Testimony to the Senate Finance Committee on House Bill 59

Zach Schiller

Good morning, Chairman Oelslager, Ranking Member Sawyer and members of the committee. My name is Zach Schiller and I am 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 the bill, 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.

Why do we address the need for revenues in a budget focused on tax cuts? Because needs are great, especially for those hurt by the recession and the slow recovery, and because Ohio is not investing as much as it needs to achieve long-term economic success. 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. Local government services have been battered by state funding cutbacks.

As the budget emerges from the Senate, many urgent needs remain unmet. More funds are needed for foodbanks to feed the hungry. Stakeholders ask for $20 million to fund and staff Adult Protective Services, a state mandate for local government that has seen state funding and local staffing drop significantly over two decades even as the senior population has grown. Throughout the nation, elder abuse is increasingly known as the "silent epidemic" because of underreporting and lack of detection. Expansion of Medicaid would provide a great enhancement to health and human services, but with its removal from the budget, restoration of important health and human services is not possible – particularly in the area of addiction services and mental health, where even the new funds included in the Senate budget fail to recoup a decade of disinvestment.

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. Ohio residents in the middle fifth of the income spectrum pay 10.6 percent of their income in such taxes, compared to just 8.1 percent for those in the top 1 percent. Those in the bottom fifth pay relatively more: 11.6 percent (See report based on analysis by the Institute on Taxation and Economic Policy, www.policymattersohio.org/income-tax-jan2013).

This explains why it would be misplaced to cut the income tax, the only major tax based on the ability to pay, either to cut rates generally or to provide a business-income tax break. Since the General Assembly approved income-tax cuts in 2005, Ohio has trailed every state but three in job growth, and underperformed the nation before, during and after the recession. We have finally been reporting a lower unemployment rate than the nation – but more because workers are leaving the labor force than because of job growth. Income-tax cuts have not worked to spur growth here. Indeed, the higher 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.

The business-income exclusion proposed by Gov. Kasich and included in the Senate budget bill is very poorly targeted and is unlikely to result in significant new job creation. 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. And the taxpayers who would benefit from the exclusion 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.

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. This supports what national research has found. 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."

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. Over the past decade, the General Assembly has repealed the corporate franchise tax and the estate tax, with their 44 tax expenditures. Yet if the current version of this budget bill is approved, there will be 131 state tax exemptions, credits or deductions, just seven fewer than a decade ago.

The substitute version of HB 59 now before you continues the pattern of adding new special-interest tax breaks or expanding existing ones. This includes broadening the sales-tax exemption for purchases of data-center equipment and creating a new exemption for the aerospace industry. Less than a year ago, Gov. Kasich vetoed the identical language for this latter tax break, saying: "Aerospace is a valued industry in Ohio but there is no justification for granting this specific industry such a broad exemption for its research and development efforts." Can we honestly answer that the policy of adding new breaks for everyone from race car teams to owners of captive deer has succeeded?

Some tax expenditures do make sense. Creation of a refundable state Earned Income Tax Credit would benefit 800,000 working families in Ohio. Initiated under President Gerald Ford in 1975 and supported by every president since, the EITC lifts families with children above the poverty line, helps make work pay, and sends 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.

However, all tax expenditures should be sunsetted and continue only if legislators determine that they are necessary. Two years ago, the Senate included provisions for a permanent review mechanism in its budget bill. You should do the same today.

The bill on the one hand calls for a review of the Commercial Activity Tax, and on the other creates a new structure with its own rate for the motor fuel business. Rather than carving out special terms within the CAT for one industry during the final weeks of budget bill consideration this issue should be included in the review of the CAT that is included in the bill.

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 budget bill takes a welcome step in that direction with its click-through nexus provision. 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.

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 allowing me to testify. I am happy to answer any questions that you may have.

Policy Matters Ohio is a nonprofit, non-partisan research institute with offices in Cleveland and Columbus.