64 percent of UI benefits paid out are properly charged to the claimant's former employer. Figure 9 shows each state's ERI for 2009.

SOLVENCY TAXES

Solvency taxes are levied on employers when a state's unemployment fund falls below some defined level. These are generally across-the-board taxes imposed on all employers, including new employers in many cases, which undermine experience rating efforts while increasing UI tax burdens and compliance costs. The GAO has criticized solvency taxes, saying that such a tax:

[D]istorts experience rating in that it changes an employer's experience-rated rate relative to those of other employers. For example, an employer with a tax rate of 3 percent would now have a tax rate of 3.9 percent, an effective 30 percent increase. On the other hand, an employer with a 5 percent tax rate would, with the fund-building component added, now have a tax rate of 5.9 percent—an 18 percent increase.⁶⁵

All states except Maryland, New Mexico, North Dakota, and Vermont have statutes automatically imposing surtaxes upon a defined fund balance trigger occurring.

Currently 18 states impose a solvency tax on employers, although they operate under different names: Alaska (solvency adjustment), Arkansas (stabilization tax), Colorado (solvency tax), Delaware (supplemental assessment), Illinois (fund building factor), Louisiana (solvency tax), Massachusetts (secondary adjustment), Minnesota (Additional Assessment & Falling Trust Fund Adjustment), New Hampshire (emergency power surcharge), New Jersey (solvency addition), New York (subsidiary contribution), Oklahoma (temporary surcharge), Pennsylvania (solvency measures), Rhode Island (solvency surtax), Texas (deficit assessment), Virginia (fund building rate), Washington (solvency surcharge), and Wisconsin (solvency rate).⁶⁶

60 U.S. Government Accountability Office, *supra* note 16, at 16.

61 U.S. Department of Labor Office of Workforce Security Division of Fiscal and Actuarial Services, *Significant Measures of State UI Tax Systems 2010* (Oct. 2010), <http://workforcesecurity.doleta.gov/unemploy/pdf/sigmeasuitaxsys10.pdf>

62 U.S. Government Accountability Office, *supra* note 16, at 16.

63 Additionally, certain nonprofit organizations, government agencies, and Indian tribes may "opt out" of UI tax payments on the condition they "self fund": reimburse the government for any benefit claims from former employees. These "reimbursable employers" total 4 percent of claims paid. See U.S. Department of Labor Office of Workforce Security Division of Fiscal and Actuarial Services, *supra* note 61.

64 U.S. Government Accountability Office, *supra* note 16, at 5.

65 *Id.* at 17.

66 See U.S. Department of Labor, *supra* note 19 at Chapter 2.

States should be sure that their UI tax systems are not overly complex and burdensome, particularly to new employers, and that they balance the goal of spreading the costs of unemployment among all employers, with the danger of overly subsidizing high-turnover employers by enabling them to pay lower wages that do not compensate their workers for lower job security.

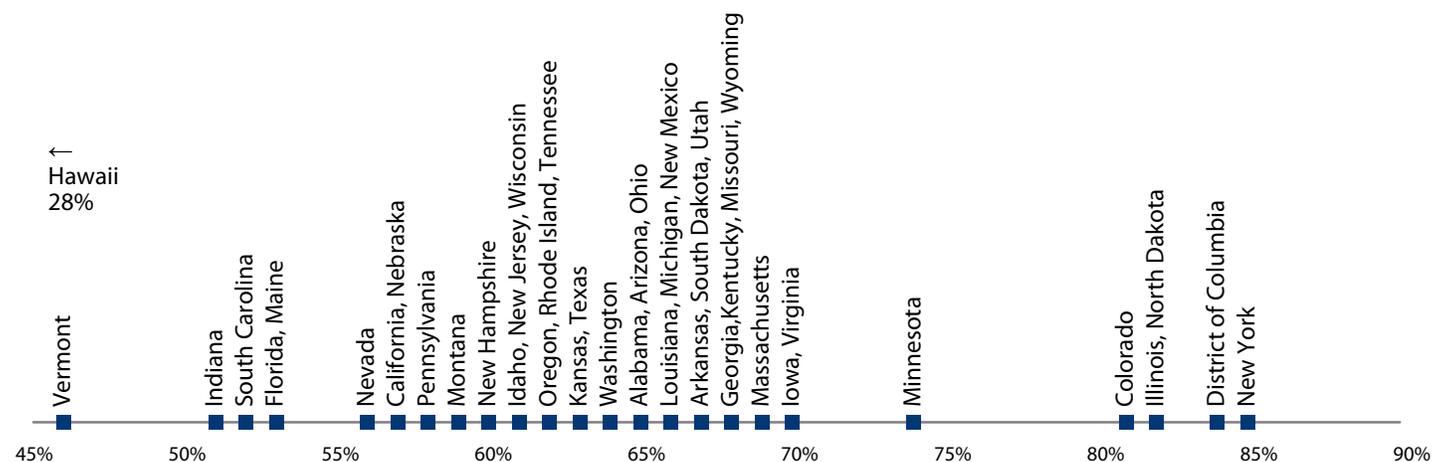
Job Creation and Countercyclical Fiscal Policy: Making the Economy Better or Worse?

The Social Security Board's March 1937 pamphlet explaining the rationale for unemployment insurance emphasized that the overriding

purpose was for UI benefits "to act as a first line of defense in protecting the industrial worker from distress caused by involuntary unemployment."⁷¹ Even then, they added a second objective: "Unemployment compensation can thus act as a cushion to the downswing of the business cycle when business is beginning to slacken, since it helps to sustain the buying power of the consuming public."⁷²

Keynesian economists today refer to such a policy as **countercyclical**—that is, a policy that cools down the economy in an upswing or stimulates an economy in a downswing.⁷³ These commentators assert that UI benefits are countercyclical, and further, that they are effective at retaining and even creating jobs. This conclusion relies on Keynesian economic models' focus on

Figure 9
Percentage of Paid Benefits Properly Charged to Claimant's Former Employers
Experience Rating Index (ERI), 2009



Lower score (below 60%):

- UI system **penalizes low-turnover** employers with high taxes
- Benefits to laid-off workers borne heavily by all employers
- Employers pay similar taxes

Score in the middle means:

- UI system **penalizes neither** high- nor low-turnover employers
- Benefits to laid-off workers primarily but not exclusively borne by former employers
- Employers pay higher or lower taxes according to their layoff history but without extremely high rates

Higher score (75% or above):

- UI system **penalizes high-turnover** employers with high taxes
- Benefits to laid-off workers borne heavily by their former employer
- Employers pay higher or lower taxes

Note: ERI calculation not available or applicable for Alaska, Connecticut, Delaware, Maryland, Mississippi, North Carolina, Oklahoma, and West Virginia.

Source: Department of Labor calculation by the National Foundation for Unemployment & Workers' Compensation, Fiscal Data for State Unemployment Insurance Systems 2000-2009 (Table 11)(Oct. 2010).

67 U.S. Government Accountability Office, *supra* note 16, at 21.

68 Advisory Council on Unemployment Compensation, *Collected Findings and Recommendations: 1994-1996* at 39 (1996), <http://research.upjohn.org/cgi/view-content.cgi?article=1000&context=externalpapers>.

69 U.S. Government Accountability Office, *supra* note 16, at 28. See also Dr. William B. Conerly, *Getting Back to Work: Reforming Unemployment Insurance to Increase Employment*, Goldwater Institute Policy Report at 5 (Jan. 2004), <http://www.goldwaterinstitute.org/article/1230> ("Researchers have estimated that five percent of all layoffs are due to improper experience ratings. Other researchers focusing only on temporary layoffs found that the system itself caused 20 to 30 percent of such layoffs. At the depth of a recession, poor experience ratings cause about 50 percent of all temporary layoffs.")

70 More specifically, the formula is $ERI = (1 - ((\text{Ineffective Charges} + \text{Inactive Charges} + \text{Noncharges}) / \text{Benefits}))$.

71 U.S. Social Security Board, *supra* note 5.

72 *Id.*

boosting “aggregate demand,” or overall spending in the economy, and the contention that UI benefit recipients are more likely to spend rather than save their benefits. For example, in summer 2010, then-House Speaker Nancy Pelosi argued that an extension of UI benefits “injects demand into the economy...[i]t creates jobs faster than almost any other initiative you can name.”⁷⁴ The U.S. Department of Labor asserts on its website that “for every dollar spent on unemployment insurance, this report finds an increase in economic activity of two dollars.”⁷⁵ Moody’s analyst Mark Zandi, one of the architects of the 2009 stimulus law, states that “every dollar spent on extending unemployment insurance benefits produces \$1.61 in economic activity.”⁷⁶

Critics argue that such “multipliers” (the number of times spending induces other spending) are assumptions built into economics model, rather than evidence produced by the models. In other words, Zandi’s statement that UI benefit payments produce economic effects greater than \$1.00 for every \$1.00 spent (a multiplier of 1.0) is assumed, rather than the conclusion reached from analysis.⁷⁷ Writing in the *Wall Street Journal*, Reagan Administration economist Arthur Laffer responded to Zandi’s claim:

While the unemployed may spend more as a result of higher unemployment benefits, those people from whom the resources are taken will spend less. In an economy, the income effects from a transfer payment always sum to zero. Quite simply, there is no stimulus from higher unemployment benefits.

To see these effects clearly, imagine a two person economy in which one of the two people is paid for being unemployed. From whom do you think the unemployment benefits are taken? The other person obviously. While the

one person who is unemployed may “buy” more as a result of unemployment benefits, the other person from whom the unemployment sums are taken will “buy” less. There is no stimulus for the economy.

But it doesn’t stop there. While the income effects sum to zero, the substitution effects aggregate. The person from whom the unemployment funds are taken will find work less rewarding and will work less. The person who is given the unemployment benefits will also find work relatively less rewarding and will therefore work less. Both people in this two-person economy will be incentivized to work less. There will be less work and more unemployment.⁷⁸

Whether unemployment insurance benefits create net jobs or not, the claim that UI is effective countercyclical policy is belied by the prevalence of UI tax reductions in good economic times and UI tax increases, benefit cuts, and borrowing in bad economic times. All told, 35 states raised UI taxes in 2010 by increasing either the tax rate or the taxable wage base⁷⁹ while fiscal pressures are leading many states to cut benefits. In years leading up to the recession, by contrast, many states reduced UI taxes and did not accumulate reserves during times of low unemployment. For example, between 1995 and 2005, 31 states reduced UI taxes by at least 20 percent.⁸⁰ One study concluded that “[c]hanging demographics, industry mix, and state UI statutes have all contributed over time to create a UI system that is no longer countercyclical and may be counterproductive.”⁸¹ The GAO also concluded that “[l]ong-standing state UI policies and practices have led to trust fund vulnerability.”⁸²

With insufficient accumulated state trust fund reserves, benefit payouts today are financed

73 See, e.g., Martin Feldstein, *The Role for Discretionary Fiscal Policy in a Low Interest Rate Environment*, NBER Working Paper No. 9203 (Sep. 2002), <http://www.nber.org/papers/w9203>.

74 Pelosi: *Unemployment Checks Fastest Way to Create Jobs*, FoxNews.com (Jul. 1, 2010), <http://www.foxnews.com/politics/2010/07/01/pelosi-unemployment-checks-best-way-create-jobs/>.

75 U.S. Department of Labor, Summary: *The Role of Unemployment [Insurance] as an Automatic Stabilizer During a Recession*, (Nov. 2010), <http://www.dol.gov/opa/media/press/eta/eta20101615fs.htm>.

