Policy Matters Ohio

Tax Policy

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Testimony to the House Ways & Means Committee on House Bill 49

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Good morning, Chairman Schaffer, Ranking Member Rogers 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 provisions of House Bill 49.

Ohio needs a tax system that will generate adequate revenue to make the investments we need for our state to thrive. Ohio has important needs that are not now being met. Governor Kasich's budget proposal flat-funds far too many key services, or even cuts them when spending is adjusted for inflation. Reducing spending in so many of our school districts is not a recipe for educating our young people. Ohio ranks 45th among states in college affordability, yet higher education gets just a minimal increase, and support for our key scholarship program for lower-income Ohioans trails far behind where it once was. I work in Cleveland, which just raised its income tax in no small measure because of cuts in state aid that have not been restored despite the improvement in the state's finances since they were first imposed. Instead of substantially increasing its investment in public transit, the state is imposing major reductions. In short, we are underinvesting in key services that will allow our state to thrive and Ohioans to succeed. We need more revenue.

While there are a number of positive elements in Governor Kasich's tax proposal, such as raising the severance tax and cutting some unnecessary tax breaks, further slashing income taxes is not in Ohio's interest. It is unlikely to result in accelerated job creation. We have not seen greater job gains after previous Ohio income tax cuts and there is no reason to expect a different result this time.

Governor Kasich's tax proposal would further reinforce the shift in Ohio's state and local tax system in favor of affluent residents and against those with lower or middle incomes. Under the plan, Ohioans who made under $56,000 last year – those in the bottom three-fifths of the income spectrum – on average would pay more tax than they do now. Meanwhile, those in the top 1 percent, who made more than $457,000 last year, would average an annual gain of $2,412. Those are among the key findings of an analysis done for Policy Matters Ohio by the Institute on Taxation and Economic Policy (ITEP), a Washington, D.C.-based research group with a sophisticated model of the tax system. On average, ITEP found, taxpayers in the middle fifth, who made between $36,000 and $56,000 last year, would see an annual increase in taxes under the plan of $44.

Table 1							
Impact of tax changes in Kasich tax proposal							
	Lowest 20%	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Next 15%**	**Next 4%**	**Top 1%**
Income range	Less than $21,000	$20,000 - $36,000	$36,000 - $56,000	$56,000 - $91,000	$91,000 - $178,000	$178,000 - $457,000	$457,000 or more
Average income	$12,000	$29,000	$45,000	$70,000	$121,000	$264,000	$1,414,000
Average change	+$64	+60	+44	-$22	-$196	-$650	-$2,412

Source: Institute on Taxation and Economic Policy, February 2017. Includes reduction in the number of income-tax brackets from 9 to 5 and reduction in rates; increase in low-income credit to $15,000; increases in the personal exemption; a boost in the cigarette tax to $2.25 a pack and in the Other Tobacco Products tax; raising the sales-tax rate from 5.75 percent to 6.25 percent; and broadening the sales-tax base to include additional services. Covers 2016 income and includes Ohio residents only. Figures are rounded. The analysis excludes certain elements of the tax plan, such as the proposed increase in the severance tax. See http://www.policymattersohio.org/itep-kasich-tax-feb17 for further description.

