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Chairman Schaffer and members of the Committee. I am Distinguished Professor of Economics Emeritus at The Ohio University, where I am in my 52nd year of teaching. Obviously, I am not representing OU, and, indeed, they probably would be mildly horrified if they knew that I were speaking. I wish to speak about the tax components of the Governor's budget proposals.

The Background: Criteria for Good Taxation

Let me start out by making the rather obvious observation that we do not live in a perfect world, and that imperfections in our generally excellent system of representative democracy often –indeed almost always -- lead to policies that by some criteria suffer from imperfections. The Governor's budget is no exception. In a world in which I had near dictatorial powers, for example, I would ask for greater overall revenue reductions, implying more radical tax reductions, especially in the individual income tax. Indeed, I might even seek a flat rate income tax on the Michigan or Indiana model with a rate of perhaps three percent or less. I would hope that in modifying the Governor's proposals, you do so not by increasing overall expenditure, but rather by some spending reduction and enacting more tax cuts than the governor proposes. But acknowledging the difficulties in enacting pristinely perfect proposals in a society with strong vested interests, I think Governor Kasich and his staff are to be commended for proposing a responsible budget that addresses Ohio's greatest single problem, inadequate rates of growth in income and output, and with that jobs and economic opportunity.

I am today ignoring non-tax sources of revenues, which perhaps deserve some consideration, although perhaps outside the context of the operating budget and the General Revenue Fund. For example, if you could sell the Ohio Turnpike and net, say, $2 billion and use the funds to promote infrastructure development or deal with a growing concern about unfunded public employee pensions, would that not be a net plus for the state? But I will leave that issue for another day.

Turning to taxes, a good tax has four important qualities. *First, it is administratively not too expensive, nor are enforcement and compliance costs very high.* A tax raising $100 million but that costs $20 million to administer is greatly inferior to one raising the same amount but costing only $2 million to administer. In assessing administrative costs, there is a tendency to only consider the costs to governments, but in reality with some taxes the larger share of the cost of calculating and paying the tax is absorbed by the taxpayers. For example, any honest accounting of the federal income tax that includes a reasonable value on the many hundreds of millions of hours spent by taxpayers and their professional tax advisers in filling out the forms would conclude tax compliance costs are huge, maybe even in the hundreds of billions annually, far greater than the budget of the IRS.

Second, a good tax does not distort the market-directed allocation of resources much; it *is economically neutral and minimizes the harmful effects of the tax on the growth of income and wealth.* A bad tax significantly reduces the growth in inputs used to produce goods and services arising from in-migration of human and physical capital into the Buckeye State, or at least diverts them from their best usage, and leads people to abandon highly productive activities for less productive ones.

Third, a good tax is one considered fair or equitable. Much of the disagreement over tax policy relates to this criterion. I might think a tax levied at a three percent rate on all income earned is fair, whereas others would say that kind of tax burdens the poor too much and a better tax is one with a progressive structure similar to what Ohio has now. New York, California and Ohio all have highly progressive income rate structures, while Indiana, Michigan, Pennsylvania, Illinois and Massachusetts all have flat rate taxes, suggesting the perception and importance of equity varies geographically.

Tax experts often distinguished between two types of equity: horizontal and vertical. Vertical equity refers to how the tax system impacts people who are different economically; it gets into issues relating to whether the rich pay their fair share of taxes, or are the poor being unfairly burdened. Horizontal equity relates to the tax treatment of people of similar means. Suppose two families both have $75,000 annual income, but one pays $5,000 in taxes and the second pays $10,000. This could be perceived to be a horizontal inequity. When the tax system is complicated, with lots of deductions and exemptions, the possibility of horizontal inequities increase.

Fourth, a good tax is transparent: it is easy to see who is paying the burden. A basic tenet of democracy is that the people in some form determine the policies that are used to provide the governmental functions of society. For the people or their representatives to optimally fulfill the popular will, they need full information. In the case of taxes, that means they need to know where the burden of the tax falls –who pays it? In some cases, such as property taxes, it is usually pretty clear as to what the burden of the tax is and who pays it. In other cases, such as business taxes like a corporate income tax or a commercial activities tax, it is far less apparent.

Which of these criteria is most important? That is a subjective matter. Many progressives want to emphasize the equity criterion, especially issues of vertical equity, taking the view that the rich should pay most of the cost of government and that poor people should have a near zero or even negative tax burden. For some conservatives or libertarians, they feel the emphasis should be on tax neutrality and economic growth, favoring not only a low tax burden but one that minimizes the negative effects of taxes on increasing the income of the citizenry. Politicians of all political stripes often want to ignore the transparency criteria, since citizen anger rises the more aware they are of the burden they are paying. Keeping people in the dark avoids antagonizing voters.