76 Michael Leachman, *January 30 Data Release Will Capture Only a Portion of the Jobs Created or Saved by the Recovery Act*, Center on Budget and Policy Priorities (Jan. 2010), <http://www.cbpp.org/cms/index.cfm?fa=view&id=3069>, citing “The Impact of the Recovery Act on Economic Growth,” Hearing Before the Joint Economic Committee (Oct. 29, 2009) (statement of Mark Zandi).

77 See, e.g., Robert Barro, Keynesian Economics vs. Regular Economics, *Wall Street Journal* (Aug. 24, 2011), <http://online.wsj.com/article/SB10001424053111903596904576516412073445854.html>; Arthur Laffer, Unemployment Benefits Aren’t Stimulus, *Wall Street Journal* (Jul. 8, 2010), http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704862404575351301788376276.html; Alan Reynolds, *Can Unemployment Benefits Create Jobs?*, Cato Institute Blog (Jan. 29, 2010), <http://www.cato-at-liberty.org/can-unemployment-benefits-create-jobs/>.

78 Laffer, *supra* note 77.

79 National Association of State Workforce Agencies, *UI Trust Fund Solvency Survey: Summary Document of State Responses*, (Dec. 2009), <http://www.workforceatm.org/sections/pdf/2010/FINALSOLVENCYSURVEY.pdf>.

80 Ziegler, *supra* note 45.

81 Linda M. Aguilar & William A. Testa, *Unemployment Insurance: Countercyclical or Counterproductive*, Chicago Fed Letter No. 47 (Jul. 1991), http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/1991/cfljuly1991_47.pdf.

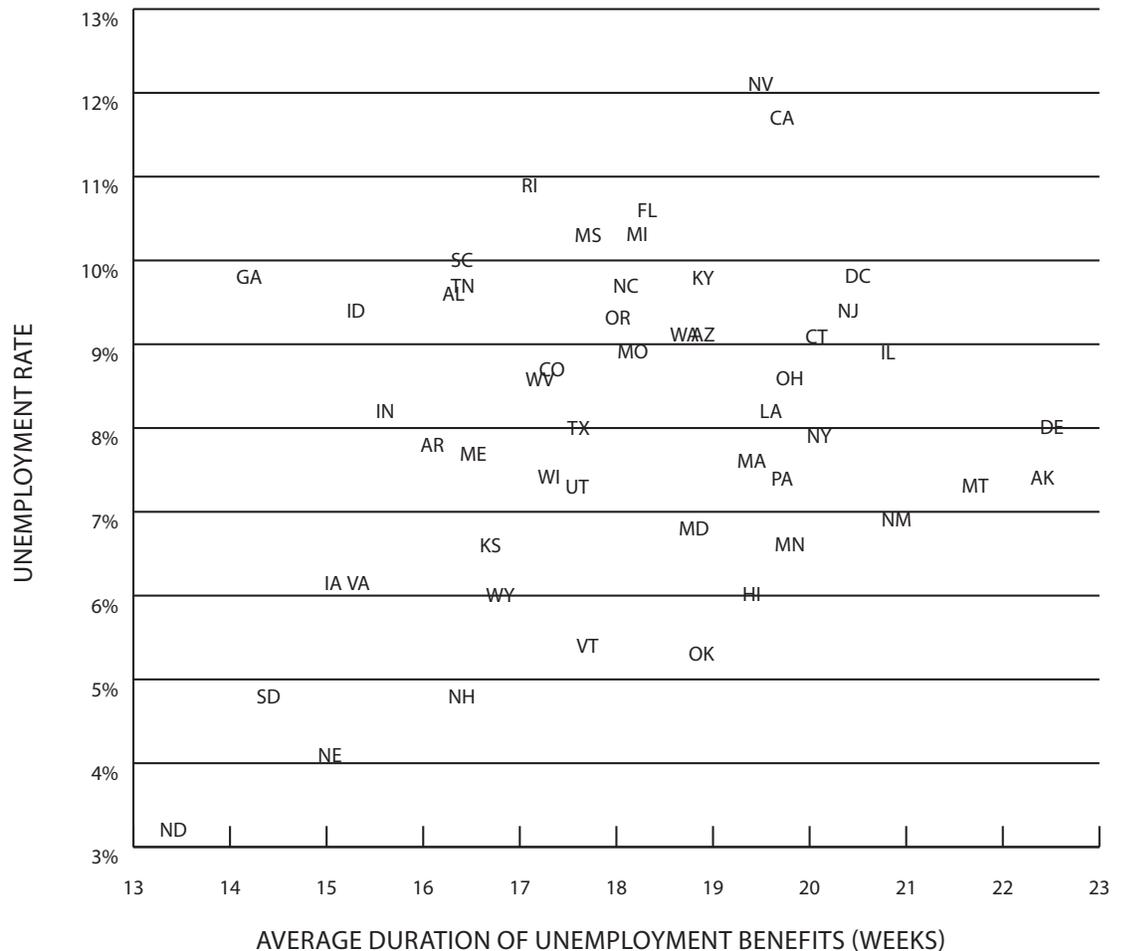
82 U.S. Government Accountability Office, *supra* note 41, at 14.

through current tax revenues and borrowing from private sources or from the federal government, which in turn is borrowing from private or foreign sources. Payments today are made from sources today, rather than from accumulated savings from good economic times. In short, the current UI system is not effective in its original goal of saving funds in good economic times to be drawn down in bad economic times. This is not merely an effect of the severity of the current downturn; the decline in trust fund reserves and pressure to reduce UI taxes in good economic times and increase taxes in bad economic times are long-standing.

Excessive Search and Moral Hazard: Extended Benefits Increase Spending while Also Increasing Unemployment

Debates over proposals to extend or expand unemployment benefits inevitably lead to assertions that generous benefits create a disincentive for beneficiaries to find suitable work quickly, a phenomenon known as **excessive search**.⁸³ Benefits, the argument goes, enable unemployed individuals to turn down or not seek less desirable work, or extend their duration of non-employment beyond what it otherwise would have been. Excessive search is an example of what is called **moral**

Figure 10
Unemployment Rate and Duration of Benefits by State



Source: Tax Foundation compilation

83 A June 2009 *Los Angeles Times* article referred to “funemployment”: “Buoyed by severance, savings, unemployment checks or their parents, the funemployed do not spend their days poring over job listings. They travel on the cheap for weeks. They head back to school or volunteer at the neighborhood soup kitchen. And at least till the bank account dries up, they’re content living for today.” Kimi Yoshino, “For the ‘funemployed,’ unemployment’s welcomed,” *Los Angeles Times* (Jun. 4, 2009), <http://articles.latimes.com/2009/jun/04/local/me-funemployment4>.

hazard: a situation where a party insulated from risk acts differently from the way it would behave if it were fully exposed to the risk.

At the creation of the federal-state UI system, proponents made clear that they were setting up a social insurance program and not a need-based welfare program.

Few deny that excessive search occurs but the extent remains hotly debated. Liberals tend to argue it is a minor problem or not a problem at all; conservatives tend to highlight it as serious. For example, in the 2009 debate over the extension of federal financing of unemployment benefits, Sen. Robert Menendez (D-NJ) responded sharply to an economist who argued that excessive search is a problem:

Dr. Campbell, even if your proposition, your argument, that unemployment benefits incentivize people to remain unemployed is correct under normal economic circumstance—a premise which I personally find highly doubtful given that the average benefit is only about \$325 per week—how do you make that argument in the current economy? How do you deal with the numbers of 3 million, 15 million, and 33 percent? Three million jobs, 15 million people ostensibly looking for jobs, whom you want to incentivize by taking away their unemployment benefits, and 33 percent of those who have been unemployed being unemployed for more than 26 weeks. So are they all lazy?⁸⁴

Sen. Jon Kyl (R-AZ) urged opposition to the federal benefits extension on moral hazard grounds:

That doesn't create new jobs. In fact, if anything, continuing to pay people unemployment compensation is a disincentive for them to seek new work. I'm sure most of them would like work and probably have tried to seek it, but you can't argue that it's a job enhancer. If anything, as I said, it's a disincentive.⁸⁵

Economics Professor Ken Rogoff of Harvard University does not deny the effect generally but

argues that the present economic situation is a special circumstance:

Well, there's certainly a truth to it, and many people believe that's why Europe, with much more generous benefits, has higher unemployment. But today, we're in a once-every-50-years, once-every-75-years recession. There just aren't a lot of jobs.

And it's hard to believe that that's really what's holding people back from getting them, that they can collect a modest unemployment check.[...]

[Conservatives are] making a correct point, but they're stretching it. The empirical work suggests that maybe if you get an extra week of unemployment benefits, your unemployment lasts a day longer, and that's in normal times.

I think it's important to have some checks and balances, not to get carried away. But they're really taking a small point and stretching it out into something bigger than it is.⁸⁶

Similarly, liberal commentator Paul Krugman today argues that “what textbook economics says [is] that when the economy is deeply depressed, extending unemployment benefits not only helps those in need, it also reduces unemployment.”⁸⁷ His own textbook (co-authored with his wife), *Macroeconomics*, does not have such a caveat.

[P]ublic policy designed to help workers who lose their jobs can lead to structural unemployment as an unintended side effect. Most economically advanced countries provide benefits to laid-off workers as a way to tide them over until they find a new job. In the United States, these benefits typically replace only a small fraction of a worker's income and expire after 26 weeks. In other countries, particularly in Europe, benefits are more generous and last longer. The drawback to this generosity is that it reduces a worker's incentive to quickly find a new job. Generous unemployment benefits in some European countries are widely believed to be one of the main causes of “Eurosclerosis,” the persistent high unemployment that affects a number of European countries.⁸⁸

A 2005 survey piece by Raj Chetty of UC Berkeley and the National Bureau of Economic

84 *Unemployment Insurance Benefits: Where Do We Go From Here?*, Hearing Before the Senate Committee on Finance, 111th Cong. 956 at 20 (2009).

85 *The Controversy Over Extending Jobless Benefits*, NPR All Things Considered (Jul. 12, 2010), <http://www.npr.org/templates/story/story.php?storyId=128470510>.

86 Id.

87 Paul Krugman, *Senator Bunning's Universe*, New York Times (Mar. 5, 2010).

88 Paul Krugman & Robin Wells, *Macroeconomics* at 210 (2d ed. 2009).

Research summarized the relevant academic findings:⁸⁹

- Moffitt (1985), Meyer (1990), and others have shown that a 10 percent increase in unemployment benefits raises average unemployment durations by 4-8 percent in the U.S.⁹⁰
- Krueger and Meyer (2002) remark that behavioral responses to UI and other social insurance programs are large because they “lead to short-run variation in wages with mostly a substitution effect”[:] distorting the relative price of leisure and consumption, reducing the marginal incentive to search for a job.⁹¹
- Gruber (2007) notes that “UI has a significant moral hazard cost in terms of subsidizing unproductive leisure.”

