

Testimony before the  
Ohio House of Representatives  
Ways and Means Committee  
In Support of the Ohio Income Phase Out Bill (House Bill 534)  
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Presented by  
Dr. Richard Vedder  
Edwin and Ruth Kennedy Distinguished Professor of Economics  
Ohio University

Good morning. My name is Richard Vedder, and my occupation is Edwin and Ruth Kennedy Distinguished Professor of Economics at the Ohio University, as well as a Visiting Scholar at the American Enterprise Institute. I am here to testify in favor of House Bill 534, calling for the phased elimination of the Ohio income tax. It goes without saying that I am not representing Ohio University in any way in this testimony.

The current recession and the associated reduction in employment and incomes are, of course, of immediate concern to the state. However, that downturn should not blind us to a far larger problem, namely that the Ohio economy is undergoing a severe long term economic decline, meaning that the long term economic future of our younger generation is significantly imperiled, and that efforts to date have done less than nothing to reverse the relative decline. It is time for new thinking and, more importantly, new actions.

Before getting specifically to H.B. 534, allow me to document Ohio's economic decline. The second slide compares inflation-adjusted personal income per capita in Ohio with that of the nation since 1969. Note that in 1969, Ohio's income exceeded the national average. I would add that is BEFORE Ohio imposed a personal income tax. Since about 1980, Ohio has fallen behind the national average, by sharply increasing amounts. Today, income per capita in the Buckeye State is nearly 10 percent below the national norm. Income has risen in our state, but much less than in the nation as a whole – we have missed out on the material fruits of much of the prosperity of the last generation.

As bad as that is, there are parts of the state that are significantly worse off than the state average, as the third slide of per capita income for 28 Appalachian Ohio counties shows – consistently well below the state average and not gaining on that average over time. The fourth slide is even more startling. In 1969, income in Appalachian Ohio was well above that of the nation's poorest state, Mississippi. Now, it is lower than in that state. Some of the nation's poorest areas are in Ohio today.

The same applies to our large cities. Slide five is a tale of two cities –Cleveland and Chicago. From 1969 to 1993, income per capita in Cuyahoga and Cook counties typically was similar, with Cook County leading in some years and Cuyahoga in others. In the past 15 years, a huge differential has grown, and Cleveland is now much poorer than Chicago, as any quick trip down Cleveland's Euclid Avenue and Chicago's Michigan Avenue will attest. In slide six, I compare

the Cleveland metro area with Chicago, Philadelphia, Pittsburgh, and Detroit. Historically, Cleveland was in the middle of the pack in income terms, now it is at the bottom, even well below Detroit.

Slide seven shows that compensation per worker in Ohio has risen less dramatically rapidly than the national average. Wages are determined by productivity, and the relative decline in productivity of Ohio workers is the key reason for the decline in the average pay of Ohio workers relative to the national average.

Why is this happening? Time is limited, but let me very briefly mention three hypotheses about Ohio's relative decline, and then focus on the tax explanation. Slide eight suggests the three explanations. Some note that manufacturing has been particularly hard hit by globalization, and Ohio is a more manufacturing-intensive state than most, meaning it is harder hit. This sometimes is called the structural employment explanation. Others, such as university presidents and state school superintendents, have historically emphasized Ohio's low rates of educational attainment, which comes at a time when returns to investments in skills seem to be increasing. Finally, still others stress the fact that Ohio has moved from being a low to being a high tax state, and that high taxes are detrimental to economic growth. Part of that argument includes the fact that Ohio relies particularly heavily on a highly progressive income tax.

Turning first to the structural argument, it is true, as slide nine shows, that Ohio has had a larger loss of manufacturing jobs than the typical state. Moreover, since manufacturing has historically been more important in Ohio than in the average state, this has impacted more significantly on us. Yet there are very significant limits to the validity of this argument. Other states with a strong manufacturing orientation, such as Pennsylvania, have fared far better than us. In 1970, per capita income was higher in the Buckeye State than in the Keystone State, while today per capita income is about 12 percent higher in Pennsylvania. Indiana was even more manufacturing intensive than Ohio in 1970, but has grown faster than us, wiping out nearly one-half of the gap between the Hoosier State and the wealthier Buckeye State in income per capita. Clearly, the structural employment argument has at best limited validity.

Slide ten documents that Ohio has been below the national average in the proportion of its population with college degrees. Interestingly, however, the gap between Ohio and the national average has been relatively stable in modern times, and there is some evidence that part of the differential between our state and the nation is due to very significant out-migration of college graduates, a point to which I will return shortly. More importantly, increasing state spending on education is not likely to have high payoffs. Work that I have done with Joshua Hall, now an economics professor in Wisconsin, suggests that there is little evidence that enhanced spending on K-12 schools increases educational performance, in this case measured by readiness for college. This reinforces a vast national literature on the subject. Perhaps even more relevant, in extensive research my Center for College Affordability and Productivity has found that increased state and local governmental spending on higher education is associated with lower, not higher growth. Money is taken from the highly productive private sector made efficient by profits and competition, and given to non-profit institutions where it is entirely possible that productivity is actually falling, from already low levels. In short, there is little evidence that

enhanced public education support will do anything positive to reverse the state's economic stagnation.

