TESTIMONY OF RICHARD VEDDER BEFORE THE
OHIO 2020 TAX POLICY STUDY COMMISSION,
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Senator Peterson, Representative McClain, and other Commission members:

I am Richard Vedder, Distinguished Professor of Economics Emeritus at Ohio University. I first worked on a tax study commission more than 50 years ago in Illinois, and although the location and economic environment has changed, the major principles governing sound public fiscal practice remain remarkably unchanged. Rather than delve primarily into lots of specifics, I will outline what I believe should be the major factors you should be looking at as you review Ohio's tax structure. There is a temptation to immediately promote pet ideas or attack unappealing taxes, but I think initially, you should resist that. You should do what your commission's name suggests: "study" –go back to school a bit. Ignore lobbyists, special interests, and political opportunists, and be good public stewards genuinely seeking a tax and revenue system

that best fits the needs of the citizens of the Buckeye State. My testimony today emphasizes primarily basic principles, touching less on specific shortcomings or strengths of what we do.

This is a good time to be examining our tax system. We are not in the midst of a fiscal crisis requiring hasty emergency action. The state's economy is in decent shape, although we are in long-term national economic slowdown of historic proportions that no doubt will adversely impact on our fiscal future. The enormous rise of unfunded federal liabilities reflecting not only a huge national debt but also unsustainably large entitlement programs will also adversely impact us.

My testimony will do three things. First, I will talk about the properties of good taxation, since taxes constitute most state revenues, and are an important part of the revenue stream of local governments. Second, I will briefly discuss non-tax forms of revenues, such as fees and intergovernmental grants. Finally, I will look at issues of overall fiscal management, including budget

forecasting and the problems of revenue volatility. Because time is valuable, I will remember what Elizabeth Taylor may have told her sixth husband: "I'll be brief," but given the complexity of the topic, forgive me for talking 30 minutes.

Properties of "Good" Taxes

Public finance experts have differing value systems, emphasizing different things when discussing optimal principles of taxation, but virtually all would agree that four things are desirable in any tax. First, a good tax is relatively simple, easy to understand, and does not require lots of resources to collect. Second, a good tax does not distort economic activity from what market forces reflecting the desires of consumers and the costs imposed on producers dictate. That implies a good tax does not reduce the rate of economic growth. Third, a good tax is perceived as fair, generally acceptable to the citizenry on equity grounds. Lastly, a good tax is transparent –its burden is generally observable and measurable.

I would note that debates over tax policy usually evolve because of differences in opinion over the relative importance of each of these four points, and even differences sometimes over whether a tax promotes or detracts from achieving one of the basic tenets of a good tax. Moreover, there are some tradeoffs involved, the most obvious of which is that a tax viewed widely as being fair or equitable might also have distortive effects on the use of resources and therefore reduce the rate of economic growth.

Administrative Costs and Tax Compliance

Consider two taxes each raising $100 million. One costs $20 million to collect, the other $1 million. Obviously, the tax with lower administrative costs is preferable. Also, a tax that nearly every person actually pays is preferable to one where 25 percent of taxpayers evade payment. *Good taxes are cheap to collect and hard to evade.*

Government bureaucrats tend to ignore the costs of compliance to the general public. The Tax Commissioner might say

that income tax enforcement costs X number of dollars, but that excludes the value of the many hours of time that individual taxpayers spend computing their tax, or the costs paid professional tax preparation services. At the federal level, the complexity of the income tax imposes several hundred billion dollars of annual compliance costs on taxpayers. If 10 professional tax experts were asked to compute the federal income tax in a moderately complex situation, it would not be surprising if they come up with several different calculations of the tax owed. Simplicity in the tax code is usually a great virtue.

Tax Neutrality and Economic Growth Effects

If some forms of activity are taxed higher than others, resources are allocated away from what human desires and costs suggest are desirable. Beyond that, the Law of Supply is at work. If you reduce the compensation for producing goods and services, you reduce resource usage, production, and income. High marginal tax rates are particularly distortive, and the empirical evidence

confirms they have significant adverse effects on economic growth. Indeed, economic decisions are generally made at the margin. This means usually a tax with a very wide base but low rates on additional activity is better from an economic growth perspective to taxes imposed on a small base but where the marginal tax rates tend to be very high. On this criterion alone, a flat rate tax is preferable to a tax with progressive rates.

