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Testimony to the House Legislative Study Committee on Ohio's Tax Structure
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Good morning, Chairman Adams and members of the committee. Thank you for the opportunity to testify today on Ohio's tax structure. I am Zach Schiller, research director of Policy Matters Ohio, a nonprofit, nonpartisan research institute with offices in Cleveland and Columbus.

The tax overhaul of 2005 was billed as just the thing Ohio needed to generate jobs and improve its economic standing. It hasn't worked. It's time to revisit it, both to generate more revenue to meet the state's needs and to make the tax system fairer for Ohioans.

Ohio has a smaller share of the nation's manufacturing jobs and overall jobs today than it did when House Bill 66 was passed in June 2005. Our incomes have grown more slowly, as has our economic output. If the tax changes were as important and as useful as they were touted to be, they should have at least allowed us to maintain our position vs. the rest of the country. That has not happened.

It's not surprising that the tax cuts didn't bring strong economic gains. As researchers at the Federal Reserve Bank of Cleveland have found, there isn't a significant relationship between state income growth and average tax rates. States can invest their tax dollars in productive ways that have every bit as much impact, or more, than cutting taxes.

Yet the tax cuts of 2005 have had a profoundly destructive impact. You have already heard from Fred Church that they amount to at least \$2.5 billion a year. That's the lion's share of the budget gap that the General Assembly had to close in the state budget.

Yes, Ohio should have an efficient and effective government. But laying off state and local government workers does not help the state economy. Whether a worker is employed by a small business, Ford Motor Co. or the State of Ohio, the economic effect of their layoff is same: Less spending at grocery stores, restaurants, dry cleaners, auto dealerships and businesses across Ohio.

Tax cuts are not a magic potion that will cure Ohio's economic ills. They have not shown that, and the committee should keep that in mind in making its recommendations. On the contrary, Ohio needs more revenue to make needed investments in its people.

Nor are state and local tax levels in Ohio out of line with the rest of the country. Overall, our state and local taxes ranked 16th as a share of personal income in Fiscal Year 2008. That was 2.7 percent higher than the average for the country as a whole. A number of studies have found that Ohio's taxes on new business investments are relatively low.

Ohio's tax system is, however, weighted against lower- and middle-income taxpayers. The attached sheet comes from an analysis by the Institute on Taxation and Economic Policy, which has a model of state and local tax systems across the country. It shows that the top 1 percent of non-elderly Ohio taxpayers, with income of at least \$352,000 a year in 2007, pay 7.8 percent of their income in state and local taxes. Taxpayers in the middle fifth of the income spectrum, with average incomes of \$40,500 a year, pay 11.0 percent. And taxpayers in the lowest fifth, who make less than \$17,000 a year, pay 12.0 percent. This understates the real differences, because affluent families receive far more for deducting state taxes from their federal tax bills.

Commercial Activity Tax. The Commercial Activity Tax has a major thing to recommend it: It is a very broad, low-rate tax, covering a wide array of businesses, and including businesses no matter whether they are corporations or limited liability companies. But as you have previously heard, the CAT generates about \$1.8 billion a year less than the two taxes it replaced. This contributes to the imbalance between what individuals and businesses pay in state and local taxes: Businesses pay far less as a share of the total now than they did in the 1970s. Prof. Ned Hill of Cleveland State University found that to be so in a study 10 years ago for the Ohio Manufacturers' Association, and it continues to be true today.

Because of the way the CAT is structured – to only require tax on products and services sold in Ohio – a business can pay very little in CAT tax and receive the benefits of public services, from public education for employees' children to law enforcement. This is one reason that the business tax system should include a component related to company income. Ohio is one of only six states without a corporate income tax.

Proponents of the 2005 business-tax overhaul argued that another benefit would be a reduction in loopholes and tax abatements that were so common with the Corporate Franchise Tax and the Tangible Personal Property Tax. But while some loopholes did go away with the disappearance of the franchise tax, new tax incentives have been instituted. The amount of local real-property tax abatement has continued to climb – between 2005 and 2009, the assessed valuation of real property tax abatements rose 50 percent, to \$9.4 billion. Major incentives have been awarded to one company after another, even when there is little likelihood that Ohio will lose their investment without it. These tax breaks have become entitlements. They should be closely scrutinized and cut back where possible.

