



THE OHIO STATE UNIVERSITY

JOHN GLENN COLLEGE OF PUBLIC AFFAIRS

Testimony Before the 2020 Tax Policy Study Commission of the
Ohio General Assembly

Testimony of
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September 26, 2016

Revised

September 27, 2016

Thank you Chairman Peterson and members of the Commission for the opportunity to testify this afternoon.

My name is Ned Hill, and I am Professor of Public Affairs and City and Regional Planning at the John Glenn College of Public Affairs at The Ohio State University, where I specialize in economic development and public finance. I am also a member of Ohio State University's Ohio Manufacturing Institute where I examine public policies related to manufacturing workforce and innovation.

I am going to discuss four items this afternoon: (1) Ohio's fiscal system, (2) the quality of local government fiscal data, (3) tax revenue and future business cycles, and (4) tax credit programs.

1. Ohio's Fiscal System

A fiscal system is at work in the state of Ohio with the state, counties, municipalities, and special districts collecting taxes and fees and providing services. ***The state of Ohio should thoroughly review the entire state-local government system.*** The review should examine the complete tax structure, its complexity, cost of compliance and the ability of all parts of the system to meet demands for revenue.

Ohio's elected leaders should understand how taxes interact across all levels of government and how taxes and expenditures will behave in future business cycles. We also need to know the impact of the expected fiscal demands of local government, especially those that affect statewide public infrastructure systems, including water and sewer systems, broadband, transportation, and waterways.

2. Quality of Local Government Fiscal Data

There are three barriers to understanding the interactions of the state and local revenue collections and expenditures. First, uniform charts of accounts that are appropriate for each type of local government do not exist. Different charts of accounts need to be developed for counties, municipalities, villages, school districts, and special districts. Second, municipalities use different fiscal years, which makes it difficult to compare performance across districts. Third, different accounting systems are used. Some use Generally Accepted Accounting Principles, or GAP, while others use cash accounting or modified accrual systems. Additionally, reliable information on units of local government does not exist. This poses specific problems for the state in terms of monitoring performance, to investors in local government debt, and to citizens in understanding the operations of their local government.

There are two basic tools used in managing local fiscal performance: benchmarking and historical analysis. Benchmarking revenues and expenditures against peer units of government is essential to understanding operational efficiency. This is also true for examining historical trends in revenues and expenditures. Neither is currently available to the citizens of the state of Ohio due to the lack of a consistent chart of accounts for

cities, counties, and special districts. ***Representatives Duffy and Hagan have drafted a bill that addresses parts of this problem.***

I am part of a team at the John Glenn College that has been working with local government fiscal data posted on the Auditor's website. The data are unaudited, and Auditor Yost's staff cautioned us and told us that the data were problematic. We did not listen; we should have.

We found that the data for municipalities were inconsistent, all too often did not agree with the city's Comprehensive Annual Fiscal Report [CAFR], and data quality deteriorated in 2013 and 2014. Two students supervised by Professor Charlotte Kirschner worked at cleaning the data throughout the summer, and Professor Kirschner is continuing the work.

Our conclusion is that statements made from the raw data should recognize the quality of the data. Audited data are typically not required for research, and our statistical tools can deal with random error, but in this case, the raw data are just too unreliable to be used with any degree of confidence.

Auditor Yost and his staff should be applauded for recognizing the data problems and for their efforts to improve the data quality. The 2015 data will become the basis for future audits, providing an incentive to local governments to improve the quality of the numbers they report. The Auditor's staff has been both collegial and forthcoming in advising the Glenn College team, and we thank them.

While data issues do not make for exciting headlines, quality fiscal data are essential to public leaders, civil servants, and the public itself. Between our fragmented perspectives on the state's fiscal system and the inconsistent quality of local fiscal data, we are flying a plane with a broken instrument panel.

3. Tax Revenue and Business Cycles

The Department of Taxation's 2015 Annual Report shows that 40 percent of state tax revenue comes from sales and use tax payments, 35 percent from individual income tax payments, 8 percent from the Commercial Activity Tax and two related business taxes, 7 percent from motor fuels taxes, and a bit more than 6 percent from miscellaneous other taxes. The Governor and Legislature have lowered income tax rates. Some advocates are expressing interest in the state becoming less reliant on income taxes and in shifting the composition of taxes toward consumption taxes.

