

Testimony to the House Ways & Means Committee
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Thank you for the opportunity to testify before your committee. My name is Zach Schiller and I am research director of Policy Matters Ohio, a nonprofit, nonpartisan research institute based in Cleveland. Policy Matters does research on issues that matter to low- and middle-income workers. Prior to joining Policy Matters, I covered Ohio business as a journalist for more than 20 years, including 18 at *Business Week* magazine.

The Business Activity Tax has a number of positive features. Bringing pass-through entities under the system, eliminating many special tax breaks, and shifting more of the tax burden to service industries, the growing part of the economy, all are sensible moves. However, I think that the plan does not recognize a key shift in who pays Ohio's taxes. The business share of state and local taxes is much lower than it used to be, and this should be addressed. One way to do so would be to bolster the corporate franchise tax. We also need to do additional analysis to understand what the Business Activity Tax would mean for the progressivity of Ohio's tax system.

State and local taxes are less important to economic development than you might think. Peter Fisher, an Iowa economist who has done a number of studies examining taxes and economic growth, wrote in one recent report: "...State and local taxes represent only a small share of the cost of doing business. Small differences in other costs overwhelm large differences in the tax burden."

Robert Lynch, an economist at Washington College, came to similar conclusions in a recent study. Lynch analyzed the literature on effectiveness of state and local tax cuts and tax incentives in creating jobs and economic development. He found that state and local taxes are outweighed in business location decisions by workforce quality, proximity to customers, and quality of public services. Lynch reviewed hundreds of surveys, econometric studies and case studies. He found that local tax cuts lead to economic growth only if public spending is held constant. In other words, a small amount of growth would be stimulated if public spending remained the same while taxes were cut. However, it's unlikely that this would happen, since budgets must be balanced. Lynch's study also summarizes research showing that the structure of the tax code makes state and local tax cuts inefficient, since they reduce deductions that companies can take on their federal taxes.

Robert Tannenwald, an economist at the Federal Reserve Bank of Boston, finds that "While tax characteristics may affect a state's competitiveness, policymakers should view with caution claims that changes in tax policy will dramatically improve their state's economy."

Business is paying less of the freight in Ohio than it used to. You have heard already from Prof. Ned Hill of Cleveland State University, whose study in 2001 was an important basis for the business activity tax now being proposed. In that same study, sponsored by

the Ohio Manufacturers' Association, Hill found that the business share of state and local taxes in Ohio had declined from nearly 40 percent in 1976 to 29 percent in 1999. I have updated Hill's figures, which were based on an earlier study by the Ohio Department of Taxation. The share paid by business declined slightly to 28 percent by 2002, based on his methodology, adjusted for changes in the tax system.

Other researchers, such as Raymond J. Ring Jr. of the University of South Dakota, have used higher figures than Hill did for the business share of sales taxes, in particular. That results in a slightly higher business share of the total tax load than Hill found. If one uses Ring's estimate, business's overall share of Ohio state and local taxes would have been 30 percent in 2002. The share paid by business has stabilized lately because personal income taxes aren't growing as fast as they had been. But the business share is unquestionably far lower than it used to be.

Notably, the two taxes that are to be replaced by the proposed business activity tax have grown much more slowly than the state's major taxes on individual income, sales and real property. Revenue from the corporate franchise tax actually has fallen over the last two decades when adjusted for inflation. While the personal income tax has increased by 2½ times, the tangible personal property tax has barely grown at all in real dollars. One reason for this is the major reduction in assessment rates since the late 1970s.

Overall, taxes on business in Ohio are not high. Mike Sobul, an analyst at the Ohio Department of Taxation, recently found that Ohio's business taxes were in the middle when compared to nearby states. Sobul examined per capita business tax levels in Ohio and surrounding states, plus Illinois, in a November, 2003, presentation to a committee of the governor's Blue Ribbon Task Force on Financing Student Success. He found that we ranked fourth out of seven. Overall, per capita business taxes were \$769, above those of Pennsylvania, Kentucky and West Virginia but below those of Indiana, Illinois and Michigan.

Another study of state taxes released in January was prepared by Ernst & Young for the Council on State Taxation (COST), a nonprofit trade association with 550 major-corporation members which originally was an advisory committee to the Council of State Chambers of Commerce. Though this study has a number of flaws and should be viewed with caution, it found Ohio's business tax load was below that of most other states.

Since business is paying much less of total state and local taxes than it used to, and its overall burden is not out of line, business taken as a whole can afford to pay more. That should be a key element in an overhaul of business taxes. That also fits the needs of Ohio, and especially its schools. While the proposed Business Activity Tax provides some replacement revenue for a time and more complete analysis of its effects are needed, it will leave the schools with less funding than they have now. Others will probably address this more specifically, but this seems to me a weakness in the bill.

The elimination of many special tax breaks is a positive element in the proposal. However, we shouldn't assume that the adoption of this tax would end the problem of

credits and exemptions. A recent report by the Michigan House Fiscal Agency describes 17 different types of credits that may be applied against that state's Single Business Tax, which replaced seven other taxes when it was enacted in 1975. That does not include special provisions that exist for certain industries.

As you review the BAT proposal, the committee should also consider the alternative of strengthening the corporate franchise tax to tighten the loopholes that have helped lead to its decline. A number of avenues are available that are widely used among other states, and would restore fairness to the Ohio tax code. The most important would be to adopt combined reporting, which cuts down on corporate tax avoidance by requiring companies that operate as a single business to be treated as one taxpayer.

Currently, lower- and middle-income Ohioans pay a greater share of their incomes in state and local taxes than do the most affluent citizens of the state, especially after the effect of paying federal taxes is taken into account. The corporate franchise tax is a relatively progressive tax, so it is important that it is not replaced by a tax that is ultimately shifted to lower- and middle-income taxpayers. We are still looking into what the effect of the BAT proposal might be on this issue, and may have more to say on this and other issues later.