Sales tax: Services represent a growing portion of our economy. However, since the sales tax only covers goods and those services that are specifically included, it increasingly covers a smaller and smaller part of the Ohio economy. For example, lobbying and debt collection are not taxed. Lobbyists aren't going to move to Harrisburg or Indianapolis if we start taxing their services. The General Assembly needs to broaden the base of the sales tax to cover more services. In doing so, however, it should be mindful that the sales tax is a regressive tax, meaning it falls more heavily on low- and middle-income taxpayers, so it needs to be balanced with other, more progressive taxes. A strong, graduated personal income tax is a key element providing that balance.

The General Assembly also should follow the example of other states such as North Carolina and California to make sure that companies such as Amazon.com collect the sales tax. This is only fair to Main Street retailers that have to collect the tax. The legislature should ask the Ohio congressional delegation to support federal legislation that would allow states that have implemented the Streamlined Sales Tax Agreement to require remote sellers with sales above a certain amount to collect and remit their state and local sales taxes.

The General Assembly also should carefully review the \$4.8 billion a year in sales-tax expenditures (see below). One example is the vendor discount, worth \$49.4 million in FY12, under which retailers that collect the sales tax get a 0.75 percent discount on what they collect if they send the tax in by the due date of the tax return. This is a windfall for big retailers, which get most of the benefit. According to data in the 2009 tax expenditure report, more than half of such discounts in 2008 went to the 687 retailers that collected at least \$1 million in tax, while the 197,487 other retailers got the rest.

Tax expenditures: We are glad that the committee is including tax expenditures among the subjects for review. Though the state has a tax expenditure report that is released as part of the budget process, the General Assembly has not made regular scrutiny of tax expenditures a part of the budget, or done so at any other time. It should. These are called "expenditures" for a reason. As the taxation department says in the report, "Tax expenditures result in a loss of tax revenue to state government, thereby reducing the funds available for other government programs. In essence, a tax expenditure has the same fiscal impact as a direct government expenditure." Indeed, when the tax credit for investing in machinery and equipment was eliminated in 2005, it was replaced by a grant program that did the same thing. In one case, the money came out of a tax credit that reduced revenues; in the other, by the state writing a check.

Why do we give utilities a break on the sales tax for pollution control equipment they are mandated to use? Why do buyers of time-shares in jet aircraft get a break on the sales tax? Should brewers and beer importers receive a credit on beer and malt beverage taxes they pay just for paying part of them a few weeks in advance? Why are big companies that lost money years ago allowed to write off those losses against the commercial activity tax – a tax break not available to small companies? Should people who lose money gambling in Las Vegas get a break

on their Ohio income tax? These are just some of the tax expenditures that seem dubious, at best.¹

The committee should call for a detailed study of all 128 tax breaks, as well as other items in the tax code that reduce revenues. The General Assembly should create a tax expenditure review committee as the Senate did in its budget bill, which would have required a review of these tax breaks every 8 years and of each new tax break before it was approved. However, we should also set sunset dates for all tax expenditures, so they disappear unless they are specifically renewed.

We recommend that you extend your analysis to property-tax breaks that the state provides through the two rollbacks and the homestead exemption. Gov. Voinovich and Gov. Taft both proposed means-testing the two property-tax rollbacks, just as then House Speaker Jon Husted advocated for the homestead extension when it was expanded in 2007. Policy Matters Ohio estimated at that time that the state could save over \$100 million a year by doing that with the homestead exemption. These tax breaks should go to those who need them, not to those who don't.

Ohio's state support for a wide array of public services, from libraries to day care, came under the knife as revenues fell. Yet tax expenditures – which have every bit as much impact on the state budget – did not receive the same treatment. They should be reduced. The committee should set goals for substantial reductions in tax expenditures and begin planning how they can be implemented.

Ohio's highest earners, who have seen their real income increase when most Ohioans have not, can afford to pay more. The 2005 tax overhaul did not improve Ohio's economic performance as promised, increased the share of taxes paid by middle- and low-income taxpayers, and deprived the state of essential resources for public services. The tax overhaul needs to be revisited to provide needed revenue from those who can afford to pay.

¹ Policy Matters Ohio has produced a number of studies that go over these and other tax breaks. Our analysis of the 2011 tax expenditure report, "\$7 Billion in Ohio Tax Breaks, and Nobody's Watching," is available at <http://www.policymattersohio.org/TaxExpenditures2011.htm>. An earlier study of some tax breaks that can be reduced or eliminated, "Limiting Loopholes: A Dozen Tax Breaks Ohio Can Do Without," is available at <http://www.policymattersohio.org/LimitingLoopholes2008.htm>