Ohio: Tax Foundation says tax structure is problematic

David M. Kall | Thursday, June 15, 2017

Earlier this year, we described a major problem that the Tax Foundation think tank has with the Buckeye State's tax structure - the overly complex municipal income tax system that the Tax Foundation criticized as a "serious headache" that forces businesses to withhold income taxes from every jurisdiction that any employee works in. In some cases, the compliance burden exceeds the tax obligation.

The Tax Foundation continues to criticize Ohio's ways. In *Ohio Illustrated: A Visual Guide to Taxes and the Economy*, the group, which puts Ohio at number 45 on its 2017 State Business Tax Climate Index, asserts that the state has "one of the worst business tax climates in the country."

Based on more than 100 variables, the Tax Foundation gave the highest marks to states with low rates, broad bases, and simple frameworks. Those with the lowest rankings have poor corporate and individual income tax structures.

The ten best and worst states are these:

TEN BEST	TEN WORST
1. Wyoming	41. Louisiana
2. South Dakota	42. Maryland
3. Alaska	43. Connecticut

4. Florida	44. Rhode Island
5. Nevada	45. Ohio
6. Montana	46. Minnesota
7. New Hampshire	47. District of Columbia
8. Indiana	48. California
9. Utah	49. New York
10. Oregon	50. New Jersey

The guide's overview explains that in the Buckeye State, residents paid 9.8 percent of their income to state and local taxes in fiscal 2012, the latest year for which data is available. After adjusting for inflation, collections are up 48 percent since 1985. Tax bases and structures "play an essential role in determining the strength of a state's tax climate, but Ohio's complex municipal tax system and harmful gross receipts tax "make the state uncompetitive."

As noted in previous articles, the municipal tax system has been a longstanding point of contention. In addition, in April, we addressed a case, *Crutchfield Corp. v. Testa*, in which internet retailers challenged the commercial activity tax as unconstitutional, as applied to them, because they have no physical presence in Ohio. After the Ohio Supreme Court upheld the CAT, the retailers took their fight to the United States Supreme Court before eventually settling. Under the CAT, all businesses with $500,000 or more in annual sales, as measured by a company's gross receipts from Ohio consumers, are subject to the CAT.

Municipal taxes

The Tax Foundation's guide contends that the municipal tax scheme is especially problematic because it allows localities to levy income taxes on taxpayers both where they work and live. 614 of Ohio's 900-plus municipalities impose a local income tax, with an average rate of 1.4 percent. Parma Heights levies the highest rate, at 3 percent, but large cities like Cleveland and Columbus also subject taxpayers to a relatively high rate, 2.5 percent.

"This can lead to combined state and local marginal tax rates around 9 percent, comparable to high-tax states, like New York and New Jersey." In Ohio, only 63 percent of municipalities offer a full credit to offset the tax paid to the city where an employee works.

Too many brackets

Another stand-out problem is that Ohio has nine individual income tax brackets, ranging from 0.495 percent to 4.997 percent on income above $210,600. This constitutes more individual income tax brackets than any other state except California and Missouri, which both have 10. Hawaii and Iowa, like Ohio, also have nine brackets. Even so, Ohio's top marginal tax rate of 4.997 percent is relatively low, putting it at a rank of number 35 in the country.

Commercial Activity Tax

As for the CAT, the Tax Foundation characterizes it as a "major flaw….By their very design, gross receipts taxes lead to a lack of transparency, and economic inefficiency."

"Pyramiding" is another ugly feature of these kinds of taxes, which occurs when an item is taxed at each step of the production process, as is the fact that some industries are favored over others.

ADDITIONAL TRAITS

Other attributes of Ohio's economy, many of which contribute to a shrinking tax base, include the following:

- Ohio's cost of living, measured by the cost of everyday items like food and housing, is lower than its peer states (Illinois, Indiana, Michigan, Pennsylvania, and Texas), and most of the country in general, such that the real value of $100 is almost $112.
- Ohio's income per person is only 91 percent of the average national income, which has been the case since about 1970. Excepting Michigan and Indiana, Ohio's income is also below that of its peer states.
- Health care, government, and manufacturing employ the most people in Ohio, at 13 percent, 12 percent, and 11 percent, respectively, but manufacturing comprises the largest portion of the economy, yielding 18 percent of the state's gross domestic product (GDP). Government and real estate make up the next largest shares, with 11 percent each. Nevertheless, the economy has shifted from an even split between goods and services as a percent of total private state GDP in 1963, to more than 70 percent services in 2013.
- Since 1991, Ohio has seen a net loss of 512,139 people, with a net loss occurring each year. During this time, approximately 218,270 people went to Michigan, and 193,000 to Florida.
- Ohio has an aging workforce and many retirees. The guide observes that "[j]ust under 45 percent of all Ohio residents are younger than 34 years old, a percentage smaller than most of Ohio's peer states. Only Michigan and Pennsylvania have a smaller percentage of their population younger than 34." Beyond this, the state is home to a high number of retirees, those 65 and older, relative to peer states; almost 16 percent of the population falls into this category.

The Senate's budget proposal

All of this is to say that Ohio will continue to face economic challenges; USNews reported that lawmakers are working to close a projected $1 billion budget gap. Republican senators say their plan, just completed this week, does this while also preserving essential services, and "pumping more money," $6 million, into fighting the opioid crisis. Key components include the following:

- Across-the-board agency cuts averaging 3 percent to 4 percent, for savings of $20 million
- Additional targeted agency cuts worth $100 million
- A $200 million Medicaid reduction while preserving coverage for the most vulnerable populations
- $20 million in cuts to the prisons budget
- Increases in K-12 state aid of $154 million in the first year and $117 million in the second year
- Restoring funds to foodbanks, breast and cervical cancer screening programs, and initiatives involving clean water and food safety
- Maintaining an increase in funding for early childhood programs and expanded eligibility for low-income families that could extend access to some 3-year-olds
- The removal of a House-passed provision that allowed for unlimited tuition increases
- Hikes in need-based financial aid to college students to more than $208 million over the two-year budget
- Doubling the tax deduction families can take for college savings and for the ABLE savings program for families of children with disabilities

- Incentives for agricultural job creation and rural economic development through what was previously known as the Rural Jobs Act
- The extension of the sales tax holiday to 2018

Despite closing the budget gap, the Senate president cautioned that his chamber's budget solution "is not pain-free." He also remarked that "the causes of Ohio's lagging revenues are still a bit of a mystery."

David M. Kall

Team member bio