Other key findings on the subject:

- Feldstein & Poterba (1984) found that one quarter of unemployed individuals did not take a new job unless it paid at least 10 percent more than the wage at their previous job. They concluded that more generous UI benefits increase this **reservation wage** (wage at which a person will take a job): a 10 percent increase in unemployment benefits increases the reservation wage by 4 percent. They said the results “imply that reducing net unemployment insurance benefits could significantly lower the average duration of unemployment and the relative number of long duration spells of unemployment.”⁹²
- Solon (1985) found that subjecting high-income individuals’ unemployment benefits to income tax in 1979 led to those beneficiaries reducing the duration of their unemployment by one week.⁹³
- Ham and Rea (1987) found that unemployed workers not receiving benefits are increasingly likely to find jobs as time goes on, while the

opposite is true of unemployed workers who do receive benefits.⁹⁴

- Katz & Meyer (1988) found that extending UI benefits from 6 months to 12 months would likely increase the duration of unemployment by one month.⁹⁵

In a 2008 article, economist and Clinton Administration Treasury Secretary Lawrence H. Summers references the reservation wage: “the minimum wage [an unemployed person] insists on getting before accepting a job. Unemployment insurance and other social insurance programs increase that reservation wage, causing an unemployed person to remain unemployed longer.”⁹⁶ Summers estimates that if an individual could choose between working for \$15 per hour and collecting unemployment insurance at \$8.25 per hour, the cost of unemployment to the person was only \$4.39 per hour (after accounting for taxes) while the cost to taxpayers and the economy as a whole was much larger. Summers also “estimated that the existence of unemployment insurance almost doubles the number of unemployment spells lasting more than three months. If unemployment insurance were eliminated, the unemployment rate would drop by more than half a percentage point....”⁹⁷

Krueger & Mueller (2008) reviewed the amount of time that unemployed individuals in different states and countries spent on job search activities, finding that “the average unemployed worker in the U.S. devotes about 41 minutes to job search on weekdays, which is substantially more than his or her European counterpart” and that “job search is inversely related to the generosity of unemployment benefits.”⁹⁸ They reiterated the finding of Mortensen (1977) that “job search increases sharply in the weeks prior to benefit exhaustion” for those receiving UI benefits, while job search remains constant for those not eligible to receive UI benefits.⁹⁹

89 Raj Chetty, *Why do Unemployment Benefits Raise Unemployment Durations? The Role of Borrowing Constraints and Income Effects*, (Nov. 2005), http://emlab.berkeley.edu/users/webfac/quigley/e231_f05/chetty.pdf.

90 Robert Moffitt, Unemployment Insurance and the Distribution of Unemployment Spells, 28 *Journal of Econometrics* 1, 85-101 (1985); Bruce Meyer, Unemployment Insurance and Unemployment Spells, 58 *Econometrica* 4, 757-82 (1990).

91 Alan B. Krueger & Bruce D. Meyer, Labor Supply Effects of Social Insurance, *NBER Working Paper* No. w9014 (Jun. 2002), <http://papers.ssrn.com/sol3/papers.cfm?abstractid=316793>.

92 Martin Feldstein & James Poterba, Unemployment insurance and reservation wages, 23 *Journal of Public Economics* 1-2, 141-67 (Feb.-Mar. 1984).

93 Gary Solon, Work Incentive Effects of Taxing Unemployment Benefits, 53 *Econometrica* 2, 295 (Mar. 1985).

94 John C. Ham & Samuel A. Rea, Jr., “Unemployment Insurance and Male Unemployment Duration in Canada,” 5 *Journal of Labor Economics* 3, 325-53 (Jul. 1987).

95 Lawrence F. Katz and Bruce D. Meyer, The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment, *NBER Working Paper* No. 2741 (Oct. 1988).

96 Lawrence H. Summers, Unemployment, in *The Concise Encyclopedia of Economics* (2008), <http://www.econlib.org/library/Enc/Unemployment.html>.

97 Id.

98 Alan B. Krueger & Andreas Mueller, Job Search and Unemployment Insurance: New Evidence from Time Use Data, *Institute for the Study of Labor Discussion Paper Series* (Aug. 2008), <http://politiquessociales.net/IMG/pdf/dp3667.pdf>.

99 Id., citing Dale T. Mortensen, Unemployment insurance and job search decisions, 30 *Industrial & Labor Relations Rev.* 4 505-17 (Jul. 1977).

Another study suggests that excessive search occurs regardless of regional economic circumstances. Jurajda and Tannery (2003) compared the effect of federal UI benefits between a relatively prosperous and a relatively depressed area over a multi-year period, finding “only weak support for the presence of stronger UI disincentive effects in tighter labor markets.”¹⁰⁰ Noting that “almost a third of workers who exhausted benefits managed to find work in the next week,” the study concludes that “[t]he strategic impact of exhausting benefits therefore appears to have been similar across demand conditions.”¹⁰¹

Chetty (2007 & 2008) accepted that UI benefits lead to longer unemployment durations (10 percent increase in benefits leads to 4 to 8 percent increase in duration) but argued that this is a larger factor in households with more cash on hand; former employees who had worked for a while tend to stay unemployed longer than former employees who had worked for a shorter period of time (and presumably had fewer liquid assets).¹⁰²

A number of studies examine excessive search particularly in the context of recessions, finding different results (*e.g.*, Ljungqvist & Sargent (1998, 2008) finding a larger effect; Krueger & Meyer (2002) finding a smaller effect).¹⁰³ Recent work by the Federal Reserve Bank of San Francisco, for example, estimates that without federal UI extensions, the unemployment rate in December 2009 would have been 9.6 percent instead of 10 percent.¹⁰⁴ It is therefore likely that extending unemployment benefits does increase consumer spending (and government debt, as benefit payments are at present borrowed by governments for the most part) but also modestly increases the unemployment rate. See Figure 10 for a comparison of unemployment benefits and average duration of benefits by state.

Eligibility: Unemployment Insurance Steadily Drifting Away from Social Insurance toward a Need-Based Program

At the creation of the federal-state UI system, proponents made clear that they were setting up a social insurance program and not a need-based welfare program:

It is designed to compensate only employable persons who are able and willing to work and who are unemployed through no fault of their own....

[It] is not a system under which every unemployed person is assured of benefits for any and all unemployed time. It provides protection primarily for the person who normally is steadily employed. It can take care of the seasonal worker or the intermittently employed person only for very limited periods of time. It makes no attempt to protect unemployable persons such as those who are so old or

SUBSIDIZING SEASONAL EMPLOYERS

Some states deliberately use unemployment benefits as a way to subsidize seasonal employers by effectively reducing the wages they must pay to seasonal workers. California, for instance, intentionally uses its unemployment insurance program to subsidize agricultural production. As explained by the U.S. Government Accountability Office (GAO):

[B]enefits paid during the off-season became [after 1985] an essential part of an agricultural worker’s annual income.... [A] pattern of a working season, followed by a period of subsisting on unemployment benefits, followed by another working season, has become the norm for many of these workers.¹⁰⁹

The use of the program in such a manner permits the agricultural sector to offer lower wages to its seasonal employees, subsidized by higher UI costs to employers and society as a whole.

Sixteen states provide benefits to seasonal workers: Arizona, Arkansas, Colorado, Delaware, Indiana, Maine, Massachusetts, Michigan, Mississippi, North Carolina, Ohio, Pennsylvania, South Dakota, Utah, West Virginia, and Wisconsin. Only Wisconsin attempts to cover the additional costs of ongoing UI benefits during the off-season with a tax on seasonal employers.

100 Stepan Jurajda & Frederick J. Tannery, Unemployment Durations and Extended Unemployment Benefits in Local Labor Markets, 56 *Industrial & Labor Relations Rev.* 2, 343 (Jan. 2003).

101 *Id.*

102 David Card, Raj Chetty, & Andrew Weber, Cash-on-Hand and Competing Models of Intertemporal Behavior: New Evidence from the Labor Market, 122 *Quarterly Journal of Economics* 4, 1511-60 (2007); Raj Chetty, Moral Hazard vs. Liquidity and Optimal Unemployment Insurance, 116 *Journal of Political Economy* 2, 173-234 (2008).

103 L. Ljungqvist & T. Sargent, The European unemployment dilemma, 106 *Journal of Political Economy* 514-50 (1998); Krueger & Meyer, *supra* note 91.

104 Rob Valletta & Katherine Kuang, Extended Unemployment and UI Benefits, *Federal Reserve Bank of San Francisco Economic Letter* (Apr. 19, 2010), <http://www.frbsf.org/publications/economics/letter/2010/el2010-12.html>. See also Felix Salmon, The effect of unemployment insurance on unemployment, Reuters (Dec. 9, 2010), <http://blogs.reuters.com/felix-salm-on/2010/12/09/the-effect-of-unemployment-insurance-on-unemployment>.

Table 5
Work Search Requirements

State	Contacts per Week Required to Maintain Eligibility
Alabama	No Minimum
Alaska	1
Arizona	No Minimum
Arkansas	1
California	No Minimum
Colorado	No Minimum
Connecticut	3
Delaware	1
Florida	5
Georgia	2
Hawaii	3
Idaho	2
Illinois	No Minimum
Indiana	3
Iowa	2
Kansas	1
Kentucky	1
Louisiana	1
Maine	No Minimum
Maryland	2
Massachusetts	3
Michigan	No Minimum
Minnesota	No Minimum
Mississippi	2
Missouri	3
Montana	1
Nebraska	2
Nevada	3-5
New Hampshire	No Minimum
New Jersey	3
New Mexico	2
New York	No Minimum
North Carolina	2
North Dakota	2
Ohio	1
Oklahoma	2
Oregon	No Minimum
Pennsylvania	No Work Search Requirement
Rhode Island	3
South Carolina	No Minimum
South Dakota	2
Tennessee	2
Texas	Varies by Claimant
Utah	4
Vermont	3
Virginia	2
Washington	3
West Virginia	2
Wisconsin	2
Wyoming	2
District of Columbia	2
Puerto Rico	3

Source: National Foundation for Unemployment Compensation & Workers' Compensation

handicapped physically that they are unable to work.¹⁰⁵

These eligibility restrictions generally serve the purpose of keeping the program tied to its objective of socializing the costs of involuntary unemployment, enabling the worker laid off through no fault of his or her own to maintain a basic standard of living while transitioning between jobs.

There are four main eligibility standards:

- **Previously a member of the labor force**, as demonstrated by an appropriate employment history. All states require that a beneficiary must have earned a specified amount of wages or must have worked a designated period of time, known as the base period.¹⁰⁶ Part-time workers are excluded as they pay less into the system, families were historically unlikely to be put into poverty on the loss of a part-time job and because it is difficult to police against part-time workers seeking to game the UI system.¹⁰⁷
- **Able and available for work**. This requirement is subject to wide variation, with many states specifying only that an individual be able and available only for “suitable work,” defined as something similar to prior training and experience. Seasonal workers, retirees, mobile workers, students, or those traveling or in the hospital are generally excluded under this standard. Refusing suitable work also can lead to postponement, reduction, or denial of benefits.¹⁰⁸
- Federal law prohibits punishing a beneficiary for refusing work as a strike replacement worker, work substantially inferior to other area jobs in wages or work conditions, or work that requires union membership as a condition of employment.

105 U.S. Social Security Board, *supra* note 5.

106 The base period in the United States is generally earnings during the first four of the last five calendar quarters. This is to prevent situations like the “Lotto 10/40” in Canada, where one may work for 10 weeks and then become eligible for up to 40 weeks of UI benefits. See Conerly, *supra* note 69, at 10.

107 See Conerly, *supra* note 69, at 11 (“For example, a job applicant might become very inflexible: claiming to only be available for selective hours for any particular job, guaranteeing that the search for a job continues indefinitely.”).

108 See *National Foundation for Unemployment Compensation & Workers' Compensation, Highlights of State Unemployment Compensation Laws* (2011) (Table 28).

