Policy Matters Ohio

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Statement on the Proposed Budget
Tax policy shortchanges Ohio's public services; Weak job growth continues

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Introduction

In 2005, Policy Matters Ohio testified in the Ohio legislature against sweeping tax law changes that gave massive tax breaks to wealthy individuals and certain segments of the business community. As the Ohio House of Representatives considers making changes to the budget submitted by Governor Strickland, we call on legislators to take stock of the effects of tax reductions on public services and consider whether the tax changes have helped the economy. Nearly two years after the tax changes, Ohio's total non-farm payroll employment stands at 5.43 million, barely higher than in the summer of 2005. The manufacturing sector, which was supposed to be the main beneficiary of tax reduction, lost nearly 29,000 jobs since June 2005. House Bill 119 reflects continuation of anemic revenue growth from previous years: Aid to local governments is barely increased after years of being frozen, higher education continues to be squeezed, and it is a struggle to find revenue even to restore parents' coverage under Medicaid to 100 percent of the poverty level.

Shifting priorities under artificial revenue constraints means "robbing Peter to pay Paul," as illustrated by House Speaker Jon Husted's plan to increase state aid to public universities and create new science and mathematics scholarships. Complete funding details are unknown at this point, but Husted's office identified expansion of parents' Medicaid coverage as a major funding source. If we had a reasonable tax policy, we could afford to do both.

Underinvestment in public services leads to a decreased quality of life, not better economic growth. Billions of dollars will be lost each year as the tax law changes are phased in. In order to maintain effective public services in the long run, we call on the Ohio General Assembly to take the following actions:

• Halt further cuts to personal income tax rates, and reverse the cuts for the most affluent.

• Retain the corporate franchise tax, Ohio's corporate income tax. This tax is being phased out, together with the tangible personal property tax, and replaced by the new Commercial Activity Tax. In the coming years, all of the CAT tax revenues will be required to reimburse schools and local governments for tangible personal property tax revenue losses. Instead of abandoning the corporate franchise tax, Ohio should plug the loopholes that have weakened it. Ohio could take a major step in that direction by instituting combined reporting of corporate income, so that companies that operate as a single business report their corporate franchise tax as one taxpayer.

This reform cuts down on shifting income to other states to avoid tax. New York just became the 20th state to adopt combined reporting.

• Establish a permanent, comprehensive mechanism to provide regular evaluation of the effectiveness of all tax expenditures, and approve closing four specific tax loopholes as proposed in the governor's budget.

Closing Tax Loopholes

Each year, the state reduces its general tax receipts by over $6 billion, or nearly one-fourth of the potential total, due to exemptions, deductions, and credits. In February, we released a report, *Exempt from Scrutiny: Tax Breaks in Ohio,* that explained that very few of these special tax breaks receive regular evaluation to ensure that they are achieving their intended purposes. [Click here to read the report.] Budget analysts label these breaks as "tax expenditures" because from an economic standpoint they are no different than the state directing a grant to support specific organizations or activities. Yet because these breaks are in the tax code they do not require an appropriation, so most of them escape regular scrutiny. We urge the General Assembly to use House Bill 119 to establish a permanent, comprehensive mechanism to provide regular evaluation of the usefulness of all tax expenditures.

House Bill 119 provides for the restructuring, elimination, or expiration of four current tax expenditures: the sales tax vendor discount; the sales tax exemption for non-resident motor vehicle purchases; the $300 monthly exemption for cigarette importation; and, the exemption for motor fuel sales from the CAT tax. We urge the General Assembly to approve these measures. The motor-fuel exemption to the CAT, for instance, represents a serious breach of the reasoning behind this tax. It was to be a broad tax without the loopholes and abatements in the two taxes it replaces. Exemptions like the one for motor fuel violate this concept and open the way for more special-industry carve-outs.

Growing Revenue Losses Cause Cuts to Services

Two years ago, we stated our opposition to the overall tax package contained in House Bill 66 of the 126th General Assembly. One of our main concerns was that steep cuts in revenue would leave the state with insufficient resources on a long-term basis. House Bill 119 clearly reflects that the tax cuts approved in 2005 exacerbate already slack revenue growth. For example, higher education institutions are being asked to accept a compact that constricts overall institutional revenues at the same time that they are expected to enroll thousands of more students. Local government funds are still squeezed. While there is much to support in HB 119, tax cuts are keeping Ohio from investing enough in its people and its future.

After nearly two years of experience with tax reform, the Office of Budget and Management's updated revenue projections show a total General Revenue Fund revenue reduction of $502 million in FY 2008, growing to more than $2.2 billion in FY 2011 when compared to a statutory baseline sales tax rate of five percent.[1] FY 2011 begins in less than four years. By way of comparison, the governor's proposed annual operating budget for all Board of Regents programs in FY 2008 is $2.3 billion.

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[1] Table B-1a Estimated Fiscal Impacts of Major Tax Law Changes in House Bill 66, p. B-8. State of Ohio. Executive Budget. Fiscal Years 2008 and 2009.

These OBM projections include higher CAT revenue estimates but larger losses for the corporate franchise tax and personal income tax than were originally expected. In FY 2011, CAT tax revenues, which remain subject to a downward trigger, will be slightly below the level necessary to replace tangible personal property tax losses for schools and local governments, and will not begin to substitute for another $1.6 billion in losses from the phaseout of the corporate franchise tax. Other tax changes will be inadequate to replace nearly $2.4 billion in lost revenue from the income tax. Revenue from the cigarette tax will actually decline over time.

Despite the removal of some very low income taxpayers from personal income tax liability, tax reform still leaves us with the worst of both worlds – a regressive state and local tax system and inadequate revenues. Nearly a quarter of the income-tax cuts are going to the highest-earning 1 percent of Ohio's taxpayers, who average more than $600,000 a year in income.[2]

Will Tax Changes Improve our Economy?

We urge the General Assembly and the Administration to develop objective criteria to monitor whether tax reduction is achieving its desired purpose of improving economic conditions. This will not be an easy task, as employment trends are influenced by many different factors besides state spending levels. The budget process gives an opportunity to take stock of recent trends. As of March, Ohio's seasonally adjusted non-farm payroll employment stood at 5.43 million. This is 10,000 jobs or less than 0.2 percent higher than the level of employment in June 2005, when H.B. 66 was approved. National employment grew by 4 million jobs over the same time period, a gain of 3 percent. The tax changes were designed specifically to help Ohio's manufacturing sector, but statewide manufacturing employment declined by 28,600 jobs. Tax policy has not overcome the impact of restructuring in the domestic automobile sector or outsourcing to foreign countries.

Ohioans do not have to choose between a false dichotomy of adequate public services and improved economic growth. In a research report issued last year, we analyzed the relationship between rates of expansion in the public sector and private sector economic growth among all fifty states [click here to read the report]. We found that faster rates of public sector growth were associated with faster rates of growth in per capita private sector Gross State Product. Although this result does not imply causation, we can reject the notion that there is a trade-off between investment in public services and growing our economy. Our quality of life requires investment in education, infrastructure, and other effective public services. Our tax system must allow us to make these investments. We should not turn our back on these goals.

[2] The distributional effects of the many of the tax changes are estimated in a March 2005 joint press release with the Center for Community Solutions. Click here to read the release.