Policy Matters Ohio

Tax Policy
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Testimony to Senate Ways & Means Committee on House Bill 59

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Good afternoon, Chairman Schaffer, Ranking Member Tavares and members of the committee. My name is Zach Schiller and I am the research director at Policy Matters Ohio, a nonprofit, nonpartisan organization with the mission of creating a more prosperous, equitable, sustainable and inclusive Ohio. Thank you for the opportunity to testify today regarding House Bill 59.

As you consider tax proposals, we believe it is especially important to ensure that the state has adequate revenue to make needed investments in Ohio's future, and that those who are able to pay are bearing the biggest responsibility for doing so. Neither of these things is true now. Nor does Ohio's state tax system meet the tax policy principles of simplicity and a broad base when 129 tax expenditures valued at more than $7 billion a year clutter the tax code.

Ohio is not investing as much as it needs to achieve long-term economic success, or to provide the services that distinguish a caring society. Our spending on K-12 education is not adequate. A large majority of Ohio school districts responding to a recent survey report that they have cut or frozen salaries and benefits, laid off staff, or cut back on classroom materials and supplies to deal with the loss of state funding since 2011. Students in many districts are facing larger class sizes, reduced course offerings, and an increase in "pay-to-play" requirements for extra-curricular activities. Despite what Governor Kasich recently called "these unbelievably high costs of higher education," actions to make college affordable remain insufficient.

At the same time, we require poor and middle-income Ohioans to pay more of their income in state and local taxes than the most affluent do. This is clear from a recent analysis by the Institute on Taxation and Economic Policy. Ohio residents in the middle fifth of the income spectrum, who made between $31,000 and $49,000 in 2010, pay 10.6 percent of their income in such taxes, compared to just 8.1 percent for those in the top 1 percent, who made at least $324,000 in 2010. Those in the bottom fifth, who made less than $17,000, paid relatively more: 11.6 percent.

With that backdrop, it would be misplaced to cut the income tax, the only major tax based on the ability to pay. Nor is it sensible to seek additional sources of revenue in order to add a business-income tax exemption to the rate reduction the House approved in HB 59. Since the General Assembly approved income-tax cuts in 2005, Ohio:

- Has trailed every state but three in job growth;
- Has seen slower employment growth than the nation in every major industrial sector;
- Underperformed the nation on job growth before, during and after the recession;
- Has finally been reporting a lower unemployment rate than the nation—but more because workers are leaving the labor force than because of job growth.

This shows that income-tax cuts are not the tonic for Ohio's economy. On the contrary, we should bolster the income tax so that top earners pay more than they do now. The 7.5 percent top rate adopted under Gov. George Voinovich in 1992 did not prevent Ohio from generating more than 100,000 jobs each year from 1993 to 1995.

Ohio has phased out its corporate income tax, becoming just one of six states in the country without one. While the Commercial Activity Tax has a broad base, it delivers far less revenue than the two business taxes it replaced. This was been made painfully clear to school districts and local governments that have seen huge reductions in the state payments that reimbursed them for lost tangible personal property tax—including vital levies for mental health, children's and senior services. Over the last generation, Ohio's taxes have shifted so that individuals are paying a greater share of state and local taxes, while the share paid by business has declined. This needs to be rebalanced.

Tax expenditures deserve to be examined and debated on a regular schedule just as state spending is. Many tax expenditures have continued for decades, draining state revenue, providing a special advantage to certain taxpayers, without an accounting for whether they serve their original purpose or even what that purpose is. All tax expenditures should be sunsetted and continue only if legislators determine that they are necessary.

In reviewing the state's 129 tax expenditures and other elements of the tax code, it's important to keep in mind that the state and local tax system is weighted against low- and middle-income Ohioans. Reducing or eliminating income-tax exemptions and credits such as the personal, spousal and dependent exemption or the $20 credit and using the funds for an across-the-board income-tax cut would amount to a tax shift from poor and middle-income Ohioans to the more affluent. That's because it is the latter who benefit the most from across-the-board cuts.

Ohio tax policy should be moving in the opposite direction. One way to begin doing this would be to establish income limits for local property-tax credits and reimbursements. Both Gov. Voinovich and Gov. Taft attempted to set a ceiling for the two property-tax rollbacks, limiting the amount that could go to owners of the most expensive homes. When he was House Speaker in 2007, Jon Husted similarly attempted to means-test the homestead exemption, which was significantly expanded. These were worthy efforts that deserve reexamination.

We need to modernize our tax system so it covers today's industries. This means a severance tax that will capture more than the current tiny share of revenue from hydraulic fracturing as our state's resources are depleted. Studies of the oil and gas industry over the past 40 years make clear that state tax rates have miniscule impact on oil and gas production.

It also means collecting the use tax due on catalog and Internet purchases. The House budget bill that includes a click-through nexus provision is a welcome step in that direction, as is action pending in Congress. This is not a new tax; the use tax has been in place since the 1930s. Separate from the collection of taxes already due, the shrinking share of Ohio's economy that is covered by the sales tax mandates a long-term evaluation of adding services to the sales-tax base.

More immediately, creation of a refundable state Earned Income Tax Credit would benefit 800,000 working families in Ohio. Created by President Gerald Ford in 1975 and supported by every presidential administration since, the EITC is lauded for its direct impact in lifting families with children above the poverty line, making work pay, and sending federal dollars to local communities (for an interactive map of the benefits a state EITC would bring to each Ohio county, see www.policymattersohio.org/eitc-map-apr2013). A state EITC would help make Ohio's tax system fairer. As a percentage of the federal credit, it would be easy to implement.

Finally, I would like to discuss the business-income exclusion proposed by Gov. Kasich. This plan is very poorly targeted and is unlikely to result in significant new job creation. The taxpayers who benefit on average would get so little that they couldn't add employees in any meaningful way. Based on 2009 taxation department data, the median taxpayer benefiting from the exemption would be able to exclude annual business income of $3,103. Even if all of this income were taxed at the top rate, the exclusion would result in an annual tax cut of less than $200. A recent national study by researchers at the U.S. treasury department found that only 11 percent of taxpayers reporting business income own a bona fide small business with employees other than the owner.

Yet at the same time, the proposed business-income exclusion represents a windfall for affluent passive investors, and partners in law firms and other partnerships. It also creates the potential for abuse of the tax system, since it creates an incentive for owners of passthrough businesses to reclassify their income as "profit" – half of which will go untaxed – rather than "salary."

Business owners who will benefit from the exclusion also received the 2005 income-tax cuts, since they pay tax on such income under that tax. Yet there is scant evidence that those cuts resulted in growth in Ohio's small businesses. Between 2004 and 2010, Ohio's share of U.S. employment fell both at companies with fewer than 20 employees and those with fewer than 500 employees.

Lately, there has been some discussion of including both a rate cut and some form of the proposed business-income tax break in the budget. Limiting the business-income exemption to sole proprietorships would reduce the cost of that tax break, but it would not make it any more effective as a job creation measure. The vast majority of sole proprietors do not employ others besides their owners. Nor would rejiggering the maximum income and percentage of income that is excluded result in a jobs bonanza. An exhaustive analysis commissioned by the U.S. Small Business Administration and published last year concluded, "We find no evidence of an economically significant effect of state tax portfolios on entrepreneurial activity."

Ohio's tax system should be overhauled to produce the revenue we need for public services and investments that support our economic success and maintain and improve our quality of life. At the same time, it needs to depend less on low- and middle-income Ohioans, and more on those who can afford it.

Thank you for the opportunity to testify. I would be happy to answer any questions.