109 U.S. Government Accountability Office, *supra* note 16, at 29.

- **Unemployment is involuntary**, through no fault of the claimant. Analogous to refusing to honor fire insurance for a property owner who sets fire to his building, those who quit their job or are dismissed for cause or misconduct are disqualified from receiving UI benefits until they work another job for a minimum time period.¹¹⁰ Many states also offer more stringent disqualifications for those fired for criminal behavior, such as cancelling all previous wage credits for future benefit calculation.¹¹¹ Adjudication of these standards can be difficult in practice if the employer and employee dispute whether the conduct violated company policy. The National Federation of Independent Business, for instance, points out that “many departing employees automatically file for unemployment compensation. They have nothing to lose; filing a claim costs nothing and it puts the ball in the employer’s court.”¹¹² Indeed, unemployment benefits are awarded if the employer does not respond; if the employer objects, an administrative judge issues a ruling at a hearing.

States also have different rules with regard to leaving work due to illness, compulsory retirement, or quitting due to spousal moving or illness.¹¹³ For labor disputes (strikes and lockouts), many states postpone benefits with waiting periods but ultimately provide them, to prevent serious drains on reserves and maintain a certain neutrality with reference to labor issues.¹¹⁴

- **Actively seeking work**, or making a reasonable effort to find a job. In addition to being ready to accept an offered job, all states except Pennsylvania also require that the beneficiary demonstrate active efforts to find a job. All states count in-person and Internet-based job inquiries for the work search requirement, and all states except Arizona, Vermont, and Virginia count telephone inquiries.¹¹⁵ States vary in how many job contacts they require each week (see Table 5). Four states

impose a work search requirement but explicitly do not verify the documentation: Delaware (verifies EB claims only), Minnesota, Missouri, and New Jersey.¹¹⁶

Efforts to reorient the program towards a need-based welfare program ... blur its insurance feature as a benefit that people pay into and then use, and increase the overall cost.

Fraud is a basis for disqualification or even enhanced penalties. Typical UI fraud includes receiving benefits while not reporting earnings or cash earned “under the table,” being self-employed, or being in prison, out of town, or otherwise unavailable for work. All states also disqualify illegal immigrants, professional athletes during the off-season, school employees during summer, and full-time students enrolled in universities.¹¹⁷

These eligibility restrictions generally serve the purpose of keeping the program tied to its objective of socializing the costs of involuntary unemployment, enabling the worker laid off through no fault of his or her own to maintain a basic standard of living while transitioning between jobs. Efforts to reorient the program towards a need-based welfare program—evident in the federal government’s pressure for states to pay benefits to part-time workers, pay benefits to workers in training programs, pay benefits to workers who leave due to spousal moving, and pay additional benefits to claimants with dependents—blur its insurance feature as a benefit that people pay into and then use, and increase the overall cost.

110 See *National Foundation for Unemployment Compensation & Workers’ Compensation*, supra note 108, (Table 27).

111 *Id.*

112 National Federation of Independent Business, *Unemployment Compensation: Start Controlling Your Costs Today*, <http://www.nfib.com/business-resources/business-resources-item?cmsid=49702>.

113 See *National Foundation for Unemployment Compensation & Workers’ Compensation*, supra note 108, (Table 26 & 31).

114 *Id.* (Table 29).

115 *Id.* (Table 33).

116 *Id.*

117 *Id.* (Table 31).

Waiting Week: Discouraging Non-essential Claims and Encouraging Worker Saving

Insurance programs often require a “co-payment” or “deductible” of some amount that must be paid by the beneficiary before the insurance pays out. For example, a health insurance policy with a \$1,000 deductible would require that the beneficiary pay out of pocket all medical costs up to \$1,000 per year; the insurance company would cover all costs above that amount. Co-payments and deductibles make people think twice about filing a minor claim, lowering overall costs and reducing unnecessary claim processing. They ensure that beneficiaries do not rely entirely on the insurance program, taking actions to minimize or avoid out-of-pocket costs (again, **moral hazard**).

A significant roadblock preventing innovation in the federal-state UI system is the “firewall” between administrative funds and benefit funds. ... The price of such a strict federally required “firewall” is to impede state efforts that could be more effective at getting people back to work.

A waiting week serves as a “deductible” for UI programs: most states do not begin paying benefits until one week after either job loss or filing for unemployment. Thirteen states do not impose a waiting week: Alabama, Connecticut, Delaware, Georgia, Iowa, Kentucky, Maryland, Michigan, Nevada, New Jersey, Vermont, Wisconsin, and Wyoming.¹¹⁸ In these states, employees do not have an obligation to rely on their own resources for a brief period of time before turning to tax-financed support, with benefits available even to the shortest transition periods between jobs. A UI tax reform task force in New Jersey, a state

that abolished its waiting week in 2002, noted a “correlation between a modification in the waiting week and claims related to school-related and/or seasonal employment....”¹¹⁹ They estimated UI program savings of \$56 to \$59 million annually if the waiting week were reinstated.

In the private sector, a zero deductible insurance policy is usually accompanied by a higher premium. States that do not require a waiting week consequently will face more nonessential claims and higher costs than states that do require a waiting week, and may discourage workers from saving in anticipation of potential job loss.¹²⁰

Full Federal Reimbursement of Costs Impedes Innovations within the Existing Program

A significant roadblock preventing innovation in the federal-state UI system is the “firewall” between administrative funds and benefit funds. The federal UI tax paid by employers is used to finance federal loans to states and reimburse states for administrative costs.¹²¹ This creates an incentive problem, as explained by UI expert William B. Conerly in his analysis of Arizona UI reforms:

The federal funds DES [Arizona Department of Economic Security] receives for administration are based on workload, measured by administrative functions such as claims processed, benefits paid, and appeals hearings held. If the department were to find better ways to help the unemployed, it would lose funding.

The federal role in funding administration also creates a “two bucket” problem. Money for administration comes from one bucket while the money that pays out benefits to the unemployed comes from another bucket. Because there is a “firewall” between the buckets, there is no incentive to meaningfully monitor recipients or otherwise prioritize administrative resources in the interest of total fiscal savings. If DES finds a way to save three dollars in benefits at a cost of one extra dollar in administration, there is no way to implement the solution. Administrative dollars are limited

118 *Id.* (Table 19).

119 *New Jersey Department of Labor and Workforce Development, New Jersey Unemployment Insurance Task Force Report* (Feb. 2011), http://lwd.dol.state.nj.us/labor/forms_pdfs/lwdhome/press/2011/UITaskForceReport2011.pdf.

120 See Eric M. Engen & Jonathan Gruber, *Unemployment Insurance and Precautionary Saving* (Jun. 1998), <http://econ-www.mit.edu/files/99> (“[R]educing the UI benefit replacement rate by 50 percent would increase the gross financial asset holdings by 14 percent, or \$241, for the average worker. We also find empirical evidence that this ‘crowd out’ effect of UI on household saving is stronger for those facing higher unemployment risk and weaker for older workers....”).

121 Of course, it must be remembered that “federal UI taxes” and “state UI taxes” are paid by the same people: employers. The economic incidence of the tax likely falls heavily on workers, as they are a cost considered by employers when hiring.

and benefit savings cannot be converted into administrative funds.¹²²

The workers' compensation system could be a working model for a wholesale reform of the unemployment insurance system, moving it away from a single-provider model.

Proponents of the status quo see value in the federal government reimbursing states from a national pool, as this allows the country as a whole to support those states that have weaker economies, smaller populations, or higher processing costs. Additionally, under the current system, administrative costs cannot “compete” with benefit costs or other state funding priorities. However, the price of such a strict federally required “fire-wall” is to impede state efforts that could be more effective at getting people back to work. These ideas, discouraged by the existing system, include:

- **Work options:** Requiring long-term UI beneficiaries to engage in available short-term or part-time work while receiving their UI benefits and searching for full-time work. Oregon has had success offering a subsidy to employers to create new positions for unemployed individuals at the lower end of the experience and training scale, mentoring the new employees and getting them working sooner.¹²³ The Georgia Works program offers to trainees a stipend to cover childcare and transportation expenses while undergoing eight weeks of on-the-job training with an employer, and was highlighted by President Obama as a possible innovation option.¹²⁴
- **Active case management:** Counselors work one-on-one with the unemployed to help them find work. This could help direct state unemployment offices toward viewing their mission as putting people to work, as opposed to just

paying out benefits. A trial program in Arizona estimated a \$14.94 savings in benefit costs for each additional \$1 in administrative costs.¹²⁵

Requiring face-to-face goal and monitoring sessions with unemployment officials after a certain number of weeks, rather than just Internet and phone-based contact, “discouraged procrastination and provided emotional support for the workers’ job search efforts.”¹²⁶

- **Mandatory job search seminars and assessments** for claimants identified as likely to exhaust their benefits before becoming reemployed. These have been shown to be effective, although it appears that the requirement to attend a mandatory seminar induced reemployment more than the information at the seminar itself. In one study, “[r]eemployment was found to occur between the time that notice of the mandatory seminar was given and the time of the seminar.”¹²⁷
- **Offering bonuses to workers who find new jobs quickly**, which when tested in four states was found to be strongly effective at inducing reemployment but not in reducing costs (unemployed people who would not have previously filed did so, to take advantage of the bonus program).¹²⁸ Curiously, nearly half of the subjects returned to their last employer, suggesting the program would discourage temporary layoffs.
- **Fraud prevention efforts:** Many states have a “New Hires” database, often used for tracking down individuals behind on child support payments, but they could also be used to identify individuals receiving improper UI payments. Improving communications between employers and the government could also reduce fraud. However, unless savings from benefits could be moved to fund administration costs (or vice versa), the state has no incentive to engage in such anti-fraud efforts.

A 2002 Bush Administration proposal (“New Balance”) to devolve the UI system completely to the states failed to be considered. Intermediate options that could be considered now include using

122 Conerly, supra note 69.

123 See Conerly, supra note 69, at 15.

124 See, e.g., Errin Haines, “President Obama puts Georgia Works on jobs agenda,” *Associated Press* (Sep. 8, 2011), <http://www.chron.com/news/article/President-Obama-puts-Georgia-Works-on-jobs-agenda-2162082.php>.

125 See *Arizona Department of Economic Security, Reemployment Services Performance Report* (Dec. 23, 2002) (estimating program costs of \$330,636 but benefit savings of \$4,940,213).

126 Dr. William B. Conerly, *Unemployment Insurance in a Free Society, National Center for Policy Analysis Policy Report No. 274* at 14 (Mar. 2005), <http://www.ncpa.org/pub/st/st274>.

127 Conerly, supra note 69, at 5, citing David E. Balducchi, Terry R. Johnson & R. Mark Gritz, *The Role of the Employment Service, in Unemployment Insurance in the United States*, (Christopher O’ Leary & Stephen A. Wandner eds.) (1997).

128 See, e.g., Bruce D. Meyer, *Implications of the Illinois Reemployment Bonus Experiments For Theories of Unemployment and Policy Design*, NBER Working Paper No. 2783 (Dec. 1988), <http://www.nber.org/papers/w2783>.

federal funds to pay a percentage of state costs, rather than the full amount, or permitting states to increase funded administrative innovations that reduce benefit costs and induce reemployment.

Workers' Compensation Offers a Viable Model for Unemployment Insurance

Under current federal law, there are severe restrictions to redesigning UI to resemble state **Workers' Compensation** programs.¹²⁹ Such programs pay for an employee's lost income and medical expenses caused by a job-related accident. Not required by federal law, all 50 states nevertheless have set up a workers' compensation program, often as a mandatory alternative to the less predictable and more costly tort lawsuits.