Large credits and deductions eroding the tax base are also viewed as harmful. Also, deductions and credits tend to favor some forms of activity over others, violating principles of neutrality. Such deductions and credit add to tax complexity, and thus are usually suspect on grounds of administrative costs and ease of compliance.

Equity or Fairness

Around 1990, Margaret Thatcher's government in Britain proposed what essentially was a head tax –a fixed payment for every citizen. Such taxes are marvelously simple, neutral and transparent, not having any impact at the margin on economic behavior. But the

furor of protest was so great that it ended Mrs. Thatcher's long tenure as prime minister. Why? Because the tax was viewed as hideously unfair –the burden was modest for affluent persons, but substantial for the poor, who paid the same amount in pounds as the rich. The tax was highly regressive –taking a much larger proportion of the income of the poor than the rich.

The quest for a fair or equitable tax is not an uncontroversial one, however. What is regarded as fair by some often is viewed as unfair by others. Some view a flat rate income tax as fair –everyone pays the same proportion of income to the government. Others believe in the "ability to pay" concept of equity that suggests the affluent should pay a higher proportion in taxes than others.

Equity also has other dimensions. Horizontal equity refers to fairness between persons of similar economic circumstance. If two persons both earn $75,000 a year but one pays $3,000 in state income taxes but the second pays only $1,000, some would say that is

unfair –violating horizontal equity. Deductions and credits often contribute to perceived horizontal inequities.

Transparency

In a modern democracy, citizens should be aware of the tax burdens the government is imposing upon them. It is anti-democratic for lawmakers to impose burdens on taxpayers that are disguised or distorted in magnitude, and it contributes to decision-making often inconsistent with the will of the people.

Note this principle often runs counter to the instincts of politicians. Politicians love to impose a burden that is real but where voters fail to understand its magnitude. There is relatively little political cost to them. The violation of the transparency principle has occurred sometimes in Ohio.

Are Ohio's Major Taxes "Good" with Respect to Basic Principles?

Let's us evaluate the quantitatively most important taxes used in the Buckeye State with respect to the four major criteria just outlined.

Sales Taxes

Sales taxes are important at both the state and local level. They get high marks on administrative cost and transparency grounds, and pretty good on economic neutrality grounds as well. I do not observe empirically strong negative relationships between sales tax revenues and economic growth. Also sales taxes are typically slightly less volatile than income taxes, so revenue fluctuations arising from the business cycle are not as great as with income taxes. The exclusion of a large number of services and some goods from the base poses issues on both administrative and economic neutrality grounds. Changing modes of retail trade, particularly the Internet, have posed challenges.

The big complaint about sales taxes is on equity grounds. A general sales tax tends to be regressive. Affluent people spend a

smaller percentage of their income on consumer goods purchased within Ohio than poorer persons. The exclusion of most food purchases from the sales base relieves that problem somewhat. Nonetheless, persons putting emphasis on vertical equity concerns and who believe in the ability to pay principle tend to prefer income to sales taxes. As people spend a greater proportion of their income outside the traditional retail sales environment, either on the Internet or other jurisdictions, the problem of sales tax base erosion grows. For example, cruise travel by Ohioans has boomed, but is mostly not subject to Ohio sales taxes.

Personal Income Taxes

The biggest fiscal changes in Ohio since 1970 relate to the enormous growth in personal income taxes. In 1970, Ohio did not have a state income tax. Today, Ohio not only has one, but it has been far more aggressive than most states in the use of income taxation by local governments. For example, to my knowledge Ohio

is the only state with relatively extensive income taxation for school districts as well as for municipal governments.

Progressive income taxes tend to be relatively income-elastic, meaning they rise even faster than income itself. Inflation and economic growth has the unintended long term effect of increasing income tax burdens as people get pushed into higher income brackets.

