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Statement on the Budget Shortfall
House Finance & Appropriations Committee Hearing
February 26, 2008

Good afternoon Chairman Hottinger, Ranking Member Skindell, and members of the House Finance and Appropriations committee. I am Dr. Jon Honeck, a Senior Researcher in the Columbus office of Policy Matters Ohio. Thank you for the opportunity to testify today about the projected state budget shortfall.

In 2005, Policy Matters Ohio testified on H.B. 66 of the 126th General Assembly. At that time we objected to sweeping tax law changes that gave massive tax breaks to wealthy individuals and certain segments of the business community. These changes were retained in the current budget bill (H.B. 119) even though the economy was on shaky footing, and the reductions have led to severely reduced revenue growth. Tax Department estimates from last year predict a loss of $2 billion in state revenue when compared to the policies we had in place before H.B. 66. In the absence of major reform to our revenue policies, it is likely that this is the first of many severe cutbacks to state services and state employment.

As the Ohio House of Representatives considers Governor Strickland's budget reduction order, 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 because employment trends are influenced by many different factors, most of which are beyond the control of state government. This hearing process gives us an opportunity to take stock of recent trends. As of December, Ohio's seasonally adjusted non-farm payroll employment stood at 5.43 million. The state has gained a total of 4,400 jobs since tax reform was approved in summer 2005 (one-tenth of one percent). National employment grew by 4.9 million jobs over the same time period, a gain of 3.7 percent. The tax changes were designed specifically to help Ohio's manufacturing sector, but statewide manufacturing employment declined by 37,000 jobs, a loss of 4.6 percent, or over two times the national rate.

In order to maintain effective public services in the long run, we urge 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 business income tax. This tax is being phased out, together with the tangible personal property tax, and replaced by the new Commercial Activity Tax (CAT). CAT revenue levels are designed to reimburse schools and local governments for their tangible personal property tax revenue losses, and do not replace vanishing corporate franchise tax revenues. Instead of abandoning the corporate franchise tax, Ohio should plug the loopholes that have weakened it by adopting combined reporting. This reform limits a corporation's ability to shift income to other states to avoid tax. Twenty states have adopted combined reporting.

◆ Means-test the homestead property tax credit. Our analysis last year showed that the state could save $144 million by limiting the credit to households with incomes below $40,000 per year. An alternate plan that retained the previous credit structure and indexed the value of the credits to 1980 levels would have saved $118 million.

◆ Establish a permanent, comprehensive mechanism to provide regular evaluation of the effectiveness of all tax expenditures. The state will reduce its general tax receipts by over $7 billion in FY 2009, or approximately one-fourth of the potential total, due to exemptions, deductions, and credits. In February 2007, 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. 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.

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. We have estimated that nearly a quarter of the income-tax cuts are going to the highest-earning one percent of Ohio's taxpayers, who average more than $600,000 a year in income.

Adequate funding for public services is consistent with a thriving economy. Being able to fund schools, roads, infrastructure, job training, and other needs results in the kind of society where business can succeed. In a research report issued in 2006, we analyzed the relationship between rates of expansion in the public sector and private sector economic growth among all fifty states (*Economic Growth and the Public Sector).* 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.