While many states have public funds for workers' compensation, employers in nearly all states can opt to purchase private workers' compensation insurance, self-insure, or group self-insure. The diversity of options has been a success: injury rates have steadily dropped and so has the cost of workers' compensation coverage. The workers' compensation system could be a working model for a wholesale reform of the unemployment insurance system, moving it away from a single-provider model.

At a time when the unemployment insurance system is exhausting its financial reserves, failing at its countercyclical objective, and imposing higher taxes on employers and greater fiscal pressure on the states, and a time when the public is skeptical of extending benefits without broader changes, it may be an opportune moment for significant UI system reform.

Prior to the launch of the federal-state UI program in the 1930s, unemployment benefits were offered by many labor unions and private employers:

Between World War I and 1933, firms such as General Electric, Eastman Kodak, Procter and Gamble, and manufacturer J.I. Case established programs. The latter firm, now Case Corporation, had an employee contribution of 5 percent of earnings—matched by the company—until one year's earnings had been accumulated.

There was also growing interest at the time among insurance companies in introducing UI plans to the public. It is true that private UI would face some economic challenges, particularly the problem of “adverse selection.” Workers at low risk of unemployment would separate themselves from workers with higher risks and form separate insurance pools, or not buy insurance at all.[...] One market response to this situation would be that workers in more cyclical and risky industries would demand higher compensation. Some people would choose to work in industries with higher chances of layoffs, even without any available insurance, if the pay was right. Indeed, economist Price Fishback notes that in the pre-1935 economy, “workers in industries that suffered from layoffs and unemployment generally received higher wages to compensate for this risk.”

Legal restrictions have been a hurdle to the development of private UI. Law Professor Michael Rappaport found, for example, that two Michigan insurers profitably sold UI plans beginning as early as 1910, but state law limited their market to just railroad conductors. Michigan's prohibition on UI insurance was not unique. In the 25 years prior to the enactment of the UI system in 1935, no state clearly authorized the general sale of UI policies. Rappaport looks at the historical evidence and rejects the view that private unemployment insurance wouldn't work.

Consider the experience of Metropolitan Life. The insurance firm's president, Haley Fiske, was adamant that private UI could be sold. However, Fiske “tried to sell UI almost twenty years before the Social Security Act, but the laws of New York State prohibited its sale.” Fiske's effort to legalize UI policies was opposed in the state legislature by Samuel Gompers, who feared that UI plans would strengthen company unions at the expense of his union. Legislation did finally pass the New York legislature, but it was vetoed by Governor Franklin Roosevelt in 1931, who worried that success-

129 Dr. William B. Conerly, *Is Workers' Compensation a Model for Unemployment Insurance?*, National Center for Policy Analysis Brief Analysis (Apr. 2003), <http://www.ncpa.org/pub/ba435>.

ful private UI might undermine support for a government UI system.¹³⁰

Instead of mandating that all employers pay into the federal and state UI funds, Congress could instead let states require that all employers demonstrate ability to provide UI benefits to laid off workers, either through self-funding, purchasing private insurance, setting up savings accounts for workers, or participating in the state fund. This could build on the existing right of certain nonprofit organizations, government agencies, and Indian tribes to self-fund unemployment benefit costs.

Individual Unemployment Benefit Accounts: Design Options

Economist Martin Feldstein proposed the idea of Unemployment Insurance Savings Accounts (UISAs) in 1975. Key features of his proposals have been that each individual (or the individual's employer) would be required to contribute to his or her account, with the mandatory saving stopping when a specified accumulated balance is reached. He has emphasized the goal of "substantially reducing the adverse incentive effects of the existing unemployment insurance system without any decrease in the protection of those who become unemployed."¹³¹ Insurance funds are invested in money markets and earn interest; individuals who exhaust their accounts "can borrow from the government at the same rate as they earn in their account."¹³²

Contributions would be tax-free but withdrawals would be taxable (as UI benefits are today). In a 1998 paper with Daniel Altman, Feldstein laid out five alternative options:¹³³

- **High Saving Base:** Individuals contribute 4 percent of earnings up to a cap of three times the average weekly wage (approx. \$2,637 in 2011). High wage earners would see more rapid accumulation than other earners would.
- **Low Saving Base:** Individuals contribute 4 percent of their earnings up to a cap set at the average weekly wage (approx. \$879 in 2011). This would adjust for the fact that low earners are more likely to rely on UI benefits, so requiring high earners to accumulate savings is less important.

- **Target Account Fund:** Sets a goal of funding an individual's account with 50 percent of their annual income. This would enable the individual, after losing his or her job, to draw out half of their prior wage for up to 12 months.
- **Experience-Based Target Account Fund:** Individuals required to save until the fund reaches (1) 30 percent of their annual wage plus (2) twice the individual's UI withdrawals over the past two years. This ensures that an individual with a history of unemployment will, when employed, be saving higher amounts than other individuals.
- **Experience Rating Component:** Combines Option 2 with a requirement that employers fund the first five weeks of benefits. This would reduce withdrawals for all employees while giving employers an incentive not to create excess unemployment.

Chile implemented an individual account-based unemployment insurance system beginning in 2002. How it works:¹³⁴

- Workers pay 0.6 of their wages into individual accounts, and employers pay a further 1.6 percent of the worker's wages into the account.
- Employers pay a 0.8 percent payroll tax into a "solidarity fund" that pays benefits to new or low-wage workers when their accounts are exhausted.
- Accounts are conservatively invested in a variety of securities by managing funds that also operate the workers' retirement funds.
- After a worker's account has accumulated sufficient funds to pay five months' worth of benefits, no further contributions occur.
- The worker's individual account pays out when the worker becomes unemployed or retires. Unemployed individuals can withdraw 30 to 50 percent of their previous wages each week for up to five months.

Individual accounts would eliminate "excessive search" as unused unemployment funds would add to a worker's retirement income. Workers also own their accounts, enabling them to access the funds immediately on unemployment without extensive processing or claim disputes. Enhanced saving could also help low-income individuals accumulate capital for retirement. The Chilean

¹³⁰ Edwards & Leef, *supra* note 4.

¹³¹ Martin Feldstein & Daniel Altman, *Unemployment Insurance Savings Accounts*, 21 *Tax Policy and the Economy* 35, 36 (May 2007), <http://www.nber.org/papers/w6860>.

¹³² *Id.* at 41-42.

¹³³ *Id.* at 41-44.

¹³⁴ Dr. William B. Conerly, *supra* note 126, at 14.

experience found these effects: “We find that for beneficiaries using the [solidarity fund] the pattern of job finding rates over the duration of unemployment is consistent with moral hazard effects, while for beneficiaries relying on UISAs, the pattern is free of such effects.... Our results provide strong support to the idea that UISAs can improve work incentives.”¹³⁵

Congress could permit states to experiment with providing private accounts, or permit them to offer accounts as an option alongside the existing UI system. Elements of the Feldstein approach and the Chile approach could be combined or redesigned as part of a UI reform, to keep features of social insurance and self-insurance.

Conclusion

At a time when the unemployment insurance system is exhausting its financial reserves, failing at its countercyclical objective, and imposing higher taxes on employers and greater fiscal pressure on the states, and a time when the public is skeptical of extending benefits without broader changes, it may be an opportune moment for significant UI system reform. The reforms could be modest, such as eliminating the firewall between administrative costs and benefits, reducing cross-subsidies through

greater use of experience ratings, and relying more on face-to-face training and advising. The reforms could be major, such as adopting elements of state workers’ compensation programs and experimenting with individual accounts to enhance saving.

Key questions must be asked no matter what form the UI system takes. How long should benefits be offered? Should jobless workers be required to take jobs below their education and skill level? Should the long-term unemployed be treated separately? Should the UI system have need-based features? How should benefits be financed when a state exhausts its reserves? At what point should a single employer’s costs be socialized and borne by all employers? Should UI be used as a tool for fiscal stimulus? Should UI benefits be taxed? Who should be ineligible and how should the system be designed to prevent abuse by those not entitled to benefits? What should the taxable base and the tax be and should they change? Should benefit levels and benefit weeks be standardized across states and across industries? How can the system permit innovation while ensuring solvency?

We hope that the facts, analysis, and options provided in these pages contribute to a healthy public debate.



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Editor, Alicia Hansen

Tax Foundation
National Press Building
529 14th Street, NW, Suite 420
Washington, DC 20045-1000

ph. 202.464.6200

www.TaxFoundation.org
TF@TaxFoundation.org

135 Gonzalo Reyes Hartley, Jan C. van Ours, & Milan Vodopivec, *Incentive Effects of Unemployment Insurance Savings Accounts: Evidence from Chile*, *Institute for the Study of Labor Discussion Paper Series* (Jan. 2010), <http://www.politiques-sociales.net/IMG/pdf/dp4681.pdf>.



7/12/11

RE: Board of Tax Appeals (BTA)

Through the recently enacted budget bill¹, the legislature has directed the Tax Commissioner to conduct a review of the operations of the Board of Tax Appeals. I need your assistance to develop a comprehensive review of the BTA's appellate process that addresses a current backlog as well as ways to prevent this backlog from occurring in the future.

In recent years due to the volatility in the economy appeals to the BTA have increased significantly while the BTA's appropriations have been reduced. These factors in combination with others have resulted in a current backlog at the BTA totaling approximately 8,000 cases. The current budget for fiscal years 2012-2013 has increased the BTA's funding. Restoration of the funding will help with some of the backlog. However, a more comprehensive review is needed to prevent future backlogs from occurring.

As you know, the BTA receives appeals from decisions of the County Boards of Revision, the Tax Commissioner, Municipal Income Tax Boards, County Budget Commissions and others. Some who are intimately involved with those appeals previously have attempted this type of analysis. The result of their review has been a number of viable ideas for restructuring the BTA's processes. We have compiled and enclosed a summary of a variety of the ideas that have been discussed in the past for your review and comments. Please look over these items and include other ideas that you and your organization believe should be a part of the BTA's appellate process including those used in other jurisdictions. Feel free to think creatively. Your comments and recommendations should be returned to Stan Dixon, Deputy Tax Commissioner at Stanley_Dixon@tax.state.oh.us no later than August 31, 2011.

I hope that with your assistance together we can provide a report to the legislature that could result in the enactment of legislation. The citizens of Ohio deserve a much more expeditious yet comprehensive administrative appeals process. Thank you for your cooperation with this important matter.

A handwritten signature in black ink, appearing to read "Joe Testa".

Joe Testa
Tax Commissioner

¹Am.Sub. H.B. 153, Section 757.30. The Tax Commissioner shall conduct a review of the operations of the Board of Tax Appeals, and not later than November 15, 2011, shall submit a written report to the Governor, Speaker of the House of Representatives, and President of the Senate providing an assessment of the Board's operations and recommendations for improvement. The Tax Commissioner's review shall include Consultation with persons who have participated in or have had matters before the Board and are familiar with the Board's operations and procedures. The report shall include recommendations for improving the appeals process, internal operations, and other operational matters the Commissioner deems advisable. The Commissioner may designate an employee of the Department of Taxation to conduct the review

1. Filing Fees

Institute a fee schedule for appeals. The BTA may modify the fee amounts by rule. The appeal is subject to dismissal for nonpayment.

Small claims division cases	\$50
All other appeals	\$200

Ear mark the fee to a technology fund to purchase & maintain a case management system and upgraded interactive web-site.