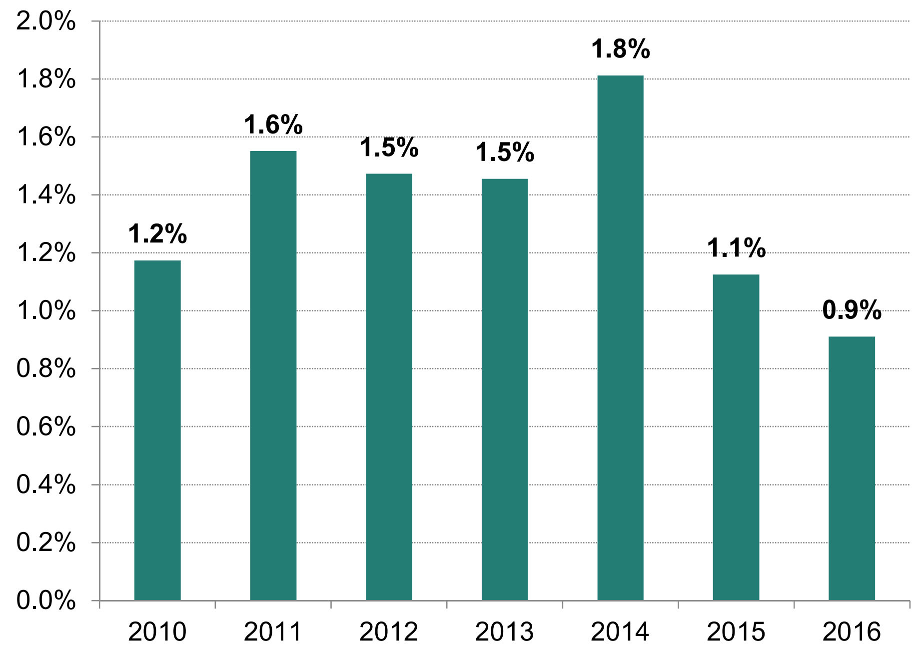
The administration has touted that fewer Ohioans will have to pay income tax under its plan, and has provided hypothetical examples of how income-tax cuts from 2011 to 2018 would be larger than sales-tax increases for various hypothetical Ohio families. However, 1.5 million tax filers now don't pay income tax because of the existing rate structure, credits and deductions. They will not benefit from the plan—and many are among the poorest Ohioans. Even apart from that, the state income tax is not the major state or local tax most affecting low- and moderate-income Ohioans. As previous analysis from ITEP has shown, sales and excise taxes in particular fall more heavily on lower-earning state residents than the income tax does. Middle-income nonelderly Ohioans paid about 10.6 percent of their income in state and local taxes in 2015, but only 1.6 percent of that was for state income tax. For those in the bottom fifth, state income taxes accounted for just 0.2 percent of income, when total state and local taxes amounted to 11.9 percent. Lowering the income tax will do little for low-income Ohioans. Meanwhile, they will pay more under the tax increases in the plan, especially the increase in the sales-tax rate.

Reducing the number of brackets in the income tax is a solution in search of a problem. It will do little to simplify the tax system: Most taxpayers can simply find their rate in a table. Moreover, the number of brackets in the income tax is not linked to economic performance. Does anyone believe there are fewer successful start-up businesses in California because its state income tax has 10 brackets, more than the nine in Ohio? Among the seven states that have had a flat, one-rate tax for the last decade, three have shown better job performance than the nation as a whole. But four have lagged behind—and those four happen to be the ones most similar to Ohio: Illinois, Indiana, Michigan and Pennsylvania.

Overall, Ohio has reduced taxes by $3 billion a year through income-tax and other reductions since 2005. This has not resulted in the predicted growth in jobs. The forecast used in developing the Kasich administration budget proposal, from IHS, shows that Ohio will trail behind the United States in output, personal income, nonfarm employment, unemployment rate and retail and food service sales during the next budget (see page B-4 of the governor's proposal). While the state did somewhat better than average early on in the economic recovery, performance has lagged again since then. As Table 2 below shows, last calendar year was the worst job-creation year for Ohio since 2009. Our job gains in the 12 months ended in January ranked 39th in the country.

Table 2

2016 Job Growth worst since the recession



Source: Policy Matters Ohio calculation of annual job growth rate since 2010, Dec-Dec, by year. Based on CES data, released March 3, 2017, available at http://ohiolmi.com/asp/CES/CES.htm.

One key element in the tax cuts was the elimination of income tax on the first $250,000 in income from passthrough entities like partnerships and S Corporations, and a lower, 3 percent flat rate on such income above that amount. According to the tax expenditure report included with the executive budget, this tax break will cost $580 million in the year beginning next June, and almost $600 million the year after, Fiscal Year 2019. That makes it the third-largest break in the state tax code.

But it hasn't led to an increase in jobs at new small businesses since the first version of it, later expanded, was approved in June 2013. The U.S. Bureau of Labor Statistics tracks how many employees are hired each quarter at businesses that have hired employees for the first time, and its data show that Ohio hasn't seen an improvement since this big new tax break was approved.

Ohio legislators should pay attention to what their counterparts in Kansas have realized: This kind of tax giveaway is not productive. A more expansive tax break of the same kind passed by their state legislature, which eliminates all state income tax on passthrough business income, hasn't worked. The legislature there recently voted to repeal it, and nearly overrode a veto by the governor. Republicans and Democrats joined together in opposition to this misguided policy.

The passthrough business-income deduction also means that the income-tax cuts in Governor Kasich's budget plan will have no impact on business owners. The proposed bracket and rate reductions won't affect what owners pay on their business profits. This makes it even more difficult to claim that they somehow will create jobs and economic growth.

