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Testimony of Jon P. Honeck, Ph.D.
On Am. Sub. H.B. 66 before the
Senate Finance & Financial Institutions 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 the tax provisions of House Bill 66. Policy Matters Ohio is a non-profit, non-partisan institute that does research on tax and economic development policy.

Mr. Chairman, we are deeply concerned about the revenue package in this bill. As made clear by the proposed cuts to local government funds, cuts to Medicaid family coverage eligibility and optional services, six percent increases in college tuition, and the probable layoff of hundreds of prison personnel, 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 income tax cuts that will decrease income tax revenue by more than 2 billion dollars when fully phased-in. And, despite the removal of income tax liability for 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 key issue that tax reform must address is providing a stable and adequate long-term revenue stream for the state. We are concerned that the new commercial activity tax (CAT) falls well short of accomplishing this goal. The Governor's original budget proposal explained that the CAT was designed to replace most of the revenue from the non-financial portion of the corporate franchise tax and the machinery & equipment and inventory portions of the tangible personal property tax. The House added a phase-out of the furniture and fixtures portion of the tangible personal property tax despite the recommendation in the Executive Budget that this tax be retained. Unfortunately, the House did not adjust the targeted revenue amounts for the CAT accordingly. The new revenue targets of 859 million dollars for FY 2008 and 1.548 billion dollars for FY 2010 are the same as the Tax Department's initial estimates for the CAT at the beginning of the budget process. When the phase-outs are complete, the revenue shortfall between the CAT and the two taxes it will replace will be roughly 600 million dollars.[1]

This estimate of revenue shortfall does not even address the fact 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. A strengthened, more effective corporate franchise tax would have brought in half a billion dollars more than the fiscal 2004 level of corporate franchise tax receipts. We see no point in devising a completely new and even unique system of business taxation only to have the amount of revenue collection remain inadequate. Therefore, if it is the intention of the Senate to completely eliminate the tangible personal property tax, we urge that you adjust the CAT to fully replace all of the lost revenues from that tax, which will amount to over 400 million dollars annually.

We recommend that the Senate retain the corporate franchise tax. Wiping out this tax would mean that highly profitable companies no longer would have any obligation to pay taxes in relation to their income, violating a bedrock principle of fair taxation. Some companies would pay millions of dollars less than they do now. The corporate franchise tax can be strengthened separately through the adoption of mandatory combined reporting by multi-divisional companies, the elimination of the net worth cap, the extension of the tax to S Corporations and other pass through entities, and the elimination of unneeded tax credits. Strengthening the corporate income tax would help to address the historical shift in Ohio's state and local tax burden from businesses to individuals. 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]

Mr. Chairman, I will now turn to the other parts of the tax package. In our view, the premise that our tax structure is a major cause of Ohio's economic difficulties is incorrect. In our current economic environment, it is easy to forget that Ohio's unemployment rate was at or below the national average during the 1990s, and did not begin to diverge substantially from the national rate until 2003.[3] Likewise, it is easy to ignore the fact that Ohio's per capita personal income growth tracked the national average during the 1988 – 1998 period before lagging in recent years.[4] Ohio's economic problem is that it is more heavily concentrated in the manufacturing sector than the nation, and we are in an era in which the manufacturing sector is experiencing both record trade deficits and extremely rapid productivity growth.

The assertions that the income tax is a major hindrance to investment in Ohio and a major cause of out-migration are unfounded. In 1993, the top rate of the personal income tax was raised to 7.5%. If one takes the view that the income tax is a major determinant of our economic fate, then one would have expected dire economic times for Ohio in the 1990s. As noted above, this did not occur. In fact, solid economic growth enabled the General Assembly to enact the Income Tax Reduction Fund, which reduced rates from 1996 to 2000 and decreased income tax revenue by several billion dollars. Even when the state income tax reverted to statutory rates, the federal government embarked on a major reduction in income taxes on an even larger scale. Federal personal and corporate income tax cuts over the last four years returned an estimated 24.4 billion dollars to Ohio, yet Ohio lost roughly 180,000 jobs during this time period.[5]