2. Appeals from County Boards of Revision:

Options:

1. BTA full hearing

- a. Filing fee \$200
- b. Appealable to Court of Appeals, then to Supreme Court (no direct right of appeal)
- c. Mediation Available

2. Small Claims Informal Hearing with Tax Commissioner

- a. \$100,000 market value or less differential with County Auditor value
- b. \$50 filing fee
- c. No discovery
- d. Limited to evidence presented to BOR
- e. No precedential value
- f. No right of appeal
- g. Non moving party may opt out of the small claims process and file at BTA with \$200 fee

3. Appeals from Tax Commissioner's Final Determinations (not originated at BOR) to BTA full hearing with \$200 fee, direct right of appeal to Supreme Court retained.

4. Appeal Process

What changes would you like to see regarding the BTA appeal process?

Case Schedule
 Transcripts
 Discovery
 Pre Hearing settlement/Mediation Conferences
 Hearing Dates
 Briefing Dates
 Continuances

5. Other Specific Recommendations

- a. Specification of error in notice of appeal to BTA
 - Propose a change to R.C. 5717.02 that would permit a taxpayer to amend its notice of appeal to include specification of errors not in the original notice of appeal within some reasonable time after the conclusion of discovery.
- b. Specification of error in notice of appeal to BTA must have been raised before the Tax Commissioner -- remand procedure
 - Amend R.C. 5717.03(G) to permit the BTA to remand a case to the Tax Commissioner if an error specified in the notice of appeal was not properly raised before the Tax Commissioner. Allow the Tax Commissioner to waive remand.
- c. Discovery
 - Amend OAD 5717-1-11 to allow for more time for discovery or reopening discovery upon motion for good cause. Good cause should include receipt of transcript after forty-five day period.
 - Review of BTA procedures with the goal of using technology to expedite the discovery process (e-discovery).

6. Technical Changes

- Revise Forms for BTA and BOR
- Corrections to the Ohio Revised code:
 - 5715.19 (G) – Preclusion of Evidence on appeal
 - 5715.19 (D) – Carry Forward Limit to next Reappraisal or Triennial
 - 5715.19 (A)(1) – Authorization to File Notice of Appeal

7. BOR Rules

It has been suggested that a uniform set of rules to be promulgated by the Department of Tax Equalization for all 88 county boards of revision. Some suggested areas include, but are not limited to, the following:

- Basic information about the process as an educational tool
- Appearance and practice before the BOR
- Service of pleadings and notice requirements
- Continuances
- Suggested information to be provided at hearing for:
 - Commercial
 - Residential
 - CAUV
- Dismissals

Understanding the Commercial Activity Tax in the Context of the 2005 Tax Reform Package

Legislative Study Committee on Ohio's Tax Structure

Testimony of Deputy Tax Commissioner Frederick Church
August 24, 2011

Outline of Presentation

- What was the rationale for the CAT?
 - The CAT was a piece of a significant structural reform of Ohio business taxes
 - Desire to eliminate the tangible personal property (TPP) tax and the corporate income tax
 - Replacement tax needed to make temporary replacement payments to school districts and local governments for TPP tax loss and also to generate revenue for state GRF
 - Desire was for a low rate, broad-based tax that would enhance Ohio's competitive position, particularly for manufacturing

Outline of Presentation

- How has the CAT performed?
 - CAT revenues have been somewhat below target, and have not been enough to make replacement payments (until HB 153 law changes)
 - CAT revenues have been shown to be strongly cyclical, as taxable gross receipts declined sharply in the recession before rebounding recently
 - A recent study and anecdotal evidence suggest that the reform has substantially reduced the Ohio state and local tax burden on capital investment

3

Why the 2005 Tax Reform?

- Weak economic growth in Ohio
 - Sense that the tax system was not aligned with Ohio's comparative advantage in manufacturing
 - Studies had pointed to Ohio's tax structure discouraging investment
- Sense that the tax system burden was not fairly distributed across sectors
 - Tax planning had contributed to the unfairness, favoring big companies with significant legal and accounting expertise

4

Setting the Stage for Reform – Prior Studies

Committee to Study State and Local Taxes- March 2003

“The committee heard significant testimony indicating that the tangible personal property tax is a disincentive to investment. This tax particularly impacts Ohio’s capital-intensive businesses, such as manufacturing.” (p68)

Ohio’s Competitive Advantage: Manufacturing Productivity by Prof. Edward Hill - April 2001

“The tax code also provides disincentives to invest in capital, hurting productivity and income growth, and putting those portions of the state’s economy in which it has a natural and historical competitive advantage at a disadvantage.” (p96)

Economic Development Study Advisory Committee - May 1999

“At the top of the list of proposed state business climate improvements is the recommendation to reduce, and eventually, eliminate Ohio’s onerous Tangible Personal Property Tax, which deters business investment and job creation.” (p15)

Taxation and Economic Development: A Blueprint for Tax Reform in Ohio - October 1995

“A third concern is that the system is complicated, probably more than is necessary. The problem areas here are the real property tax, the net worth tax, the tangible personal property taxes and the municipal income tax.” (p15)

5

Broad Outline of HB 66 Tax Reform Package

- Eliminate the TPP tax burden on capital investment
- Reduce the personal income tax
- Eliminate the corporation franchise tax
- Create a broad-based, low rate business tax that is flatter than the existing business taxes
- Phase in changes over 5 years to minimize dislocation

6

Commercial Activity Tax (CAT)

- The CAT was intended to be a very broad-based tax with a very low tax rate, in order to minimize the distortion of economic decisions
- The CAT was intended to be structured to ensure that out-of-state companies pay their fair share of the tax, and to fall as lightly as possible on Ohio-based companies in order to encourage investment and job growth

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Commercial Activity Tax: Theory and Operation

- Tax applies to Ohio-generated gross receipts
 - Tax does **not** apply to exports of goods and services out of Ohio
- Theory was that tax should be commensurate with “economic presence,” or degree to which a business utilizes the Ohio market as measured by in-state sales
- Tax was designed to benefit manufacturing, creating a favorable “platform for production” in Ohio

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Commercial Activity Tax (CAT)

- The debate about the CAT replacing the TPP tax and the corporate franchise tax was influenced by an April-2005 analysis by the consulting division of Regional Economic Models, Incorporated (REMI). The REMI report compared the proposed CAT to the business taxes that it replaced and came to the following conclusion:
 - "To provide a standard method of comparison... we modeled the impact of each tax given a \$100M increase. When evaluated in this format, the results show that the least economically damaging among the three business taxes is the commercial activity tax."
 - "the current business taxes place a burden on Ohio firms that sell their products outside of Ohio, placing them at a competitive disadvantage. This is not the case with the CAT, which exempts exported goods."

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Commercial Activity Tax: Theory and Operation

- A broad-based, low rate tax (0.26%) for gross receipts from business activity in Ohio
- A business privilege tax, not a transactional tax (sales tax law and rules don't apply)
- A business privilege tax, not an income tax (federal PL 86-272 restrictions don't apply)

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Commercial Activity Tax: Theory and Operation

- Taxpayers with less than \$150,000 in taxable gross receipts are not subject to the CAT
- Rate structure of the tax:
 - Pay \$150 minimum tax for first \$1 million in receipts
 - Receipts above \$1 million, pay \$150 plus 0.26% for amount in excess of \$1 million

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Commercial Activity Tax: Theory and Operation

- Tax is measured by gross receipts, but gross receipts are defined to exclude portfolio income
 - Dividends not included in base
 - Interest not included in base (limited exceptions)
 - Capital gains not included in base
 - Certain hedging transaction receipts not included in base
- Gross receipts do not include goods or services exported out of Ohio

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Commercial Activity Tax: Theory and Operation

- Tax is generally measured by gross receipts, but many gross receipts are exempt
- The entity generating the gross receipts may be exempt (some of these entities are subject to an alternative business tax):
 - Financial institutions
 - Insurance companies
 - Public utilities subject to the utility excise tax
 - Nonprofits
 - The state and its agencies or instrumentalities
 - Numerous other organizations

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Commercial Activity Tax: Theory and Operation

- Tax is generally measured by gross receipts, but many gross receipts are not in the tax base
 - Receipts that result from business done between entities in a “consolidated group” are exempt from the CAT
 - Groups of entities can choose to file as consolidated groups based on common ownership or control standards

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Commercial Activity Tax: Nexus and “Bright-Line Presence”

- The bright-line nexus standard was designed to help ensure that out-of-state companies pay their fair share of the CAT on their usage of the Ohio market

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Commercial Activity Tax: “Bright-line Presence”

- Bright-line nexus is a non-sales tax nexus standard
- Person has “bright-line presence” if any of the following applies at any time during the calendar year:
 - Property of at least \$50,000 within Ohio
 - Payroll of at least \$50,000 within Ohio
 - Taxable gross receipts in Ohio of at least \$500,000
 - Has at least 25% of total property, payroll, or receipts in Ohio
 - Is domiciled in Ohio (commercially or legally)

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Commercial Activity Tax: Nexus and Consolidated Returns

- In order to get exemption for related entity revenues – e.g., from a subsidiary to a parent – companies must forego the nexus battle and agree to file consolidated returns with everyone in the group
- Taxpayers can file combined rather than consolidated and only include entities that clearly have nexus, but then no related entity exemptions are allowed

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Commercial Activity Tax: Combined vs. Consolidated Returns

Consolidated Elected Taxpayer vs. Combined Taxpayer

- Consolidated Elected Taxpayer
 - At least 50% or 80% common ownership
 - Option to include or exclude non-U.S. entities
 - Must include all entities regardless of whether question exists about Ohio nexus
 - **Gross receipts between members are excluded**
- Combined Taxpayer
 - More than 50% common ownership
 - **Combined only required to include entities with nexus in Ohio**
 - Gross receipts resulting from payments between members are subject to the CAT

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Legal Challenges

- Legal Challenges

- Grocers
 - Application of CAT to gross receipts from food
- Road contractors and county engineers
 - Application of CAT to gross receipts from motor fuel, how the revenues so derived may be used
- Remote sellers
 - Application of CAT nexus standards

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Legal Challenges

- Grocers Case

- Grocers sued on the grounds that the CAT violates Ohio constitutional bans against imposing taxes on food consumed off-premises and against taxing food at the wholesale level
- The Ohio Supreme Court decided that the CAT is not a prohibited tax on food (*Ohio Grocers Assn. v. Levin*, 2009)
 - “when the CAT’s practical operation is considered, it becomes evident that it is what it purports to be: a permissible tax on the privilege of doing business, not a proscribed tax upon the sale or purchase of food.”

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Overall Fiscal Impact of HB 66 Tax Reform

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- By FY 2012, taxpayers will have seen a total of \$3.8 billion in annual tax relief (state and local taxes)
 - If the sales tax change is treated as a 0.5% increase instead of a 0.5% reduction, the tax relief is \$2.5 billion
 - TPP tax elimination saved about \$1.7 billion annually
 - Last year tax was at full strength, tax year 2005, TPP tax raised \$1.70 billion
 - Corporation franchise tax elimination saved as much as \$1.5 billion annually
 - For FY 2006-2008, adjusted for rate changes as the tax phased down, the CFT brought in about \$1.7 billion annually
 - The remainder of the franchise tax (primarily on financial institutions) is bringing in about \$0.2 billion annually

Overall Fiscal Impact of HB 66 Tax Reform

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- By FY 2012, taxpayers will have seen a total of \$3.8 billion (or \$2.5 billion, depending on how the sales tax change is counted) in annual tax relief (state and local taxes)
 - While the TPP and CFT eliminations saved about \$3.2 billion annually, the largest amount the CAT has generated so far is \$1.4 billion (in FY 2011), so the business tax changes generated net tax relief of about \$1.8 billion annually
 - The 21% cut in the personal income tax is responsible for another roughly \$2.2 billion in annual tax savings
 - The additional cigarette tax and the repeal of the 10% property tax credit for business property provide about \$0.8 billion annually in offsetting revenue or reduced expenditure

How Broad is the CAT Base?