Income taxes usually get relatively high marks on transparency grounds –people know what they are paying. Many persons praise income taxes also on equity grounds, and most of the arguments for increased income taxation are based on income distribution arguments. The income tax is progressive, while sales taxes are regressive.

There are, however, severe objections to income taxes on both economic neutrality/growth grounds and also at least somewhat on the grounds of administrative costs and complexity. There is overwhelming evidence that there is a statistically significant

negative relationship between income taxation and economic growth. Literally millions of persons have left the 41 states with individual income taxes and moved to the nine states without them – states like Florida, Tennessee, Texas, Nevada, and Washington. States with high income taxes find resources moving to more congenial environments to work and invest funds. It is not an accident that Bill Gates lives in the state of Washington without an income tax. California, with a top marginal income tax rate exceeding 13 percent, is faring by almost any measure less well than fellow Sun Belt States Florida or Texas because the latter states have no income tax.

Income taxes work best from an economic growth perspective when tax rates are relatively flat and low, as opposed to highly progressive with high marginal rates. Interestingly, the three largest neighbors of Ohio, Michigan, Pennsylvania, and Indiana, all have flat rate income taxes.

Property Taxes

Property taxes are reasonably transparent, although renters of property invisibly pay them as the owners shift the tax forward. Business property taxes are arguably levies on production, just as income taxes are on work effort or dividends. Such taxes potentially reduce output. One huge issue arises because of property tax abatement schemes favoring some businesses over others, distorting economic activity and viewed negatively by tax professionals. There are very significant administrative cost issues that even have equity implications, specifically because of the constant need to reevaluate property values.

The biggest issue regarding property taxes relates to the geographic distribution of taxable property, and the fact that these taxes are used to significantly fund public schools. Some areas have highly capital intensive property from, say, power plants, while others are almost entirely reliant on residential housing. The unequal distribution in property tax revenues between school districts can be dealt with in several ways including reducing

reliance on property taxes for funding school districts or converting them mainly into state collected and administered taxes. It can be argued, however, that the tie of property taxes to school funding along with the requirement that voters approve tax increases works to hold school districts accountable to the people for their actions.

Commercial Activities Tax

The Commercial Activities Tax enacted in 2005 raised $854 million in 2015. It has several deficiencies, which is why only five states have gross receipts taxes. Neighboring Michigan abandoned its equivalent of a CAT tax a few years ago. The tax is not transparent. Who pays it? Who knows? That is why politicians love it, of course. It is potentially very distortive of economic activity, and implicitly imposes very different rates on the value added to economic activity by different type of businesses, favoring capital intensive businesses. It also potentially provides incentives for vertical integration and large scale operation, a problem only partly alleviated by the $150,000 exemption. Fortunately, however, in Ohio the rate of the

tax is relatively low. Attempts to raise the CAT tax, however, will no doubt occur, potentially increasing problems associated with this tax.

Taxes on Cigarettes and Alcoholic Beverages

In fiscal year 2015, Ohio collected over $800 million in tobacco excise taxes, and another $100 million in the general fund for alcoholic beverages. Economists generally are suspicious of excise taxes, on several grounds. Cigarette taxes, for example, are extremely regressive. When levied at very high rates, there are significant compliance costs associated with interstate smuggling. Our whole governmental regulatory apparatus with respect to alcoholic beverages makes no sense, raises too little revenue, and is extremely anti-competitive. It exists because the General Assembly is extremely susceptible to campaign contributions from the industry lobby, contributions arguably the equivalent of bribes.

Other Taxes

Time permits only a cursory mention of other taxes, including on utilities and insurance. In some respect, the violation of neutrality rules applies here –why tax insurance differently than transactions by other financial institutions? The area of probably greatest contention, however, relates to taxes on natural resource extraction –severance taxes on gas and oil, for example. Ohio's economic advantage in this area has increased considerably with technological advances in extraction, and it appears that Ohio's taxation is dramatically lower than other states. My guess is that the adverse effects of raising those taxes have been considerably overblown, and that the replacement of, say, some income tax revenues with enhanced severance taxes would on balance be growth inducing. If press accounts are even remotely correct, however, this would seem to be another area where the lobbyists, not you, are determining public policy, hindering this Commission's ability to improve the tax system.

