



# FISCAL FACT

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## Ohio's Poor Tax Climate at the Heart of the State's Economic and Fiscal Woes

*By Scott A. Hodge*

Ohio lawmakers recently reached a last-minute deal to close the state's \$851 million budget shortfall by delaying a scheduled 4.2 percent income tax cut. As many lawmakers acknowledged, the deal was just a band-aid solution and avoids addressing the more structural issues facing the state's finances.

At the heart of Ohio's fiscal problems is a tax system and business climate that has been driving people out of the state for more than 15 years, resulting in a shrinking economy and a smaller tax base. At the same time, state government spending grew unchecked, resulting in a heavier tax burden on the state's remaining citizens. Ohio taxpayers now have one of the highest tax burdens in the nation.

The key to reversing these trends and improving the long-term fiscal health of the state is a sensible reform of the state's tax system.

### 15 Years of Taxpayer Flight

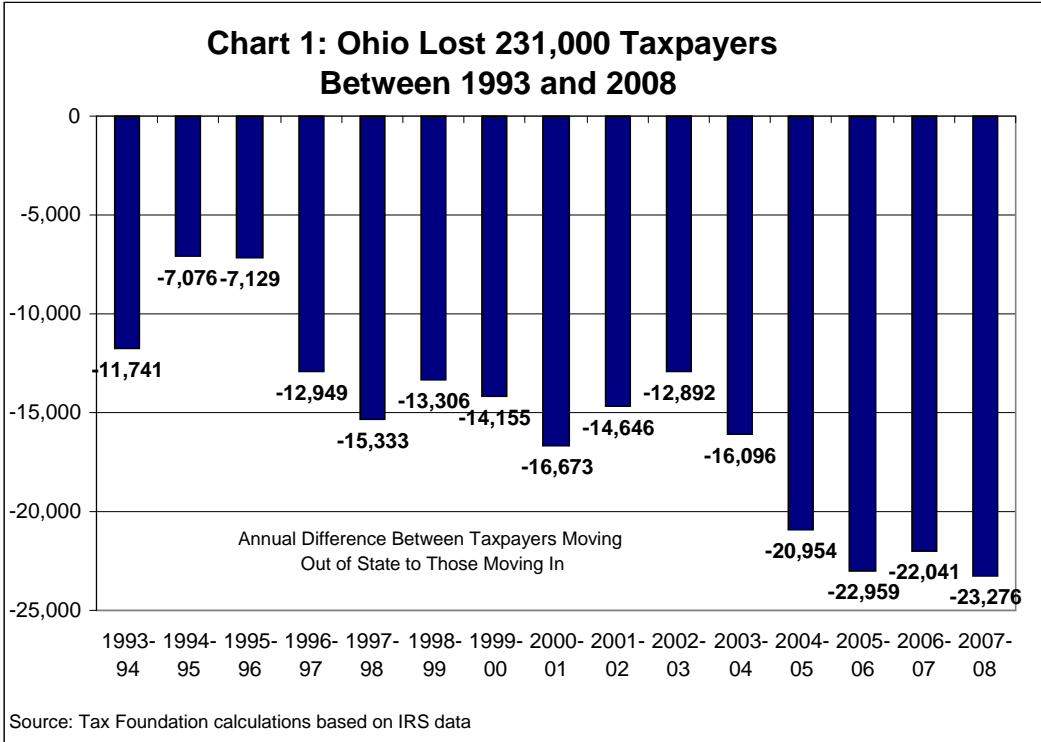
For more than 15 years, Ohio has seen more taxpayers leave the state than move into it. Chart 1, based on Tax Foundation analysis of IRS migration data, shows the net loss of taxpayers (or tax returns)<sup>1</sup> to other states between 1993 and 2008.

We can see that while the state lost a substantial number of taxpayers during the early and late 1990s, the out-migration accelerated dramatically after 2003. Overall, the state lost 231,000 taxpayers between 1993 and 2008, but more than 105,000 of those taxpayers left within the past five years.