This brings us to taxes. Slide 11 shows that Ohio's tax burden has risen sharply relative to the nation. Whereas in 1970, which not coincidentally is right before the institution of the Ohio income tax, Ohio was a low state tax, while today the nonpartisan Tax Foundation says we have the nation's fifth highest tax burden. Slide 11 also shows that the increase in tax burden in Ohio from 1970 to 2007 was five times the national average. Indeed, Ohio ranks FIRST in the nation –easily-- in the percent that the tax burden rose. Finally, Ohio is first in something –tax increases. Unfortunately there is voluminous evidence that high taxes are harmful to economic growth.

Slide 12 shows the changing state and local tax burden for Ohio and nine neighbors or other large states. Ohio's taxes rose enormously over from 1970 to 2007 relative to any other state on the list, and some states that had far higher taxes than Ohio in 1970, including the nation's most liberal large state, Massachusetts, now have significantly lower tax burdens than in the Buckeye State.

There are few more clearly demonstrated propositions in economics than high tax burdens have terribly destructive effects on human behavior. The 2004 winner of the Nobel Prize in Economics, Edward Prescott, has demonstrated that America's growing economic superiority over Europe emerged in large part because tax burdens in Western Europe soared after 1970, while they did not generally in the United States. Within our nation, high tax Vermont has grown less rapidly than its low tax neighbor New Hampshire. Tennessee, without an income tax, has outperformed much higher tax neighbor Kentucky. South Dakota, without an income tax has outperformed its near identical twin North Dakota which has a progressive tax. Similarly, Ohio, with a progressive high rate tax has grown less than neighbors Indiana or Pennsylvania which have flat rate levies with much lower top marginal rates. Even smart liberal Democrats are aware of this phenomenon. Governor Strickland has made it clear he opposes a tax increase, and even President-elect Obama seems to be at least temporarily moving away from attempts to significantly raise marginal tax rates in 2009 at the national level.

Slide 13 looks at the growth in personal income of 10 states with either no income tax or one with no increase over time, and compares them with the ten states with the highest increased income tax burden over the period 1957 to 1997. Note that incomes grew more than twice as fast in the no income tax states. Income taxes are levies on productive activities –work and investing. They are taxes on what people *give* to the economy, unlike sales taxes that are levies on what we take away. People hate income taxes. How do I know? Because of their migration habits.

Slide 14 shows that from 2000 to 2007, over 2.6 million Americans moved from the 41 states with income taxes, including Ohio, to the nine states without those levies. Every day, Saturday and Sunday included, over one thousand persons on average left the states that taxed the productive activities of their citizenry for the nine states that did not. This huge migration – unmentioned in the mainstream media –was disproportionately younger, productive persons. Ohio is one of the nation's leading states in the out-migration of college educated persons

between the ages of 25 and 34. We have unleashed a brain drain of monumental proportions. Our educational attainment is lagging these days less because of our educational policies than because of our disastrous fiscal policies.

The highly progressive nature of the Ohio income tax is the single most important reason Ohio has gone from being a low to a high tax state. Slide 15 shows that over the period 1957 to 1997, states that newly inaugurated income taxes, a group including Ohio, had their tax burden rise nearly four times as much as those states that remained without an income tax. States with continuing income taxes also had a much greater increase in tax burden than states without income taxes throughout the period. The income tax is a money machine that crowds out entrepreneurial, competitive private enterprise spending in order to fund less efficient government bureaucracies and fund transfers. Its existence has contributed mightily to Ohio's relative economic decline over the past one third of a century.

Let me comment briefly on the bill before the House. This bill does exactly what Ohio needs most, getting rid of the income tax. It does not do so precipitously, allowing the state a full decade to adjust to an income tax-free environment. The mere expectation of falling taxes should induce some resources to remain in the Buckeye State that otherwise would leave, and induce other resources to move into the state, something that would not otherwise be considered. The 10 year phase in allows the state to transition in a non-disruptive way to a new fiscal regime.

Do I believe the state could make this transition without the imposition of lots of new or higher existing taxes? Yes, I do. Do I believe it has the political will to make that adjustment, and the answer is no. Yet a compromise can be reached that allows the overall tax burden to fall significantly, but still allows for existing state services to be maintained. In studies that I have done on Missouri and on South Carolina, I have found that it is feasible to eliminate state income taxes over roughly a decade period without reducing real expenditures or materially raising other taxes. Economic growth generates revenue, as should be abundantly clear as the current negative growth is causing revenue losses.

Even if the state decides it needs to partially replace revenues from a reduction in income tax rates, alternative revenue sources are likely to be less debilitating to the state's economy than the current highly progressive income tax. Dollar for dollar, consumption taxes have dramatically lower negative effects on incomes, output, jobs, migration and the like than do income taxes. Above all, however, the state can use the abolition of the income tax to reinvent the way it provides governmental services. There are many services that probably could be provided more cheaply and at least as effectively by private providers. We can use the sale of assets under privatization plans to fund some activities. We should, for example, sell the Ohio Turnpike, and perhaps state university housing facilities. We could completely get out of the liquor business in a manner that could increase state revenues without raising consumer prices, a win-win situation. We should review our nursing home expenses under Medicaid and compare them with other states, and do other moves to make state provided medical services more affordable to the taxpayers. In short, the fiscal inducements of reduced tax revenues should propel the state into a frenzy of activity designed to make the state leaner and meaner, doing more with

less. In doing so, we will build a better Ohio for our children and grandchildren, a state they can enjoy and prosper in, rather than flee and disparage. We have a moral as well as an economic imperative to our children, and this bill is a major step in meeting our obligations to them.

Thank you.