We are currently completing a study of migration patterns using IRS data from the late 1980s through 2003. We have found that Ohio's migration patterns are not explainable by income tax rates. Ohio has a negative net migration rate (we lose more population due to migration than we are gaining), but so do most other Northeastern and Midwestern states. These states include Indiana, Illinois, Michigan, and Pennsylvania, all of which are states that have flat income tax rates.[6] These findings are in keeping with academic literature on this subject, which finds that migration is a complicated process with both "push" and "pull" factors.

Net migration did not increase significantly when the 7.5% top rate was imposed in 1993 or when the income tax reduction fund was in effect. After the top rate was added in 1993, there was less than a two percent total increase (roughly 1,500 households) in outward migration over the 1994 to 1996 period. Throughout the time period under study, Florida, a state with no income tax, is the preferred destination for Ohioans, but it is also the leading source of in-migration. Ohioans are nearly as likely to move to states with high marginal income tax rates (e.g., North Carolina, New York, and California) as they are to states with no income tax. In 2000, the last year of the income tax refund, Ohioans migrated to states with no income tax at nearly the same percentage as to states with high personal income tax rates. In 2000, 19,115 filers, 19.8% of those leaving Ohio (12% to Florida alone) went to states with no personal income tax while 19.5%, or 18,788 filers, went to states with high personal income tax rates at the middle and upper levels.[7] The median income for Ohioans relocating to states with no income tax was $23,549, compared to $24,634 for those relocating to states with the highest personal income tax. For non-migrants, the average median income was $28,590. The median income of people entering and leaving Ohio is less than $30,000 throughout the period under study, indicating that typical migrants are not affluent individuals.

Will the tax changes in H.B. 66 significantly improve Ohio's net negative migration rate by improving our economy? In our view this is unlikely. Findings to the contrary in the recently-released study by Regional Economic Models, Inc. (REMI) for the Department of Development are very misleading. The REMI study modeled the economic effects of some of the tax changes, but it did not take into account the cuts in services that would be required to balance the state's budget due the size of the tax cuts. This is a glaring omission given that the tax changes modeled in the report produce a revenue shortfall of 2.8 billion dollars in FY 2010 even after dynamic economic effects are considered. If these offsetting service cuts were included, they would significantly reduce the positive economic impacts of the tax package.

If it had been used properly, REMI's expertise could have been harnessed to consider alternative scenarios of public spending and tax changes. This is important because government is more likely to purchase locally-produced goods and services than the private sector. Moreover, the study did not model all of the tax increases that have been proposed, most notably the elimination of the 10% commercial property tax rollback. Without taking into account corresponding cuts to government services, the study predicted an increase of 43,250 jobs statewide by FY 2010, a number that is less than 1% of our current statewide total. It is also important to note that cutbacks in public investment in functions such as education and infrastructure may have significant negative long-term effects on economic development that must be taken into account, even if they are beyond the scope of the model.

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

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[1] This is a conservative estimate. The effects of the credits against the CAT and the effects of changes made by the House may reduce revenues by $200 million per year.
[2] The 1976 figure is based on a study by Professor Edward Hill of Cleveland State University for the Ohio Manufacturers' 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] U.S. Department of Labor, Bureau of Labor Statistics seasonally adjusted unemployment rates.
[4] Ohio Office of Budget and Management. *Executive Budget for FYs 2006 and 2007,* p. D-3 and D-4. *See* Table "Per Capita Personal Income, Ohio vs. U.S. and Great Lakes States," p. D-4.
[5] 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.
[6] Michigan and Illinois' net migration rates are far worse than Ohio's.
[7] According to the Institute on Taxation and Economic Policy, the states that best fit this category are California, Maryland, Massachusetts, Minnesota, New York, North Carolina, Oregon, and Wisconsin. It is important to note that income tax brackets vary from state-to-state.