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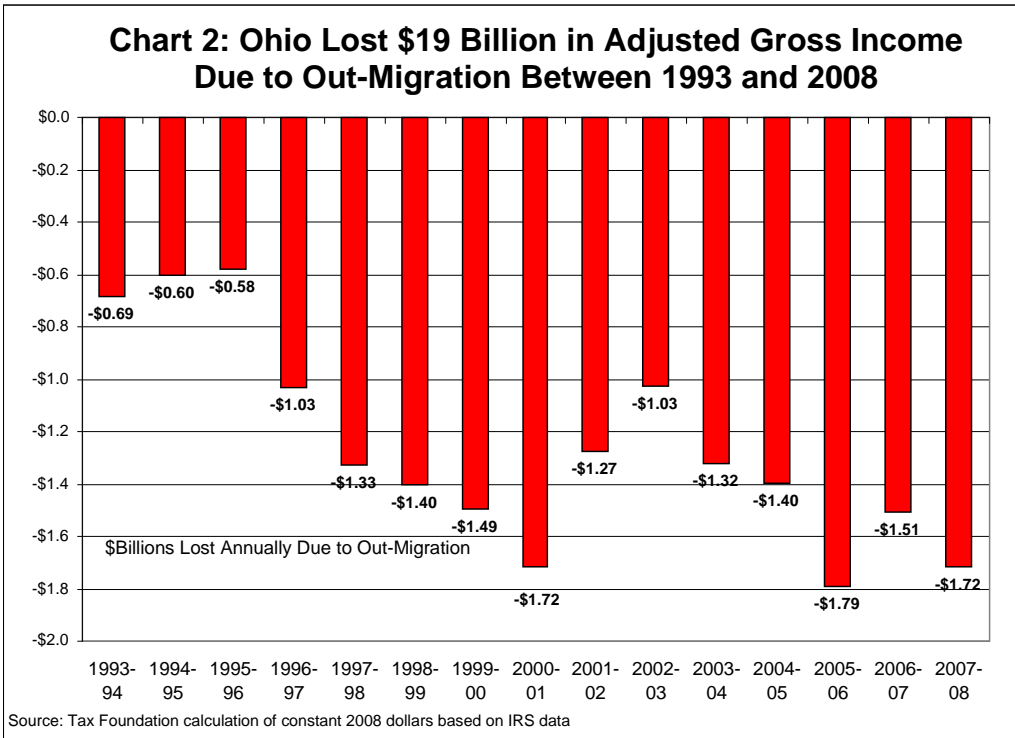
<sup>1</sup> A tax return can represent a single individual, a married couple with children, a sole proprietor or a larger business enterprise such as an LLC or S-corporation. The 231,000 tax returns that Ohio lost during this period had 347,000 personal exemptions associated with them, so the state lost 1.5 persons for every tax return that left the state on net.

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Naturally, as people leave the state, they take their incomes with them. This means that as the population shrinks, the tax base shrinks with it. IRS migration data allows us to calculate the net amount of adjusted gross income that moves in and out of a state each year due to migration. For Ohio, these figures are startling.

