

Public Policy Brief

Five Steps to Fundamental Tax Reform: A Pro-Growth Blueprint

By Samuel R. Staley, Ph.D.
and Joshua C. Hall

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Executive Summary

Ohio policymakers are at a crossroads on tax reform. Ohio's current tax burden ranks among the highest in the nation, stifling economic growth and job creation. The tax system can be changed to promote private investment and job creation by adopting fundamental reforms that improve transparency, equity, and consistency in the tax code. This can be accomplished by:

- ❖ Adopting a flat income tax, or dramatically reducing the number of tax brackets, and potentially generating 55,790 jobs;
- ❖ Reducing income tax rates and generating as many as 70,000 jobs;
- ❖ Reducing the sales tax to prevent the loss of 100,000 jobs;
- ❖ Broadening the sales tax base to improve equity;
- ❖ Moving toward user fees for state agencies to improve accountability and performance.



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The Buckeye Institute for Public Policy Solutions

88 East Broad Street, Suite 1120

Columbus, Ohio 43215

(614) 224-4422

www.buckeyeinstitute.org

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Introduction

With the 10th highest state and local tax burden, Ohio can no longer afford to rely on past wealth and investment to finance future state government spending.¹ Generating new wealth is crucial to the economic and political viability of the state.

Ohio's tax code is in need of substantial reform. Indeed, fundamental reform will be crucial for restoring Ohio's economic health. While Gov. Bob Taft and the legislature wrestled with reform issues in 2003, budgetary concerns derailed attempts at significant reform.

The following analysis provides a blueprint for reforming Ohio's tax code to promote private investment, entrepreneurship, and broad-based economic growth. The sequence is important. Income tax reform, for example, should be accomplished before sales tax reform because the economic impacts are likely to be more significant. Similarly, Ohio's attempts to reform the tax code *without reducing rates* have historically led to higher taxes and tax rates.² Thus, reducing sales tax rates should come before the state embarks on broadening the sales tax base. We have listed the steps toward reform in the order of priority.

Pro-growth tax reforms can be achieved if policymakers focus on reforms that conform to three basic principles of public finance:

- ❖ *Transparency* so citizens and businesses can understand the tax system (and their liability),
- ❖ *Equity* to ensure individuals and businesses are treated fairly, and
- ❖ *Certainty* so that businesses and citizens can reliably predict what their taxes will be in the future.

Step 1: Flatten the Income Tax

In a poll of registered Ohio voters, 61 percent favored adopting a flat income tax if it raised the same amount of money as the current income tax system.³

Ohio's income tax is a silent job killer. It is also becoming a political liability.

One of the most damaging effects of a progressive income tax is its dizzying complexity. Ohio's is no exception. Individuals and companies must enlist tax professionals to accurately estimate their tax liability and successfully navigate Ohio's Byzantine tax code.⁴ This complexity creates significant uncertainty among Ohio businesses and households, giving both incentives to move to states with simpler tax codes. Flattening the income tax by reducing the number of tax brackets (ideally to just one rate) has the immediate effect of simplifying the tax code, making compliance easier, *improving transparency and increasing certainty*.

Step 2: Reduce the Income Tax Rate

In 2001, the Beacon Hill Institute at Suffolk University in Boston estimated that reducing the number of tax brackets to half would produce 55,790 jobs and increase Ohio payroll by \$1.8 billion.⁵

Clearly, high income taxes encourage wealthy people to migrate to other, more tax-friendly states. A more important effect of Ohio's income tax, however, may be in the way it discourages investment and entrepreneurship in innovative, cutting-edge technologies. Most new firms, as well as thousands of established ones, are small companies, partnerships, and IRS Code "Subchapter S" Corporations. These companies are taxed at Ohio's *personal income* tax rate, not the corporate rate. Thus, while many large and established companies have seen their tax burden lowered over the past decades, innovative and small businesses have seen their tax burden increase dramatically. Thus, a flat income tax combined with reduced rates can also *improve equity*.

The Buckeye Institute outlined an approach to simplifying the tax code in 2001 with the Beacon Hill Institute in Boston and concluded that:⁶

- ❖ As many as 25 percent of current filers could be removed from the state income tax rolls by setting income tax rates to zero for those families earning less than \$10,000 in taxable income;
- ❖ Cutting income tax rates across the board by 10 percent could generate 46,613 jobs;
- ❖ Cutting income tax rates across the board by 15 percent could generate 70,036 jobs.

Step 3: Reduce the Sales Tax

Permanently raising the Ohio sales tax from 5 percent to 6 percent could destroy as many as 100,000 jobs and reduce payroll by \$1.5 billion.⁷

The legislature increased the sales tax to fill a budget hole in 2003. Legislators should resist the temptation to make the sales tax increase permanent. Higher sales taxes relative to neighboring states place the retail economies of Toledo, Cincinnati, Youngstown, and eastern Cleveland at economic risk.