The important thing to recognize is that there is no perfect tax, and a tax that is good on some criteria is bad on others. A head tax –a tax of a fixed amount levied on everyone, is great from an administrative standpoint and also is as neutral as is possible, having no impact at the margin on economic behavior. It is also extremely transparent. It is a near perfect tax, but seldom used. Why? Most people consider it to be extremely unfair, burdening the poor a great deal and the rich hardly at all. Progressive income taxes look good on vertical equity grounds to some, and are relatively transparent. They can, however, be somewhat costly administratively and can have very significant negative effects on economic growth by reducing the supply of productive resources or lead to their inefficient use.

The Governor's Budget: An Assessment of Proposed Revenue Changes

Turning to the Ohio budget, let me start off my saying I believe Ohio's largest problem is relatively sluggish economic growth. There has been some encouraging developments in recent years, and past fiscal actions taken by the General Assembly and the Governor have contributed to that. But the picture in Ohio still is one of a state not maximizing its economic potential. At the beginning of World War II, Ohio's income per capita was over 10 percent above the national average; a few years ago, it was some 10 percent below that average, and although we have narrowed the income deficit a bit in recent years, we still have ways to go to achieve parity with the nation as a whole.

On the equity front, the evidence harder to assess, but on average Ohio's tax system appears less regressive, or more progressive, than that of most states, largely because of this state's high reliance on a highly progressive individual income tax. Only California has more income brackets in its individual income tax than Ohio. Some 43 percent of Americans live in one of the 17 states where there is either *no* state income tax or one with flat rates. If you add in states like Alabama, Mississippi and Oklahoma where the top rate is reached at no higher than $10,000 in income, almost half the American population live in states where there is little or no income tax progressivity. Ohio is one of only a few prominent large states like California and New York with very aggressive income tax progressivity.

The Tax Foundation, a long established nonpartisan group, annually publishes a State Business Tax Climate Index. Ohio is currently ranked 45th, reflecting partly a fairly high total state and local tax burden, but even more the heavy reliance on income forms of taxation. By contrast, neighboring Indiana ranks a stellar 8th, Michigan is 12th, and Pennsylvania 24th. Even West Virginia at 18th far outdistances Ohio, as does to a lesser extent our fifth neighbor, Kentucky at 34th. Ohio's low ranking reflects very low ranks given for our corporation tax, the somewhat unique and eccentric Commercial Activities Tax, and the highly progressive personal income tax. Our sales tax rank of 29th puts us in the middle of states, while we look good in property and unemployment insurance taxation.

Let me now turn to some details of the Governor's budget proposal. I will comment on the overall revenue proposal and on each of the five specific changes that involve $50 million or more in annual revenues. Overall, as hinted at the beginning, I would prefer a total reduction in tax revenues greater than the small aggregate cut being proposed. I would finance that probably by some spending reductions. The reason is that the evidence overwhelmingly shows there is a negative correlation between the level of state and local taxation and the rate of economic growth, since the private sector on average is more productive than the public sector, so when taxes are reduced resources are shifted from public to private resource allocation decision-making, with positive growth effects. Larger tax cuts, particularly in income taxes, would have greater positive growth effects.

That said, however, I am a retired and previously tenured professor with zero job insecurity, while Governor Kasich and you are operating in the world of special interest groups and their very exuberant lobbies. They are good at buying legislation in Ohio, and have done so for years, often to the detriment of the people. As one who travels across the land, I sense that special interest group pleading is particularly strong and effective in the Buckeye State. I can decry that, but recognize it as a reality.

With that recognition of reality, I believe the Governor has done an excellent job with his budget. He proposes shifting somewhat from a revenue source that has particularly pernicious effects on the usage of resources, the promotion of innovation, and the creation of income, to other revenue sources that do not have those problems to the same degree. To be more specific, a dollar of income taxation typically has a greater adverse impact on income and output growth than a dollar of consumption taxes, represented by the general sales and by cigarette and alcohol excise taxes.

Let me start by praising the proposed reduction in the individual income tax. The top rate on the individual income tax in neighboring Indiana, Michigan and Pennsylvania, our three most populous neighbors, is substantially lower than in Ohio. Whereas we have a top rate almost at 5 percent, in Indiana and Pennsylvania it is at or below 3.3 percent, and in Michigan it is 4.25 percent. Moreover, Ohio is more vigorous in using municipal income taxation. I believe that we have the only school district income taxes in the nation. In total, higher income Ohioans pay roughly double the top marginal rate prevailing in the Hoosier State next door.

The statistical evidence on the relationship between individual income taxes and the growth of income or even population is overwhelming. Compare the three largest Sun Belt States. Two, Texas and Florida, have no income tax, while California has one of the highest in the country. There is actual substantial out-migration of native born Americans from California, while in each recent decade a seven digit number of Americans have moved into each of the two income tax free Southern states. High income tax states like New York and Ohio are providing low tax southern neighbors with vital human resources. It is no accident that Bill Gates and Jeff Bezos, the two richest Americans, live in a state without an individual income tax. It is also no accident that high income tax Ohio has exactly three of the 400 richest Americans according to *Forbes* magazine, while no income tax Texas has 28 and even neighboring Michigan has eight. The best and the brightest seem to avoid Ohio –it is too expensive to live here given the punitive tax environment. Not only is human capital avoiding high tax states like Ohio, so are large corporations. Our share of the Fortune 500 has declined, as companies move headquarters to other states or even, as in the case of Cleveland's Eaton Corporation, to other countries.