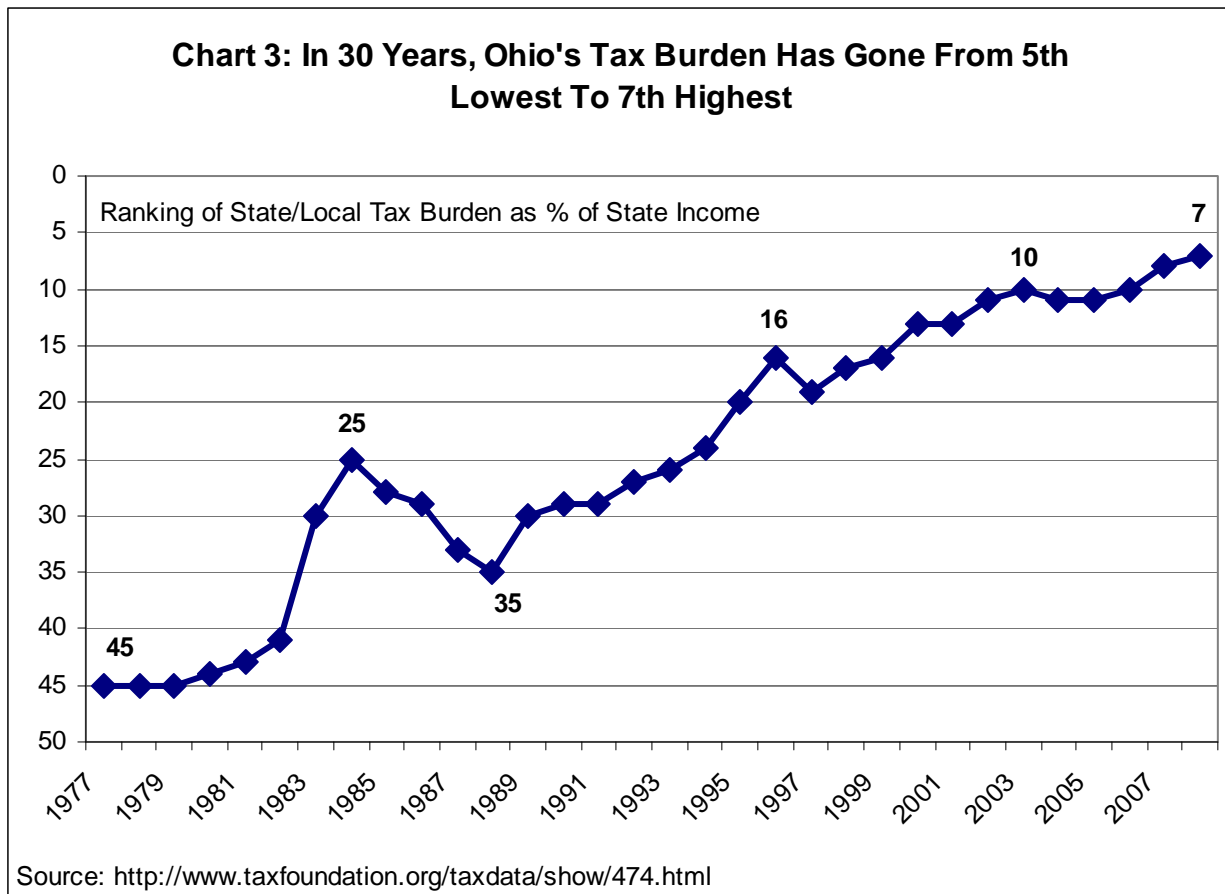
Chart 2 shows that between 1993 and 2008, Ohio lost a total of \$19 billion in adjusted gross income after adjusting for inflation. Since 1996, those losses have averaged \$1.4 billion per year.



During the same period, however, Ohio's state spending grew from \$31.6 billion in 1993 to over \$67 billion in 2008, a 47 percent increase even after adjusting for inflation and population growth.<sup>2</sup> What this means is that the state has had to raise a growing amount of money each year from a smaller pool of income.

### From Low-Tax to High-Tax State

Today, Ohio has the seventh highest state and local combined tax burden in the nation with taxes consuming 10.4 percent of the state's income.<sup>3</sup> As Chart 3 shows, this was not always the case. Forty years ago, Ohio had the fifth lowest state/local tax burden in the nation, with taxes consuming 8.7 percent of the state's income.<sup>4</sup> In just the past 10 years alone, the state has dropped 10 places in the rankings as the population flight accelerated.



From a regional competitiveness standpoint, Ohio is surrounded by states that, generally speaking, have much lower tax burdens. Michigan, Indiana, Kentucky, and West Virginia are all clustered in the middle of the national rankings (27th, 28th, 25th and 29th respectively), while Pennsylvania's tax burden is 11th highest in the nation, but still lower than Ohio's.<sup>5</sup>

<sup>2</sup> Erratum: Until January 12, this sentence mistakenly stated that state spending had grown from approximately \$38 billion to \$60 billion.

<sup>3</sup> Gerald Prante, "State-Local Tax Burdens Dip As Income Growth Outpaces Tax Growth," *Tax Foundation Special Report*, No. 163 (Aug. 2008), <http://www.taxfoundation.org/publications/show/22320.html>.

<sup>4</sup> Id.

<sup>5</sup> Id.