Non-Tax Revenue Sources

Ohio receives enormous amounts from the federal government. I worry a lot that federal fiscal pressures may put that revenue in jeopardy, especially with regards to health care. An overdue revisiting of the federal-state fiscal arrangements is unfortunately beyond your jurisdiction.

Some revenues are raised using the benefit principle of public finance that suggests users of governmental goods and services should pay for them. The most important examples perhaps are tuition fees at state universities and motor fuel levies. The 28 cent a gallon gasoline tax is above the national average, but is clearly inadequate to fully fund highway infrastructure projects. At a time of relatively low gas prices, the political opportunity to raise that tax somewhat seems relatively large. It may well be the way we handle highways should change, including the privatization of some functions. Technology has evolved allowing the use of road tolls to a greater extent than previously, reducing reliance on gasoline taxes. The evolution of non-gasoline powered vehicles is another challenge.

Regarding tuition fees, with state funding declining as a share of budgets, so-called state schools are increasingly semi-private institutions, calling into question the role the state should play in establishing fees. There is overwhelming evidence that universities are costly and inefficient, that large portions of graduates are getting low paid jobs, and that students are not learning much while in school. The state may wish to rethink its future commitment with state institutions –maybe funding students, not schools. Legislative attempts to limit tuition fee growth are often ineffective, as schools can counter efforts by a variety of means.

We probably need to review fees for hunting, fishing, occupational licensing, recreational usage and so forth. We probably should end, say, licensing barbers and beauticians. We should ask ourselves whether charging to use state parks is a good or bad idea, or whether and how much should school districts be allowed to charge fees to participate in interscholastic athletics.

Financial Management, Forecasting, and Budgeting Rules

There is a big problem with revenue volatility. Expenditures tend to be relatively stable, but revenues fluctuate a lot. We must balance our budgets every two years. We help alleviate the problem by use of a budget stabilization fund. There is a dilemma in deciding how large that fund should be. Fiscal prudence argues for a large fund – say 10 or even 15 percent of annual revenues. Yet, with all due respect, some politicians are like alcoholics in liquor stores – they just cannot resist consuming the merchandise or, in this case, raiding the rainy day fund. If the fund is too big, it might get dissipated by politicians wanting to avoid doing other unpopular things. Still, as a general proposition, a good sized rainy day fund is desirable.

I think on the whole Ohio's budgeting and forecast system works well. Mr. Keen and most of his predecessors are extremely conservative in their forecasts, and that is good because forecasting errors in the direction of having extra revenues is preferable to

shortfalls requiring hasty last minute budgeting cutting that can be disruptive of programs.

Ohio's State Revenue System: An Overall Assessment

Let me conclude by offering my overall assessment of Ohio's revenue system. I think Ohio's biggest problem over the last half century has been a slow rate of economic growth. Ohio has underperformed the nation, and even the nation as a whole is lagging historical norms. The equity problems relating to taxes are not big in this state. The distribution of income in Ohio is more equal than the nation as a whole, and the alleged regressivity of the tax system is less pronounced in Ohio than nationally. For example, we still have a good deal of progressivity in our income tax. Big inequities need to be dealt with on the federal level. Thus I am more worried about the economic growth effects of our tax policies than the equity effects.

As a consequence, I have applauded the efforts of the past decade, most recently by the Kasich Administration, to reduce

Ohio's excessively high marginal income tax rates. It is still true that Ohio taxes its most productive citizenry at the margin more than in Indiana, Michigan or Pennsylvania, our leading neighbors. The Tax Foundation ranks Ohio a lowly 42th on its just released business Tax Climate Index for 2016. Ohio's improved economic performance in the last few years reflects reductions in income taxation but clearly much more needs to be done. Government is less efficient than the private sector, so smaller government would be good –we need to control expenditures better. Also, a flat rate income tax with a rate similar to that in Indiana- ranked 8th by the Tax Foundation-- would seem to be a worthwhile goal.

Thank you.