We agree with the municipal officials who have testified on the issue that there is reason to be wary of the administration proposal to take over collection of the municipal income tax on business profits. The savings for municipalities appear in some cases to be exaggerated, it is far from clear that the state would do a better job of collecting the tax, and localities have reasonable fears about losing control of this revenue source.

There are some positive elements in the administration's tax proposals. Ohio has long needed a stronger severance tax on oil and gas. The budget bill appropriately recognizes that it is past time for us to be more in line with other oil and gas producing states. It also takes a step toward broadening the sales-tax base, a needed move when services make up such a large part of our economy. Gov. Taft attempted to add lobbying services to the sales tax, a move that makes sense today as it did when he proposed it in 2003. Lower-income Ohioans can be protected from broadening the coverage of the sales tax through a sales-tax credit, which would provide a set amount for each member of the family to offset some of the cost of the tax.

The budget bill also takes limited measures to rein in unneeded tax expenditures. One of these is to institute a minimum on the Commercial Activity Tax due from suppliers to certain big distribution centers. This tax break allows suppliers to distribution centers that buy at least $500 million a year of goods, and ship at least half of them outside Ohio, to avoid paying the CAT on what is sent outside the state. As Tax Commissioner Joe Testa has testified, the value of this exemption will balloon from $25 million FY 2008 to an estimated $174.4 million in FY 2019. Suppliers to two companies with qualifying certificates are exempt from paying any CAT tax at all. Gov. Kasich's proposal to require at least a 10 percent payment is a good idea, and you should examine making the percentage higher. It makes sense, too, to do away with special discounts for paying taxes ahead of time, and also to ensure that companies do not avoid tax altogether on their interest earnings.

One little-noticed feature of the proposal would require that future budget bills include detailed estimates of business incentive tax credits, including how much may be authorized each year, the expected amount to be claimed, and the amount of credits expected to be outstanding at the end of the biennium. This move toward budget transparency is a good one.

Commendably, Governor Kasich also included estimates in the bill of these amounts for seven different credits in the upcoming biennium. The bill estimates that more than $386 million in such credits will be claimed during the upcoming biennium, and a total of $1.5 billion of them will be outstanding by the end of Fiscal 2019.

These are large sums. They underline the need to examine Ohio's $9 billion-plus in annual tax breaks. House Bill 9 in the last General Assembly called for a joint committee to be established by next month to examine the state's 129 tax breaks over an eight-year period. We believe you should get an early start. There are a number of tax expenditures that are special-interest provisions that should be subject to immediate scrutiny and possible repeal or limitation. Beyond those mentioned above, these include:

- The sales-tax cap for fractional aircraft, a special-interest carve-out worth $15.8 million in FY2019;
- The vendor discount. This should be capped, to keep large retailers from reaping a windfall. Governor Kasich estimated that this would save $29.6 million two years ago when he proposed to do so.
- Ending the net operating loss write-off against the Commercial Activity Tax, which allows companies that experienced large losses – but not small companies – to keep reducing their CAT based on corporate-franchise tax losses. These were experienced more than a decade ago against a tax that no longer exists. Value: $4.6 million.

These are just a handful of those that should be considered; many more deserve a careful look. Limiting these unneeded expenditures would allow the state to make needed investments.

The General Assembly took positive steps in creating a state Earned Income Tax Credit (EITC) and raising it to 10 percent of the federal credit. The federal EITC helps tens of thousands of working Ohioans stay out of poverty each year. However, the state EITC could be a much more powerful tool for helping working families make ends meet and provide for their children. Because of limits imposed on its value, just 8 percent of the poorest workers—those earning $21,000 or less—see any benefit from the credit and the benefit is modest. Unlike the federal credit, Ohio's EITC cannot exceed what a taxpayer owes in income taxes, and for a taxpayer with income over $20,000, it cannot exceed more than half of what he or she owes in income taxes. That means that it does nothing to reduce the substantial share of income these same taxpayers pay in sales taxes and property taxes. If the General Assembly removed these limitations, the state EITC would reach far more of the workers who need it most and be a better-targeted income support.

With each monthly financial report, the revenue picture has been growing cloudier. Yet Ohio has the money to make the investments we need. Beyond the tax loopholes that should be closed, we are losing $3 billion a year in revenue from tax cuts since 2005, much of which has gone to affluent Ohioans. The passthrough business-income deduction alone is costing hundreds of millions of dollars a year. We need a different approach to tax policy in Ohio to generate the resources we need.

Thank you for allowing me to testify on this legislation. 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.