## Ohio's Poor Tax Structure

In order to get a more complete picture of a state's tax system, it is important not only to understand how much a state raises, but also how they raise it. The Tax Foundation's State Business Tax Climate Index assesses the structure of each state's tax system, producing a measure of business-friendliness based upon more than 100 different factors.<sup>6</sup> The Index assesses the five major elements of a state's tax system: the corporate tax, individual income tax, sales tax, property/wealth tax, and the unemployment tax. These individual rankings tier up into a national ranking.

The Index most rewards states that don't have one of the major taxes, because foregoing one of the major taxes eliminates the complexity associated with that tax. The Index also rewards state taxes with broad bases and low rates. It punishes states that have complex, highly progressive tax systems.

In the Tax Foundation's 2010 Index, Ohio ranked 47th in the nation—one of the worst business tax climates in the country. All of Ohio's neighbors rank better on this index.

## The Damaging Commercial Activity Tax

When it comes to corporate and business taxes, Ohio is an outlier. Since the introduction of the commercial activity tax (CAT) in 2005, Ohio has been imposing two tax systems on businesses because the old corporate franchise tax was phased out over five years. This double-tax has clearly impacted the state's rankings. Finally, when Ohio firms pay their 2010 taxes, the franchise tax will be fully repealed, and the state's ranking will improve modestly in the Tax Foundation's State Business Tax Climate Index.

But having only the CAT will not necessarily give Ohio a comparative advantage regionally or nationally over its neighbors who impose traditional corporate income taxes because the CAT is a particularly harmful type of tax known as a gross receipts tax.

Ohio is one of just seven states to impose a gross receipts tax, which is imposed on businesses regardless of their profitability. While politicians like gross receipts taxes because they have deceptively low rates and they are thought to be a more stable source of tax revenue, economists have found gross receipts taxes to be particularly harmful because they tax all transactions, including intermediate business-to-business purchases of supplies, raw materials and equipment. As a result, gross receipts taxes lead to taxes on taxes -something economists call "tax pyramiding."

Tax systems like the CAT are particularly damaging during economic downturns when businesses have to pay the tax even when they are losing money and laying people off. This can lead to more job losses and even bankruptcies. In contrast, a traditional corporate income tax would collect more when companies are doing well, but little or nothing when companies are doing poorly.

The CAT is also harmful for grocery stores, department stores and other high-volume, low-profit-margin businesses. Even during boom times, businesses with high volume and low profit margins will pay a disproportionate tax compared to businesses with low volume and high profit margins, like jewelry stores. Normal corporate income taxes put both types of firms on a level playing field.

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<sup>6</sup> Kail M. Padgitt, "2010 State Business Tax Climate Index," *Tax Foundation Background Paper*, No. 59 (Sep. 2009), <http://www.taxfoundation.org/taxdata/show/22661.html>.

Ohio, like all states, would do well to lower the overall tax burden on businesses. A recent Tax Foundation study found that for every dollar that states increased corporate taxes, wages fell by \$2.50 over the next five years.<sup>7</sup> And the opposite is true: When states cut corporate taxes, wages tend to rise over subsequent years.

## Ohio's Complex Personal Income Tax System

Notwithstanding the promised 4.2% reduction in income taxes for 2010 that is now cancelled, Ohio's top income tax rate of 5.925% is about average regionally and nationally. However, this does not include the income tax rates imposed by most Ohio cities and school districts which can boost the overall rate to over 7 percent.

In addition, Ohio's income tax system has nine separate tax brackets before the top rate kicks in at \$200,000 and these brackets are not indexed to inflation. Only a handful of states have more brackets in their individual tax systems. By contrast, three of Ohio's neighbors—Indiana, Michigan, and Pennsylvania—have simple flat tax systems with relatively low rates.

Despite Ohio's financial troubles, lawmakers should reject any calls for making its system more progressive or imposing a millionaire's tax. The states in the biggest financial trouble these days all have highly progressive tax systems, which has made their fiscal systems highly volatile.<sup>8</sup>

## Sales Taxes on Many B-to-B Transactions

Ohio's combined state/local sales tax rate of 6.83 percent ranks 25th nationally, right in the middle of the pack.<sup>9</sup> However, all neighboring states except Indiana have a lower sales tax rate.