Public policy in Ohio should pay attention to the performance of states that are either overly reliant on one source of tax revenue, have cut taxes very aggressively, or shifted to consumption taxation. After looking at the performance of these states it becomes apparent that there is wisdom in both moderation and diversification in the sources of tax revenue.

There are two practical problems with a tax system that becomes overly reliant on taxing consumption expenditure. One is associated with revenue volatility, the other is associated with changes in the income distribution.

Volatility

Personal Consumption Expenditures and Disposable Personal Income behave very differently over the business cycle. Income is more cyclically sensitive, or volatile, than consumption expenditure. The growth, and decline rates, partially offset each other over the course of the business cycle. The data are evidence that a balanced approach to taxation is warranted.

I examined the 12-month percent change in Real Personal Consumption Expenditure and the 12-month percent change in Real Disposable Personal Income for the nation. Both measures were seasonally adjusted. I then calculated a measure of volatility, the Coefficient of Variation, for each at different times over the recent business cycle.

- During the recovery, from January 2010 to April 2016, ***Disposable Personal Income [DPI] was nearly three times more volatile than Personal Consumption Expenditure [PCE].***
 - The average 12-month percent change was about the same for each (2.2% for PCE and 2.1% for DPI) but the standard error of Disposable Income was twice as large as the standard error of Personal Consumption Expenditure (0.82 for PCE and 1.92 for DPI). The Coefficient of Variation was 0.37 for PCE and 0.91 for DPI.

- ***The results during the Great Recession were of greater concern for fiscal management.***
 - The 12-month percent change in Disposable Personal Income was negative for two-quarters, the quarters that ended in April and October 2009.
 - The 12-month percent change in Personal Consumption Expenditure was negative in six quarters. The mean change in PCE over this period was - 0.7 percentage points, while the mean change in DPI was 0.6 percentage points. This is a difference of 1.3 percentage points.

Changes in the income distribution

Nationally the income distribution has changed with income and wealth being increasingly concentrated among the very wealthy. The shift in the income distribution is having negative effects on macroeconomic performance, bearing some responsibility for the sluggish recovery from the Great Recession. The Marginal Propensity to Consume [MPC] is at the root of this problem. The MPC is the fraction of every additional dollar an individual earns that is spent on consumption. Its complement is the Marginal Propensity to Save [MPS]. The split between the MPC and MPS changes

over the income distribution, with the MPS increasing with income. In other words, as income becomes more concentrated at the top of the distribution savings rates increase and rates of consumption drop. ***The implication is that tax revenue will become less elastic if a switch is made from income taxes to consumption taxes.***

The change in the income distribution is also resulting in the globe having a surplus in savings, as indicated by very low rates of return to savings.

4. Tax Credit Programs: A necessary evil

The Commission is examining tax credit programs and it has heard testimony on the economic impact of the Historic Tax Credit program and the New Market Tax Credit program. Both have had a positive impact on the state.

The New Markets tax credit program could become more effective if real estate investors could own the properties. Typically, start-ups and rapidly growing companies invest their funds in their operations, not in buildings. Not only do they want to invest in assets directly related to production, they often expect to have to move as they outgrow their current space.

The downside of any tax credit program is the deadweight loss that is unavoidable in their design. Tax credits are sold to an entity that wants to offset a portion of their tax payments to the state. The instruments would not be sold if the trade was a dollar-for-dollar swap of credits for taxes. The difference, or discount, between the value of the credit and the amount the developer receives at its sale, is the efficiency loss, or deadweight loss. The program would be more efficient if taxes were collected and expenditures made directly from the state's General Fund.

Advocates for the credit programs understand the efficiency loss but doubt the politics of adding the programs to the state's budget. They will also argue that the way the tax credit programs are structured improves their efficiency. Efficiency gains come from two aspects of the program's design. First, the process is very competitive, demand for funding far exceeds supply yielding higher social returns. Second, credits are only issued after the project is completed, ensuring that the funds are not wasted on failed projects. There is merit to this argument.

Thank you for providing me with the opportunity to testify and I look forward to answering any questions that the committee has.