POLICY MATTERS OHIO

Testimony of Jon P. Honeck, Ph.D.
On S.B. 1 before the
Senate Ways and Means Committee
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Good morning Mr. Chairman and members of the committee. I am Dr. Jon Honeck, a Research Analyst in the Columbus office of Policy Matters Ohio. It is a pleasure to be here to present the views of Policy Matters Ohio on Senate Bill 1, Governor Taft's tax reform proposal. Policy Matters Ohio is a non-profit, non-partisan institute that does research on issues that matter to low-and-middle income Ohioans. Our testimony is also endorsed by Advocates for Budget Legislation Equity, a Greater Cleveland community coalition whose goal is to involve citizens in the budget process.

Mr. Chairman, I regret to say that on the whole we have a very unfavorable impression of the tax code changes in Senate Bill 1. As made clear by the proposed cuts in eligibility for the Medicaid program and the local government funds, the tax package does not generate sufficient revenue even in the FY 06-07 biennium. Its long-term revenue implications are even more worrisome due to the steep reduction in income tax rates. According to the Tax Department's testimony, the net revenue shortfall of this plan in FY 2010 will be 2.1 billion dollars when compared to a baseline in which we would retain the one percent sales tax increase.[1] There still would be a shortfall of 400 million dollars in FY 2010 when compared with a baseline of using a 5% sales tax. And, despite the removal of income tax liability for some of our poorest citizens, the cumulative effect of cutting income tax rates and raising regressive taxes causes a shift in the tax burden from wealthy individuals to the poor and middle-class.

The proponents of this bill promote it as an economic development package because of the cuts in the income tax rate and the elimination of most of the tangible personal property tax. Our tax code is not a major factor in explaining Ohio's relative economic decline over the last several decades, or the recent precipitous decline in manufacturing employment. In fact, the business share of Ohio's state and local tax burden has declined from nearly 40 percent in 1976 to 30 percent in 2002.[2] Nor is it likely that cuts to income tax rates will affect our employment situation. Federal personal and corporate income tax cuts over the last four years returned 24.4 billion dollars to Ohio, yet Ohio lost nearly 200,000 jobs over that time period.[3]

When the tax changes in this bill are fully implemented, Ohio will be faced with the same problems that prevent job growth today. Some of the most important problems are federal trade and currency policies that have led to record trade deficits, and an under-educated and under-skilled workforce that is out-of-step with the needs of a modern economy.

The key issue that tax reform must address is providing a stable and adequate long-term revenue stream for the state. The new commercial activity tax (CAT) does not address the state's long-term revenue demands either because its rate is set too low. The CAT rate of .26% is designed to replace corporate franchise tax revenue from non-

financial corporations and a portion of the revenue from the tangible personal property tax. There is now widespread consensus that revenues from the corporate franchise tax are seriously undermined by tax avoidance strategies and various statutory changes such as tax credits and the net worth cap. We see no point in devising a completely new and unique system of business taxation that may spark new rounds of litigation only to have the amount of revenue collection remain inadequate. In fact, under the proposal, the CAT would fall short even of generating all the revenue of the taxes that it is replacing.

Today's corporate franchise tax is not hitting the manufacturing sector harder than most others. As a result, it has become difficult to argue for the elimination of the tax on the grounds that it discriminates against manufacturing. The relative share borne by manufacturers has dropped sharply, from nearly 50 percent of the total paid by nonfinancial companies in the mid-1990s to 25.4 percent in tax year 2003. Manufacturers now are paying a share in line with other industries such as wholesale and retail trade in relation to their share of Ohio's gross state product.

Our recommendation is that General Assembly reform the corporate franchise tax rather than eliminate it. The Committee to Study State and Local Taxes and the Governor's proposed budget in 2003 concluded that the tax should be reformed. Nothing has changed in the last two years that would undermine this conclusion. Corporate franchise tax reforms should include:

1) the adoption of combined reporting, so that companies that operate as a single business must report as one taxpayer;
2) eliminating the cap on net worth payments, which discriminates against small corporations and costs the state close to 100 million dollars a year;
3) eliminating other credits that are steadily weakening the tax; and,
4) adding a throwback provision, so that companies with Ohio production would not have income that is untaxed by any state.