More importantly, the rationale behind the sales tax increase—that the state needed a short-term boost in revenues to overcome a recession-driven deficit—is no longer valid. State government spending continues to increase at twice the inflation rate and faster than the Ohio economy.

Reducing the sales tax will be important for stabilizing the retail sector, particularly for towns, downtowns and central cities bordering Indiana, Kentucky, Michigan, Pennsylvania, and West Virginia.

Step 4: Broaden the Sales Tax Base

Broadening the sales tax base should not be considered if the sales and income taxes are not simultaneously reduced to prevent yet another general tax increase.

The state needs to lessen penalties on wealth creation, which implies moving away from its dependence on income and estate taxes to fund state and local government programs. This policy shift suggests a larger role for sales tax to fund core state government programs.

Moreover, the current sales tax has created inequities by focusing only on retail sales. While a boon to nonretail services, differential tax treatment has created an inequity in the application of the sales tax. Policymakers should consider broadening the sales tax base to include services under two conditions:

- ❖ **Income tax rates are reduced, and**
- ❖ **Sales tax rates are reduced.**

Given Ohio's economically precarious tax burden, broadening the sales tax without reducing rates would increase the overall tax burden and erode Ohio's economic competitiveness further.

Step 5: Shift To User Fees

User fees help hold government agencies accountable to consumers. Those paying directly for public services are likely to have higher performance expectations, and agencies funded through user fees are more likely to be sensitive to their customer's concerns to prevent falling revenues.

The state government provides numerous services to business and citizens, and legislators should take a stronger look at reducing government reliance on tax revenue to fund them. State policymakers should explore users fees as an alternative to the general revenue fund.

True user fees act as the rough equivalent of a price for services. Users of the service are expected to pay their full cost. Most often, user fees are applied at the local level to services such as water, sewer, trash, and parks. State agencies, however, may have several opportunities to shift toward user fee funding.

One of the most dramatic examples of this shift is the Secretary of State's office. Almost two-thirds of the office was funded through the general revenue fund in Fiscal Year (FY) 2000. By FY 2005, 82 percent of the office's activities will be funded through user fees.⁸ While total spending for the Secretary of State's office increased by more than one-third to \$18.4 billion in FY 2003, general fund revenues have fallen by more than half (and two thirds since FY 2001).⁹

Conclusion

In short, now is the time for Ohio's policymakers to adopt fundamental tax reform. Ohio's economic future depends on reforms that restore simplicity, equity, and certainty to the tax system. Moving toward a flat income tax, reducing income and sales tax rates, and broadening the use of user fees move Ohio in that direction.

About the Authors

Samuel R. Staley, Ph.D. is president and co-founder of The Buckeye Institute for Public Policy Solutions.

Joshua C. Hall is research director at The Buckeye Institute for Public Policy Solutions.

Notes

¹ Date for 2003 estimated by the Tax Foundation in Washington, D.C., <http://www.taxfoundation.org/statelocal03.html>.

² In fact, this is one of the primary arguments made by Citizens for Tax Repeal, the statewide effort to repeal the temporary sales tax increase passed in 2003. See J. Kenneth Blackwell, Jim Jordan, and Linda Reidelbach, "Repeal Effort: A Guarantee the Sales Tax Increase is Temporary," distributed by Citizens for Tax Repeal on October 7, 2003, <http://www.repealthetax.com/news.aspx?id=7>.

³ Samuel R. Staley, *New Directions for Fiscal Policy in Ohio: Key Trends in Citizen Attitudes Toward Spending and Taxation* (Columbus, Ohio: The Buckeye Institute for Public Policy Solutions, February 2003), Figure 5.

⁴ The Tax Policy Center, a joint project of the Urban Institute and Brookings Institution in Washington, D.C., notes that the maximum combined state and local tax rates were the 4th highest in the nation in 2001. See <http://taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=87>.

⁵ *Tax Reform for Ohio's New Millennium* (Columbus, Ohio: The Buckeye Institute for Public Policy Solutions, April 2001), Tables 11-12 pp. 28-29. Estimates are based on an econometric analysis using the State Tax Analysis Modeling Program (STAMP) developed by the Beacon Hill Institute at Suffolk University in Boston, Massachusetts.

⁶ Ibid.

⁷ The study examined the effects of the proposed sales tax increase on the Ohio ballot in 1998. See *The Economic Effects of Changing the Ohio Sales Tax: Estimates using the BHI State Tax Analysis Modeling Program (Second Edition)* (Boston, Massachusetts: Beacon Hill Institute, Suffolk University, January 1998), <http://www.beaconhill.org/BHISTudies/ohiojh4fc.doc.pdf>.

⁸ Data on revenues provided by the Ohio Secretary of State. Revenues do not include federal Help America Vote Act (HAVA) funds for election reform efforts. HAVA will likely contribute \$150 million to the Secretary of State's budget.

⁹ Spending for the Secretary of State's office is expected to fall in FY 2004 and FY2005.



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