- FY 2010 CAT Data on ODT Web Site
 - Taxable gross receipts (TGR) before exclusion \$585 billion. The \$1 million annual exclusion per taxpayer equals \$75.7 billion. TGR after exclusion equals \$509.3 billion.
- Data from Bureau of Economic Analysis (BEA)
 - Ohio GDP CY 2009 \$462.0 billion
 - Ohio GDP CY 2010 \$477.7 billion
 - Averaging the two numbers to get a FY 2010 Ohio GDP estimate, FY 2010 Ohio GDP = \$469.9 billion
- CAT TGR After Exclusion 1.08 times as large as Ohio GDP

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How Much Does the CAT Pyramid?

- One of the objections to gross receipts taxes like the CAT is that the tax “pyramids.” That is, the tax potentially applies multiple times to the sale of the same good or service.
- The CAT has some important features which reduce the degree of pyramiding:
 - Exemption for exports
 - Exemption for receipts within a consolidated group
 - Exemption for annual receipts below \$150,000
 - Flat tax amount for annual receipts below \$1 million

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How Much Does the CAT Pyramid?

- The ratio of Ohio CAT taxable gross receipts to state GDP for various industry groups for FY 2010 is shown in the table on the next slide
- The Ohio results must be interpreted with some caution:
 - some CAT taxpayers report as groups of many companies, and the industry code that is assigned to the group is based on the reporting entity
 - Industries with a lot of exempt receipts will have ratios less than 1. There may still be pyramiding on those receipts that are included in the tax base, so on those, the ratio would be greater than 1.

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Comparison of Ohio FY 2010 GDP by Industry with CAT Taxable Gross Receipts

Industry	FY 2010	FY 2010	FY 2010
	Ohio GDP	CAT TGR	TGR/GDP
All industry total	\$469,857	\$509,303	1.084
Private industries	\$415,233	\$509,303	1.227
Agriculture, forestry, fishing, and hunting	\$3,632	\$2,624	0.7224
Mining	\$2,191	\$3,868	1.7654
Utilities	\$9,933	\$15,187	1.5290
Construction	\$13,123	\$20,266	1.5443
Manufacturing	\$76,566	\$141,100	1.8429
Wholesale trade	\$28,390	\$78,000	2.7475
Retail trade	\$29,679	\$102,347	3.4485
Transportation and warehousing, excluding Postal Service	\$14,351	\$10,631	0.7408
Information	\$13,700	\$24,054	1.7558
Finance and insurance	\$42,746	\$6,841	0.1600
Real estate and rental and leasing	\$51,082	\$9,000	0.1762
Professional and technical services	\$28,454	\$25,784	0.9062
Management of companies and enterprises	\$14,184	\$26,249	1.8507
Administrative and waste services	\$13,879	\$6,114	0.4405
Education, health care and social assistance	\$48,069	\$16,543	0.3441
Arts, entertainment, and recreation	\$3,156	\$1,726	0.5469
Accommodation and food services	\$11,016	\$9,437	0.8567
Other services, except government	\$11,088	\$3,419	0.3084
Government	\$54,624	\$0	0.0000
Unclassified	(NA)	\$6,113 (NA)	

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How Did the CAT Weather The Recession?

- Short Answer: the CAT is less volatile than the corporate income tax, but more volatile than ODT expected

CAT Revenues and Taxable Gross Receipts
 TGR Numbers are After the \$1 Million Annual Exclusion
 millions of \$

Fiscal Year	CAT Revenue	Taxable Gross	
		Receipts	% change
2006 *	\$273.4	\$504,899	
2007	\$594.9	\$517,308	2.5%
2008	\$961.4	\$579,529	12.0%
2009	\$1,179.4	\$566,025	-2.3%
2010	\$1,342.1	\$509,303	-10.0%
2011 **	\$1,451.0	\$557,687	9.5%

* The FY 2006 number is an annualized amount based on three quarters of actual receipts

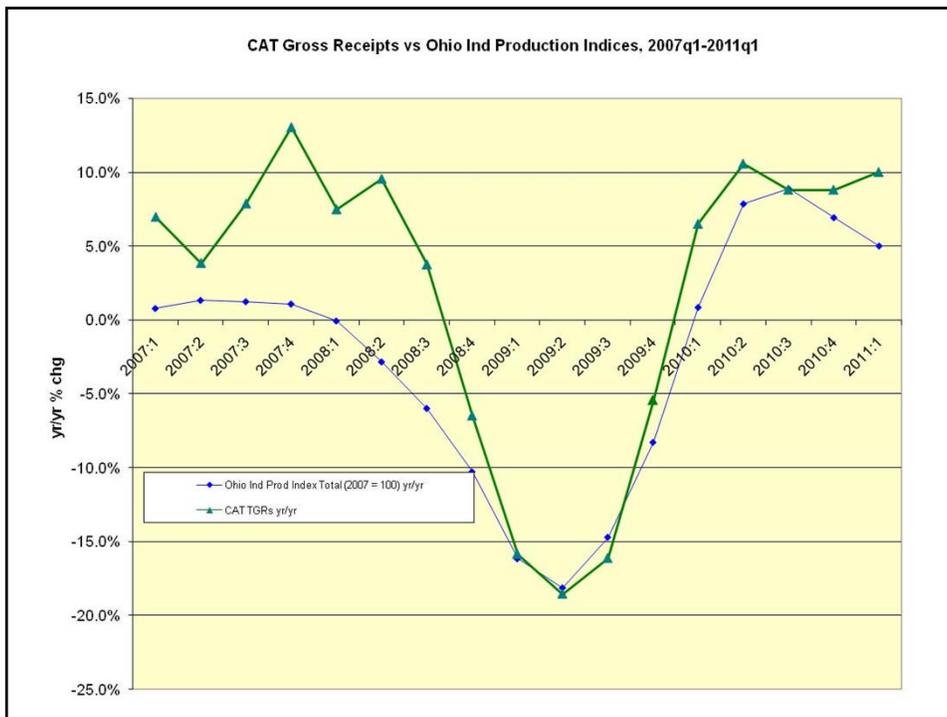
** The FY 2011 is an estimate based on three quarters of actual data

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How Did the CAT Weather The Recession?

- In the depths of the recession (2009q1-q3), CAT taxable gross receipts fell more than 15% on a year/year basis for three consecutive quarters
- CAT revenues finally rebounded to year/year growth of 10% in 2010q2
- The graph on the following slide shows that CAT taxable gross receipts move very similarly to an Ohio index of industrial production

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How is CAT Revenue Affected by Tax Credits?

- CAT credits grew sharply from \$48.3 million in FY 2010 to an estimated \$76.5 million in FY 2011
- Most of the increase from FY 2010 to FY 2011 was in the job creation tax credit (JCTC) and the job retention tax credit (JRTC)
 - JCTC increased from \$27.8 million to \$49.8 million
 - JRTC increased from \$20.5 million to \$26.8 million

Has the CAT Generated Enough Revenue to Make TPP Replacement Payments?

- For FY 2006-2008 the CAT generated enough revenue to make the replacement payments, but from FY 2009-2011 the CAT revenue was insufficient and the state GRF had to be used to supplement CAT revenues.
- The changes made in HB 153 will cause the CAT revenue to be more than enough to cover the required replacement payments for FY 2012 and beyond

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Has the CAT Generated Enough Revenue to Make TPP Replacement Payments?

Commercial Activity Tax Revenues vs Required TPP Tax Reimbursements FY 2009-2013
(\$ in millions)

	FY 2009 Actual	FY 2010 Actual	FY 2011 Actual	FY 2012 Forecast	FY 2013 Forecast
Executive Budget Proposal					
Total CAT Revenues - Baseline	\$1,179.2	\$1,341.6	\$1,451.0	\$1,490.0	\$1,517.0
Required Tangible Property Tax Reimbursements	\$1,275.0	\$1,624.0	\$1,602.5	\$1,127.1	\$779.9
CAT Revenues Minus TPP Reimbursements	(\$95.8)	(\$282.4)	(\$151.5)	\$362.9	\$737.1

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Ohio's Tax Ranking Before and After Tax Reform

- Federation of Tax Administrators (FTA) Rankings based on Census Data
 - State and local taxes per capita for FY 2008 (latest available) show Ohio 25th highest (down from 23rd in FY 2005)
 - State and local taxes as percentage of personal income show Ohio 16th highest (down from 13th in FY 2005)
 - State-only data is more recent: Ohio's FY 2010 state tax ranking was 34th highest (per-capita) and 31st highest (% of income). These rankings have dropped from 27th and 28th, respectively, in FY 2005
 - Ohio was one of 16 states whose per-capita state taxes declined from FY 2005-2010

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Ohio's Tax Ranking Before and After Tax Reform

- Ernst & Young 2011 Study
 - Ohio ranks third lowest in terms of effective state and local tax rate on new capital investment
 - “Ohio's high business competitiveness ranking reflects the major business tax reforms adopted in 2005 that substituted the modified gross receipts tax for corporate income and franchise taxes and eliminated business tangible personal property taxes.”
 - “The modified gross receipts tax uses destination sales to determine Ohio tax liabilities and significantly lowers taxes on businesses making new instate investments.”

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Definition and Measurement of Tax Expenditures

Legislative Study Committee on Ohio's Tax Structure

Testimony of Deputy Tax Commissioner Frederick Church
August 24, 2011

Tax Expenditures

- Tax expenditures typically consist of legislated tax credits, deductions, and exemptions
- Tax expenditures based on the idea that legislated deviations from a “normalized” tax base results in foregone tax revenue whose budgetary impact is akin to that of direct government expenditures.

Tax Expenditures

- Ohio law requires the Tax Commissioner to produce a tax expenditure report every two years, to accompany the Executive Budget
- Ohio's first tax expenditure report was issued in 1987
- Current report contains 128 items, showing the estimated annual foregone revenue for each (except no estimate for those with revenue impact below \$1 million)

3

Tax Expenditures

- The total revenue associated with Ohio's reported tax expenditures amounts to \$7.4 billion in FY12 and \$7.8 billion in FY13.
- The sales tax accounts for the largest amount of revenue foregone through tax expenditures: \$4.8 billion in FY12 and \$5.1 billion in FY13.

4

Tax Expenditures

- As discussed on pages 1-3 of the tax expenditure report, defining a tax expenditure is sometimes a difficult proposition.
- Measurement/quantification of tax expenditures also problematic, often due to data issues.

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Tax Expenditures

- Despite the definitional parameters laid out on pages 2-3 of the report, defining a tax expenditure not always a simple proposition.
- The difficulty is in determining the theoretical “normative” tax base to use, and the particular items that deviate from such tax base.

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Tax Expenditures

- Example 1: Credit for nonresident income. Not considered a tax expenditure because it is Ohio's method for ensuring a constitutionally-compliant income tax.
- Example 2: Sales tax exemption for property used in manufacturing. Even though it helps prevent tax pyramiding, it is generally considered a tax expenditure in most states. This is a major reason why we show it in the Ohio report.

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Tax Expenditures

- Example 3: Sales tax exclusion for most services. Not included in the report because Ohio law structures the sales tax as a tax on tangible personal property, with only specifically enumerated services being subject to tax.
- Example 4: Sales tax exemption for items to be resold. The resale exemption is fundamental to any state sales tax and it would not be appropriate to consider it a tax expenditure.

