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Ohio Senate
Ways and Means Committee

Hearing on House Bill 59, FY 2014-2015 Main Operating Budget
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Good morning, Chair Schaffer, Ranking Member Tavares, and members of the Senate Ways and Means Committee. My name is Jon Honeck. I am the Director of Public Policy at The Center for Community Solutions, a non-profit research and advocacy organization with offices in Cleveland and Columbus. The organization is celebrating its 100th anniversary in 2013. Our mission is to propose non-partisan policy solutions to improve health, social, and economic conditions for Ohioans.

I am here today to address several of the tax provisions that have been raised by the discussion about H.B. 59. The governor's original proposal had some elements worth considering, and others that were detrimental. I will focus my remarks on the proposed business income tax deduction, the sales tax expansion to services, and the need for greater review of tax expenditures.

Business Income Tax Deduction

The governor's proposal for a 50 percent business income tax deduction for sole proprietors and partnerships would create a new tax expenditure that would cost the state $700 million per year when scored against current income tax rates. According to the ODT Tax Expenditure Report the income tax already has 36 deductions, credits and exemptions. The new business deduction comes on the heels of an investment credit added in the previous budget.

The most obvious consequence of the proposed deduction would be to advantage some taxpayers more than others. In this case the deduction actually reduces tax liability by more than 50 percent because the remaining income is taxed at lower rates. The table below compares the results for two groups of representative taxpayers, who have either all salary income or all business income. A taxpayer with $60,000 in business income would pay $1,164 less than a taxpayer with the same level of salary income. I do not believe that this disparity would be seen as fair by most taxpayers.

Comparison of Representative Taxpayers with Salary vs. Business Income

Taxable Income	Tax Liability		Reduction in Tax Liability for business taxpayer	
	Salary income	Business Income	Amount	Percentage
$100,000	$ 3,594	$ 1,441	$ (2,152)	-59.9%
$80,000	$ 2,674	$ 1,041	$ (1,634)	-61.1%
$60,000	$ 1,852	$ 688	$ (1,164)	-62.8%
$50,000	$ 1,441	$ 512	$ (929)	-64.5%
$40,000	$ 1,041	$ 342	$ (699)	-67.2%

Note: Calculations by the author rounded to nearest dollar. Chart uses 2012 rates and brackets.

It is disappointing that the executive budget documents do not have any estimates of the economic impact of the proposal. From a policy perspective, it would be good to know how they arrived at the 50 percent deduction level, as opposed to any other, how many jobs would be created, how much investment would take place, how much would be saved, and how much would be used for various kinds of consumption inside and outside of the state – in other words, where would the money go? How would this scenario compare to baseline purchases of goods and services by the state and local subdivisions? In the absence of this information it is hard to judge the relative costs and benefits of the proposal.

We recommend that Ohio law contain a formal evaluation mechanism for all tax expenditures, including explicit criteria or metrics spelled out in the Revised Code. In 2011, the Ohio Senate included in its version of the biennial budget bill (H.B. 153) a proposal to create a tax expenditure review committee that would review all tax expenditures at least once every eight years. The proposal was removed in conference. **We strongly recommend that the Senate include this provision again.** It is very similar to a proposal introduced in current House Bill 24 (Rep. Boose).

The tax expenditure review proposal contained suggested criteria for evaluation. If the administration's business income deduction were evaluated along these lines, the following are some of the issues that could be explored:

- According to a recent article in the *Plain Dealer*, Tax Department information shows that 80 percent of the recipients of the deduction would have net incomes under $25,000, and nearly 90 percent have net incomes under

$50,000, so the amounts saved in taxes would be small;[1] it would be helpful to know how this breaks down across various sectors of the economy and to estimate how different sectors would respond to the deduction. This raises the issue of why the cap needs to be at a very high level of $750,000.

- The executive proposal notes that $140.3 million of the $701.6 million tax savings would go to non-resident investors (about 20 percent) (*Reforms Book*, p. 42). What is the likelihood that those savings will be reinvested in Ohio?

- What is the potential for "double-dipping" as taxpayers use this deduction in tandem with other tax expenditures?

- The literature on job creation finds that a small minority of firms that are in start-up or high-growth mode account for most net job creation among small businesses; is it better to target economic development assistance to those companies or to companies facing a particular set of common issues (e.g., R&D or training)?

In conclusion, this new tax break should be examined more closely to determine whether it is overly broad and could be better targeted or addressed through traditional economic development programs. **If the policy focus is on using the tax code to promote job creation, then that connection should be made explicit, such as through a job creation tax credit (or grant) that would be available to firms that expand their payroll and jobs above a certain baseline.** This would have the benefit of targeting resources on firms that are expanding or thinking about expanding.

Sales Tax Base Expansion

In general, we support the proposed expansion of the sales tax to new services. This concept has been discussed in Ohio and nationally for many years. For example, a comprehensive report on Ohio's tax structure issued in 1994 (*Taxation and Economic Development: A Blueprint for Tax Reform in Ohio)* stated that Ohio had a relatively narrow sales tax base and identified the failure to include services as a major source of horizontal inequity. In other words, taxpayers who purchase relatively more tangible goods were placed at a disadvantage. The report also noted a number of technical issues that arise with the taxation of services, such as how to situs service delivery, how to define a service, and how to avoid the taxation of inputs into production. Since that

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[1] Brandon Blackwell, "Kasich's proposed small-business tax cut would have little impact on most small-business owners," *Cleveland Plain Dealer*, Feb. 23, 2013.

time Ohio has added some specific services to the base but has not kept up with the overall shift in the economy away from goods.

An issue that arises from expanding the base to include more services is how to set the rate. The executive proposal includes a rate reduction to 5 percent but if this issue is decoupled from cutting the income tax, we propose that it should be lower. According to our calculations, setting the rate at 4.5 percent would still yield an estimated revenue gain of $634 million in FY 2015. (The administration estimates $1,775 million for its proposal). A rate of about 4.25 percent with base expansion would be revenue neutral. In comparison, the rate has been at 5 percent or above since 1980. The expansion of the sales tax base provides an opportunity to bring more purchases by upper income households into the tax base, but there are legitimate concerns about increasing the sales tax burden on low-income households. Lower rates can help to mitigate these concerns somewhat, but other measures can be taken such as increasing the minimum wage, raising the Ohio Works First benefit level, and/or providing offsetting credits.

If the sales tax base expansion is "too much, too soon" for this budget we recommend the creation of a study commission or other means to continue to explore this issue, which is not going away. Other states, such as New Mexico and South Dakota, have successfully utilized a broad-based consumer sales tax for many years. Hawaii and Washington have come at this issue by using a gross receipts tax paid by businesses. We recognize that there are many technical issues and taxpayer education needs that arise from this proposal. These issues should not deter the General Assembly from moving forward in some fashion to explore this issue on a bipartisan basis.

We are also supportive of language added in the House version of the bill to create "click-through" nexus for remote internet sales tax collection based on the presence of Ohio affiliates. Use tax is due on these internet sales under current law but consumers largely ignore this. Estimates of lost tax revenue run into the hundreds of millions of dollars. This provision would also create a more level playing field with traditional main street merchants.

Thank you for allowing me to testify. I would be pleased to answer any questions you may have.