The income tax is a levy on the fruits of working and investing. It discourages production. Income taxes lower the compensation of workers, and also of that of investors who create capital and invent new ways of doing things. By contrast, sales and excise taxes are levied on consumption. They are not taxes on producing goods and services, but rather of *using* them. Therefore, performing statistical analyses of the sources of the growth in per capita income amongst the 50 states, we see that income taxes are usually strongly negatively related to that growth, while sales taxes are dramatically less so. If you lower income taxes but raise sales type taxes by roughly the same amounts, which is approximately what the governor is proposing, you are likely to get an increase in economic growth, since the income-increasing impact of lowering the individual income tax exceeds the income-reducing impact of raising the sales or excise taxes.

One rap against the sales tax as it is levied in both Ohio and in 44 other states is that it does not apply to some things that we consume, and thus is somewhat distortive in character. That is absolutely true, and most economists favor extending sales taxes over a wider variety of services not presently taxed. The Governor's proposal works to reduce this problem by extending the tax over several services currently untaxed. It does not go all the way and tax virtually all services, and, indeed, is less inclusive in base expansion than what was proposed in the last biennial budget. But, to return to my early remarks, there are powerful special interests that make some reforms virtually impossible, and while the Governor is proposing revenue measures that are principled and growth-enhancing, he is also a realist who is aware of the imperfections in the democratic process imposed by some special interests. As Winston Churchill said in the House of Commons in 1947, "democracy is the worst form of government –except for those other forms that have been tried from time to time." One additional benefit of the base broadening of the sales tax is that it tends to reduce horizontal equity –differences in taxes paid by individuals of similar means.

Cigarette and alcohol taxes are consumption based levies. In terms of economic effects, they are similar to general sales taxes. In general, economists, including myself, are skeptical of consumption based taxes on specific goods, as they distort the allocation of resources from what markets provide based on the tastes and preferences of consumers and the production costs of suppliers. Moreover, these taxes tend to be regressive as well, burdening the poor more than the rich, and thus are suspect on vertical equity grounds.

These arguments, however, are more than offset by two powerful counter arguments. First, there are negative spillover effects from excessive smoking and especially drinking. Drunk drivers kill innocent people, and second hand smoke has deleterious health effects. Where negative externalities are present, it is appropriate to deliberately distort market outcomes via taxation that will discourage some consumption. Second, Ohio's current taxes in these areas are not high, especially with regards to alcoholic beverages. We have not raised taxes on wine, for example, in over two decades, and since these are not ad valorem taxes, in real terms these levies have declined substantially. As tax commissioner Joe Testa has put it, we are modernizing our tax code in this respect.

Severance taxes are generally a relatively minor revenue source so they have received far less scrutiny from public finance scholars, including myself. Like anything else, extremely high taxes on the extraction and distribution of oil or gas products discourage the development of that industry and have potentially detrimental effects, although it is important to point out that while in many cases resources can move to avoid taxes, oil and gas are tied by nature to specific locations. States with significant severance tax revenues have generally prospered over the years. Texas, Alaska and Wyoming, for example, have taken advantage of significant revenues from these sources to avoid taxing income at all, to the benefit of the citizens and the economy –Texas has been booming for several decades.

All this means that a prudent, non-excessive increase in severance taxes likely would have minimal economic impact on oil and gas activity, but would provide rather significant amounts of income for the Buckeye State. The Governor's proposed tax increases are both restrained and reasonable, and the revenues provided will help fund desperately needed reductions in our destructive, excessively high, income tax. They are not severance tax levels that are inordinately high in relation to other states. The adverse economic effects of their imposition are small relative to the potential gains to the Ohio economy from lowering income taxes.

There are a number of provisions that I have not spoken about because of time limitations, but based on the reasonableness of what I have pondered closely, I suspect that they are good suggestions. For example, I suspect that the administrative costs of municipal income tax payments on business are very high for them in relation to the revenue raised, so the proposed centralization of tax administration strikes me as highly desirable. If private payers of the tax feel otherwise, however, I would likely defer to them, as they are those most impacted.

Let me conclude by reiterating my bottom line: the Kasich revenue proposals are on the whole excellent. Adopted in their entirety, they would likely lead to at least a modest expansion in economic growth in this state. No doubt other things can be done to promote growth as well, such as adopting a right-to-work law as all our neighbors except Pennsylvania have done. If additional revenues come available, say with state revenues coming in better than anticipated, some additional tax reduction in the state income tax is desirable.

But this is a good, well thought out, and responsible revenue proposal and I support its adoption.