Proposed reduction in individual income tax rates

Ohio already has an income tax reduction mechanism in current law. The Income Tax Reduction Fund (ITRF) automatically reduces marginal income tax rates according to a formula that is based on the amount of surplus revenue in the GRF. Rates were reduced from 1996 through 2000, thereby reducing revenues by a cumulative total of 2.27 billion dollars. In 2001, when the economy slowed, marginal income tax rates returned to their statutory levels because the state needed more revenue. Using the ITRF is a more fiscally responsible approach to income tax reduction than the 21% across the board rate cut that is proposed in Senate Bill 1.

We must also take into account the interactions between state and federal law when analyzing the impact of the rate cut. Because taxpayers who itemize on their federal income tax returns are able to deduct state income tax payments, lower state taxes will result in higher federal income tax liability. We asked the Institute on Taxation and Economic Policy in Washington, D.C. to model the effects of the proposed income-tax

cuts when they are fully phased-in.[4] The model estimates that roughly one-seventh of the amount of the fully phased-in income tax reduction will be passed on to the federal government for this reason. In other words, one-seventh of the tax cut will immediately be siphoned out of state. This will hurt Ohio's economy, not help it.

According to the proponents of this bill, a top marginal rate below 6% will bring Ohio's income tax structure more in line with rates of other states. We have heard repeatedly during the debate over tax reform that Ohio's top marginal income tax rate of 7.5% is hurting our economic competitiveness, especially when combined with municipal income tax rates. There is no empirical evidence, however, that any state's use of a graduated income tax has harmed its economic growth rate or its entrepreneurial environment. California and North Carolina, for example, have among the highest individual income tax rates in the country (top rates of 9.3% and 8.25%, respectively), and yet Silicon Valley and the Research Triangle area are two of the world's leading high technology centers. Minnesota has a top marginal rate of 7.85% for individual income, and a flat rate of 9.8% on corporate income, yet the Twin Cities region has become an important center of the biomedical industry in the United States. Despite its cold climate, Minnesota's per capita personal income growth has been significantly better than Ohio's in recent years.[5]

The evidence from within Ohio refutes the notion that the combination of state income tax rates and municipal income tax rates poses a major problem for taxpayers in the highest bracket. The Ohio Department of Taxation collects information about the school district of residence for all taxpayers. This information gives researchers the ability to track income trends by school district. The table in the Appendix to this testimony shows the change in the average taxpayer return in Ohio's 30 wealthiest school districts between 1986 and 2002. These districts, which are home to many taxpayers subject to the highest bracket, had a real (inflation-adjusted) average gain per return of 42.1%. The statewide average was only 5.1%. Twenty-nine of these thirty districts had some or all of their territory overlapping a municipality with an income tax. These high-income taxpayers could have chosen to live in township areas with no income tax. Instead, these taxpayers have made a choice to reside in municipalities with excellent schools and other public services.

Only 1.6 percent of taxpayers were subject to the highest marginal income tax rate for calendar year 2002 tax returns, and the 7.5% rate only applied to the portion of their Ohio taxable income that exceeded $200,000. Retaining the 7.5% rate is important for future state revenue growth, however, because much of Ohio's income growth in recent decades has been concentrated in the upper income strata. The bottom 60 percent of Ohio workers have seen little or no increase in real hourly pay over the past 25 years. By contrast, the top 10 percent experienced a 19% increase in real hourly pay from 1979 to 2003.

An across-the-board cut in income tax rates would provide the greatest share of tax relief to wealthier taxpayers. The top one percent of Ohioans by income have an average income of $643,000. According to the ITEP model, by the time the tax cut was

fully phased in, these affluent taxpayers would receive an average income-tax cut of $8,080, which would represent 1.3% of their income. By contrast, the 20 percent of Ohioans with income of less than $16,000 a year would receive an average of $19, or 0.2% of their income. This includes the elimination of income tax liability for those taxpayers with Ohio adjusted gross income less exemptions below $10,000. While this step would be a very positive one, it cannot obscure the overall impact of the Senate Bill 1 revenue package. For the poorest Ohioans, savings from the income tax cut will be more than offset by keeping the half cent of the sales tax, even without considering the impact of the increased kilowatt hour tax or excise taxes on alcohol and tobacco.

