Policy Matters Ohio

Tax Policy
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Testimony to the Senate Tax Reform Subcommittee

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Good afternoon, Chairman Peterson, Ranking Member Tavares 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 tax reform.

For years, North Dakota has had the lowest unemployment rate of any state in the nation. Nevada, by contrast, has had the highest. North Dakota has a personal income tax, while Nevada has no personal income tax. There are, of course, other states that show a different pattern. This illustrates that taxes, and the personal income tax in particular, are not the major factor that determines state economic success.

Economists at the Federal Reserve Bank of Cleveland in a 2006 study reviewed decades of state economic performance to learn what factors had the most influence in per capita income growth. They concluded that average tax rates are not a statistically significant factor. More recently, Peter Fisher of the Iowa Policy Project and Noah Berger of the Massachusetts Budget and Policy Center looked at overall tax levels and median wages, and found no significant correlation. The Center on Budget and Policy Priorities noted in a report earlier this year that, "In the last two decades, a number of states have cut taxes deeply in hopes of spurring economic gains, with unimpressive results. That's not surprising given that the preponderance of the peer-reviewed academic studies indicate that state and local personal income tax levels do not affect economic performance."

Ohio has embraced a different view. How has that worked? Not so well. In June 2005, income-tax rates were cut 21 percent and major business taxes were slashed. Whether one begins with the approval date, the beginning or end of the recession, or January 2011, the results were the same: The Ohio job market underperformed the nation. Since June 2005, we have lost a greater share of our jobs than all but two other states, Rhode Island and Michigan. Since January 2011, the number of jobs in Ohio has grown by 2.74 percent; nationally, the figure is 4.35 percent.

Ohio taxes are about average. In fiscal year 2011 our per capita state and local taxes ranked 26th among states. At $3,910, they were slightly below the U.S. average of $4,296. Our state and local taxes amounted to 10.6 percent of personal income, the same as the national average, ranking Ohio 17th. Most states are clustered around the same relative level of taxation.

However, Ohio's state and local taxes fall more heavily on low- and middle-income residents than on the most affluent. According to a report earlier this year by the Institute on Taxation and

Economic Policy, the bottom fifth of Ohioans, who made less than $17,000 in 2010, on average pay 11.6 percent of their income in state and local taxes, compared to the top 1 percent, who earned more than $324,000 that year and on average pay just 8.1 percent. Families in the middle fifth of the income spectrum, who made between $31,000 and $49,000, on average pay 10.6 percent. These differences are even larger if you take into account the interaction of state and local taxes with the federal tax system; these numbers also are prior to the latest tax changes.

The income tax is the main reason Ohio's tax system is not more tilted than it already is against lower- and middle-income families. Attention is often focused on the top rate of the income tax. In Ohio, the top rate is paid by considerably fewer than 5 percent of all taxpayers. According to the taxation department, the average 2010 rate for Ohio residents after credits was 3.4 percent. As an average (rather than a median) this still overstates what the typical taxpayer pays; it was also before the last increment of the 2005 tax cuts went into effect.

The income tax provides balance to Ohio's tax system. It is a significant contributor to our ability to repay our debts; without revenue from the income tax, the state would exceed the 5 percent debt limit this fiscal year. And it has allowed us to make investments – think, for instance, of our nationally recognized public libraries – that contribute to opportunity for all Ohioans, our quality of life and our attractiveness as a place to do business.

Besides the income-tax cut and other changes, the 2005 overhaul of Ohio's tax system significantly reduced business taxes. The commercial activity tax replaced the corporate franchise tax and the tangible personal property tax. The taxation department estimated two years ago that these changes had reduced business taxes by about $1.8 billion a year. Overall, the share of Ohio state and local taxes paid by businesses has fallen over the past generation, while the share paid by individuals has increased. This needs to be reversed. Ohio should again tax corporate profits, as 44 other states do.

Ohio needs more revenue, not less. This is especially plain from the cuts in services we have seen with the reductions in aid to local governments, estimated by the Ohio Office of Budget and Management at nearly $1 billion or 10 percent between the two-year period covered by the fiscal years 2010-11 budget and the two years of the current 2014-15 budget. Unfortunately, we remain an undereducated state. For instance, only 26.4 percent of Ohio workers have a college degree, compared to well over 30 percent nationally. Yet need-based aid remains well below previous levels. Our support for public transportation ranks among the lowest in the nation, while some local transit agencies struggle to provide basic service. Public health investments remain inadequate. Efforts to combat tobacco use, for instance, while revived with a modest appropriation in the current budget, remain far below recommended levels. Protective services for abused and neglected elderly are mandated but for years have gotten insufficient support to meet needs. Bonding turnpike revenues will pay for some more road projects, but does not provide for our long-term infrastructure needs.

The General Assembly should increase income-tax rates on the most affluent Ohioans, starting with restoring the 7.5 percent rate on the top bracket of taxpayers. This would both provide funds to make some of these needed investments, and do so based on who is most able to pay. After the General Assembly raised the top rate of the income tax to 7.5 percent in 1992, during the administration of Gov. George Voinovich, the state generated more than 100,000 jobs in each of the following three years. Tax levels, as I said earlier, are not the main factor driving job growth.

At the same time, the state earned income tax credit should be increased and made refundable. We applaud the General Assembly for creating a state EITC. However, many of the poorest Ohioans are unable to take advantage of it despite their overall tax load, which on average is higher than that of the richest residents as a share of income.

Ohio's tax system should be modernized to cover the economy that exists now and in the future. As services have come to make up a larger share of consumer purchases, broadening the sales tax to include more of them is more sensible than raising the rate on a shrinking share of the economy. And we agree with Gov. Kasich that the tax on oil and gas drilling should be increased to put Ohio more in line with other energy-producing states. When precious, limited natural resources are extracted, the state should ensure that adequate taxes are paid, in part to provide help to the communities that face higher infrastructure and other public-service costs because of drilling and related activity. What we shouldn't do is use the additional revenue for more income-tax cuts.

Tax expenditures, which are a form of state spending just like any line item in the budget, should get regular review, and sunsets to ensure they do not become entitlements. The committee should review House Bill 24 and House Bill 81, and propose speedy approval of a regular review mechanism – with the addition of sunsets. Some other states have taken action on tax expenditures:

- Washington state, which already has a review process, recently required that all new tax expenditures have a sunset date so that they automatically expire unless renewed (the default sunset is 10 years). The law calls for each new break to include a statement of legislative purpose, and to spell out specific goals and metrics to measure performance. Taxpayers taking advantage of these new tax breaks also will have to report how much they are receiving, with certain exceptions and after a 24-month delay.
- Rhode Island has approved legislation calling for evaluations every three years of 15 specified economic development incentives, and requiring that new incentives be reviewed. It spells out a detailed framework for the evaluation, including an estimate of the jobs created, a cost-benefit analysis, and an assessment of the extent to which benefits stay in the state. It provides that the governor's budget proposal recommend whether to continue, modify or end any recently evaluated tax incentives.

We hope that the committee will examine measures like these that bolster the review process for tax expenditures or tax incentives.

Mr. Chairman, thank you for allowing me to testify on this important topic. I am happy to answer any questions that you or any of the other members of the committee may have.

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