While Ohio's sales tax rate is not exorbitant, the major fault of the system is that the sales tax is applied to too many business-to-business transactions such as cleaning services, repair services, software, and leased items. Taxing business-to-business activities not only adds to the cost of doing business in the state, but it also raises costs to consumers as the sales tax cascades through the price of goods.

## Modest Property Taxes, High Taxes on Capital

Contrary to the perception of most homeowners, Ohio's property taxes are a relatively modest \$1,165 per capita, ranking the state 24th in the nation. While voters are particularly vocal about high property taxes, taxes on capital are far more harmful for long-term economic growth and Ohio's taxes on capital are among the highest in the nation. Ohio is undermining its growth potential by being one of 22 states with a capital stock tax and one of only 10 states with an intangible property tax.<sup>10</sup>

Capital stock taxes are levied on the wealth of a corporation, usually defined as its net worth. They are often levied in addition to a corporate income tax, adding a duplicate layer of taxation and

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<sup>7</sup> Robert Carroll, "The Corporate Income Tax and Workers' Wages: New Evidence from the 50 States," *Tax Foundation Special Report*, No. 169 (Aug. 2009), <http://www.taxfoundation.org/news/show/24960.html>.

<sup>8</sup> Joseph Henchman, "State Budget Shortfalls Present a Tax Reform Opportunity," *Tax Foundation Special Report*, No. 164 (Feb. 2009), <http://www.taxfoundation.org/news/show/24321.html>.

<sup>9</sup> Kail Padgitt, "Updated State and Local Option Sales Tax," *Tax Foundation Fiscal Fact*, No. 196 (Oct. 2009), <http://www.taxfoundation.org/news/show/25395.html>.

<sup>10</sup> Padgitt, 2010 Index, p. 27-28.

compliance. A corporation's financial troubles can be exacerbated when it has to use available cash flow to pay its capital stock tax.

Intangible personal property taxes are imposed on such things as stocks, bonds, and even trademarks. This tax can be harmful to businesses that hold large amounts of their own or other companies' stock and that have valuable trademarks.

Another tax on capital (accumulated capital) is the estate tax. Ohio makes itself unattractive to entrepreneurs by imposing its own estate tax, particularly since the taxing threshold (\$338,000) is much lower than what exists at the federal level.

## Improving Ohio's Tax System

Ohio can improve its attractiveness to business by taking some decisive steps to improve its tax system.

The first step should be to reduce Ohio's reliance on business taxes by eliminating the Commercial Activity Tax, the capital stock tax, and the intangibles tax. These are the most anti-growth taxes within the Ohio tax system. Reducing the punitive effects of these taxes on business should be job one for Ohio lawmakers.

Economic research supports moving away from these taxes. Economists are finding that in a global economy, taxes on capital and income are more harmful for long-term economic growth than are taxes on consumption or property. The reason is that capital and income are the most mobile factors in production and, therefore, the most sensitive to high taxes.<sup>11</sup>

Next, lawmakers should simplify the individual income tax system by eliminating those multiple brackets and moving toward a flatter system similar to those in Indiana, Michigan, and Pennsylvania.

Another sound reform would be to eliminate the tax pyramiding in the sales tax base by exempting more business-to-business transactions.

Finally, Ohio should get out of the business of doling out incentives to lure business into the state. Fairness and experience tell us that lower tax rates for all are better than incentives for some. North Carolina learned this lesson after giving Dell millions in incentives only to see Dell close down its North Carolina facility in less than five years.

## Conclusion

It is clear that without sensible reforms soon, economic growth opportunities will pass by Ohio and the state's finances will continue to worsen. Cutting the state's tax burden and implementing pro-growth tax reforms can go a long way toward reversing these dismal trends.

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<sup>11</sup> Organization for Economic Cooperation and Development (OECD), "[Tax and Economic Growth](#)," Economics Department Working Paper No. 620 (Jul. 11, 2008) (finding that corporate taxes are the most harmful tax for long-term economic growth, followed by high personal income taxes, then consumption taxes and property taxes.)