Commercial Activity Tax

If the General Assembly decides to implement the CAT instead of strengthening the franchise tax, then the targeted level of revenue should be what a strengthened corporate franchise tax would bring in. This level is at least half a billion dollars higher than the fiscal 2004 level of corporate franchise tax receipts.

Proponents of the CAT claim that it is equitable and neutral. On the contrary, the CAT introduces a new distortion into Ohio's tax code because only in-state sales are subject to the tax. So, at an extreme, a company with only out-of-state sales would not be subject to the tax, while a company with only in-state sales would be taxed on all of its gross receipts. The proponents of the CAT claim that this is an incentive to export products or services out-of-state, but this violates the principle that companies that benefit from doing business in the state should have to pay taxes and help support state services.

Moreover, because the proposed CAT is like a sales tax, it is likely to fall more heavily on lower-and middle-income taxpayers than the corporate franchise tax. Such taxpayers in Ohio already pay more of their incomes in state and local taxes than more affluent taxpayers do.

We encourage the General Assembly to weigh carefully the costs and benefits of allowing tax credits for job creation, job retention, qualified research expenses, and R&D loan payments against commercial activity tax liability. It is widely acknowledged that the proliferation of credits severely undermines the corporate franchise tax, and it would be unfortunate if the commercial activity tax were to suffer the same fate.

Because the bill removes tangible personal property taxes from the local tax base, the General Assembly should give some consideration to changing or eliminating the enterprise zone program. Reports on Ohio's taxation and economic development policies have come to the conclusion that the main justification for the program from an economic development standpoint is it that reduces tangible personal property tax burdens for participating firms. Otherwise, the program creates unequal tax burdens among competing firms, and stimulates destructive tax incentive competition among local governments. Although the program was originally intended as a way to increase investment in economically depressed areas, this has not been the case. A recent Policy

Matters Ohio report by Dr. Mark Cassell of Kent State University found that most of the benefits of the program accrued to wealthier school districts.[6]

Mr. Chairman, thank you for the opportunity to testify before the Senate Ways and Means Committee. I would be pleased to answer any questions that you may have.

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[1] "Taft Tax Reform Plan," Testimony of Deputy Tax Commissioner Fred Church, page 20, slide # 39.
[2] The 1976 figure is based on a study by Professor Edward Hill of Cleveland State University for the Ohio Manufacturer's Association. The 2002 figure, which is consistent with Hill's results, is from the Policy Matters Ohio publication "Ohio's state and local taxes: The dwindling business share."
[3] Citizens for Tax Justice, "We're Paying Dearly for Bush's Tax Cuts," Table: "Where the Bush tax cut money goes in the first 6 years, by state," p. 5. September 23, 2003. Available at www.ctj.org/pdf/debt0903/.pdf.
[4] The Institute on Taxation and Economic Policy is a non-profit, nonpartisan Washington-based research group, on the web at www.itepnet.org. Its tax model is similar in methodology and data sources to the elaborate computer models used by the U.S. Treasury and the congressional Joint Committee on Taxation, except that the ITEP model adds state-by-state estimating capabilities. The figures mentioned use 2004 tax laws and income levels.
[5] Minnesota's nominal (not inflation-adjusted) per capita income growth rate was 67.5% between 1990 and 2002, the sixth highest growth rate of any state. Ohio's per capita income growth over the same period was 55.8%, the forty-first highest. The national average was 58.7%. Source: Policy Matters Ohio analysis of U.S. Department of Commerce, Bureau of Economic Analysis data.
[6] Mark Cassell, Ph.D. *Zoned Out: Distribution and Benefits in Ohio's Enterprise Zone Program*. Policy Matters Ohio: October, 2003.