8

Tax Expenditures

- The ability to measure the fiscal magnitude of tax expenditures, and ability to provide tax expenditure detail according to recipient size or type, varies tremendously.
- Accuracy and detail of many income tax expenditure is generally high, due to information being reported by taxpayers on tax returns.
- In contrast, most sales tax expenditures are challenging to quantify because detail on each exemption is not reported on a tax return.

Testimony of
Mark Engel

On behalf of
The Ohio Manufacturers' Association

Ohio House Study Committee on Tax Structure
September 22, 2011

Mr. Chairman and members of the Committee, my name is Mark Engel. I'm an attorney with the law firm of Bricker & Eckler LLP and I concentrate my practice in the areas of state and local taxation and economic development. I'm testifying here today on behalf of the Ohio Manufacturer's Association, urging you to remain faithful to the principles of the tax reform that was enacted in 2005, especially with respect to the Commercial Activity Tax, or CAT. The Ohio Manufacturers' Association is the state's trade association devoted to advocating on policy matters for Ohio's manufacturers. Manufacturing is the business that drives Ohio's economy.

Ohio's Previous Tax Structure

Prior to 2005, Ohio's tax structure was essentially unchanged since the 1930s. At that time, Ohio's economy was driven by agriculture and manufacturing. Its tax structure reflected that economy. The major taxes were the real property tax, the sales and use taxes, the tax on tangible personal property used in business, and the corporation franchise tax measured on net worth. Both agriculture and manufacturing enjoyed generous exemptions from the sales tax. However, the franchise tax and the tangible personal property tax, especially, both hit capital-intensive industries harder than others and had to be paid whether the entity made, or lost, money. Thus, the manufacturing sector paid an inordinately high level of state tax when compared with other segments of the economy.

As services made up a larger share of Ohio's economy over the years, the inequality in the state tax burden between manufacturing and other segments of the economy was exacerbated. Many service sector concerns operate without a significant investment in capital; hence, their tangible personal property and net worth franchise tax liabilities were minimal. Many of these services operate on more slender margins or can manipulate their finances to minimize income; as a result, little income tax was generated. In addition, many of these new service entities were organized as pass-through entities that were not subject to the franchise tax. As the demand for state services grew, the only recourse was to raise existing tax rates on existing taxpayers. In many cases, that meant an increasing tax burden for Ohio manufacturers.

Paradoxically, Ohio continued to add exemptions from, and exceptions to, the various taxes during this time. As a result, Ohio was saddled with a number of taxes that had high nominal rates, but struggled to raise sufficient levels of revenue for governmental operations. The discrepancies between taxpayers and economic segments also increased and compliance with the existing taxes became more complicated.

Calls for Reform

During the 1960s, calls for reform in Ohio's tax structure began. Over the years, various band-aids were applied to Ohio's tax structure in order to attempt to reduce its inequalities. Differences in the assessment rate applied to various types of business tangible personal property were reduced or eliminated, and the over-all assessment rate was reduced. In the early 1970s the net income tax base for the franchise tax and the personal income tax were enacted on the basis that they were perceived as "more fair" because they were based on ability to pay. Ohio's intangibles tax on investments was repealed during the early 1980s. A cap of \$150,000 was placed on the franchise tax liability of a taxpayer as measured by net worth in the early 1990s.

At the same time, Ohio continued to enact exemptions from, or exceptions to, the various taxes, thereby creating increasing disparity and complexity.

With the dawn of a new millennium, calls for tax reform increased. They were reinforced by the movement of manufacturing jobs to the sunny south and outside the borders of the United States. Ohio lost over 200,000 high-paying manufacturing jobs in the early years after the turn of the century. In addition, Dr. Ned Hill of Cleveland State University published a study that examined the impact of state tax policy on Ohio's economy and called for the elimination of the tangible personal property tax and existing dual-based franchise tax, to be replaced with a broad-based, low-rate tax based on payroll. The study also showed how capital-intensive segments of the economy, such as manufacturing, construction, and retail, paid anywhere from 3 to 11 times more state taxes than did members of many service industries. Responsive to the needs of its members, OMA financed the publication and distribution of Dr. Hill's study.

Early Tax Reform Attempts

Due in large part to Dr. Hill's study, the refrain for tax reform grew louder. Beginning in 2002, bills were introduced to consider tax and expenditure limitations, or "TEs" (A TEL typically couples limitation in the year-to-year growth in governmental expenditures with the requirement of a super-majority to enact tax increases.). Bills were introduced to make changes to the franchise tax in 2003, and 2004 saw the bills that were introduced in order to "reform" Ohio's taxes. None of these bills became law.

Tax Reform Enacted

Finally, in early 2005, true tax reform was proposed. The goals of tax reform were:

- Eliminate tax on investment and shift to the taxation of consumption;
- Broaden the tax base;
- Reduce over-all tax rates;
- Provide a more stable and predictable flow of revenue; and
- Simplify compliance.

The result was a comprehensive overhaul of Ohio's tax system by H.B. 66. As enacted, the bill:

- Eliminated the tangible personal property tax on new investment in manufacturing and phased out the tax on general business property over 4 years;
- Phased out the corporation franchise tax for most corporations over 5 years;
- Phased in a 21% reduction in personal income tax rates ratably over 5 years (the last reduction was delayed 2 years in 2009 in an effort to balance the state budget); and
- Enactment of the commercial activity tax (“CAT”), a broad-based, low-rate tax imposed upon gross receipts from virtually all business activities and entities.

H.B. 66 became law in June 2005. Although generally opposed to gross receipts taxes because of their compounding nature, most manufacturers soon found that the savings from the reduction in the onerous taxes on tangible personal property and corporation franchise more than made up for the policy misgivings regarding a gross receipts tax. Other taxpayers that initially withheld support, such as retailers and those in construction, also warmed to the tax as the savings became clear. In addition, compliance costs were slashed as taxpayers no longer had to undertake the arduous process of preparing personal property tax returns or corporation franchise tax reports.

Results of Tax Reform

Due to the phased implementation of the provisions of H.B. 66 and the general economic slowdown that has gripped the country over the past 2 years, questions have been raised regarding the effectiveness of the tax reform efforts. OMA has been at the forefront in demonstrating that, indeed, the effort was worthwhile.

- In 2009, Ohio won Site Selection magazine’s “Governor’s Cup” for an unprecedented fourth consecutive year. The Governor’s Cup is awarded annually to the state having the most major business expansions in the nation.
- A January 2009 Ernst & Young study indicated that Ohio’s business tax burden rated between 18th and 23rd best on 3 different scales of comparison. Another Ernst & Young study, conducted for the Ohio Business Development Coalition, showed that Ohio had the lowest effective tax rates on new capital investment in the Midwest.
- The Small Business & Entrepreneurship Council’s Business Tax Index in 2008 rated Ohio’s state tax system as 14th best nationally.
- In March 2010 the Federation of Tax Administrations released an analysis of new data from the U.S. Census Bureau showing that for FY 2009, Ohio’s per capital state tax burden was the 16th lowest; as a percentage of personal income, the burden was the 18th lowest.
- In April 2011, Ernst & Young and the Council on State Taxation issued a report entitled “Competitiveness of State and Local Business Taxes on New Investment” in which they concluded that Ohio had the third lowest rate of state and local taxation on new business investment. The report laid this result directly at the feet of the 2005 tax reform law.

- Finally, according to the Ohio Department of Taxation, Ohio is one of only 6 states that do not tax corporate profits, and one of 10 that do not tax business personal property.

Summary:

Since the enactment of tax reform, OMA has developed a simple, consistent approach to tax policy in Ohio. That approach insists on certainty, equity, simplicity, and transparency. The erosion of the tax reform legislation, in the form of carve-outs, exclusions, and ear-marks, reduces certainty, creates disparity by selecting winners and losers, renders the tax code more complicated, and reduces transparency as it becomes more difficult to determine who is entitled to which exclusions.

Everybody has a story; everybody has a reason why one tax or another is not fair to them. However, one cannot have an efficient and fair tax system that is different for every taxpayer. Nor is it fair to tax some segments of the economy at levels that are 10 times higher than those imposed on other segments. Every time an exclusion or exemption is created, that increases the tax burden on everybody else. The solution isn't a tax system made of Swiss cheese; we tried that already, and it didn't work. Hold fast to a broad-based, low-rate tax that is simple to enforce and simple to follow, and that treats all taxpayers the same.

Thank you. I'll be pleased to answer any questions you may have.

John Adams, Majority Whip

State Representative (R)

District: 78

Term: 3rd

Term Limit: Eligible to run for another two-year term

Address:

77 S. High St

14th Floor

Columbus, OH 43215-6111

Phone: (614) 466-1507

Fax: (614) 719-3978

[Contact Me](#)



Biography

State Representative John Adams returns to the Ohio House of Representatives to serve his third term where he was elected by his fellow legislators to serve as Majority Whip. He represents the 78th House District, which is comprised of Shelby and Champaign counties, as well as part of Auglaize County.

Originally born in Urbana and raised in Celina, Representative Adams attended Celina Senior High School. Following graduation in 1978 and several years working at Bethlehem Steel, he left to join the United States Navy. He earned the exceptional honor of being selected to serve in the Navy SEALs and was assigned to a SEAL team in California. He also served overseas and assisted in training tactical units in Japan, South Korea, Malaysia, Thailand and the Philippines.

While in California, Representative Adams furthered his education by attending Mesa Community College in San Diego. Upon returning to Ohio, he attended Edison State Community College to continue his college education and began working at a local furniture business. He worked hard to build the experience and financial stability necessary to purchase his own business, and in 1997 he fulfilled his dream of having his own business by purchasing the Francis Furniture Store in his hometown of Celina.

Representative Adams is a member of the National Federation of Independent Business/Ohio (NFIB) and was appointed to the NFIB/Ohio Leadership Council in Columbus. He has also been awarded both Legislator of the Year by the American Legislative Exchange Council and the Watchdog of the Treasury Award by United Conservatives of Ohio.

Representative Adams has served two terms on the Board of Directors of the Shelby County United Way and was elected as president in 1991. He served as the chairperson of the annual Shelby County United Way Campaign, as president and member of the Board of Directors of the American Heart Association of Shelby County, and as vice president of the Shelby County Rotary Club.

While Representative Adams is gratified by the success he has enjoyed in his business and community endeavors, his greatest joy is his family. He and his wife Tara reside in Sidney and have seven children: Alex, Brian, Andrew, Maria, Lisa, Claire and Matthew.

Education

Attended Mesa Community College



Bruce Madson

Assistant Director, Ohio Department of Job and Family Services

Mailing Address

The Ohio Department of Job and Family Services
30 E. Broad Street, 32nd Floor
Columbus, Ohio 43215

Manager and Consultant with extensive experience in planning, development, and management of Workforce Development programs at statewide, local and regional levels. Significant experience in policy development and legislative support in the areas of employment, retraining, trade and workforce security issues. Particularly interested in projects adopting unique or experimental approaches to addressing issues of labor supply and demand and integration with economic development strategies.

Specialties

Federal grant management, government liaison, negotiation, program and policy development, staff training.



Dan Fitzpatrick

Acting Deputy Director, Office of Legislation at Ohio Department of Job and Family Services

Mailing Address

The Ohio Department of Job and Family Services
30 E. Broad Street, 32nd Floor
Columbus, Ohio 43215