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Ohio Tax Reform in 2014: Framing the Conversation

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Key Findings

- Governor Kasich's 2014 tax proposal decreases individual income taxes, but pays for those tax decreases with hikes in taxes on tobacco, energy, and businesses.
- Overall, tax policy in Ohio over the last several years has been a mixed bag, but there are many ways to move Ohio down a path to fundamental reform.
- Ways policymakers should consider to improve corporate taxes would be to repeal the Commercial Activities Tax, eliminate special credits for businesses, and bring down the overall rate.
- Ways policymakers should consider to improve individual income taxes would be to overhaul Ohio's local income tax system, repeal last year's pass-through business carve out, consolidate income tax brackets, and eliminate the marriage penalty.
- Ways policymakers should consider to improve sales taxes would be to eliminate taxes on business inputs, while expanding the sales tax base to services.

Introduction

Tax policy changes in Ohio over the last few years have been a mixed bag. While income tax rates were cut during the 2013 legislative session, policymakers also enacted an increase in the state sales tax and a problematic small business carve-out that distorts the individual income tax base. Most harmfully, the 2013 tax package increased the state's reliance on the Commercial Activities Tax (CAT),[1] a tax which is routinely the subject of scrutiny from tax scholars.[2]

Governor Kasich recently called for further tax changes in his 2014 State of the State address. These proposals, too, are a somewhat disjointed attempt at tax reform that lacks principle or a unifying theme. In an effort to provide a menu of options for sound tax reform, this report lists the current proposals being considered in 2014 and options for improving them.

Governor Kasich's 2014 Tax Plan

In mid-March, Governor Kasich unveiled the specifics of his State of the State promise to cut taxes in 2014. They are listed in detail on the Mid-Biennium Review website[3] and in House Bill 472.[4] Major changes include:

Tax Changes	Revenue Impact (FY 2015-17)
Individual Income Tax	
Reduce rates across the board by 8.5 percent over the next three years Increase Earned Income Tax Credit (EITC) from 5 percent of federal credit to 15 percent Increase state's personal exemption from $1,700 to $2,700, with phase downs at incomes of $40,000 and $80,000	$2.639 billion tax cut
Excise Taxes	
Increase cigarette excise tax rate from $1.25 to $1.85 per pack Implement new tax on electronic cigarettes (49 percent of wholesale price by July 2015)	$848 million tax hike
Energy Taxes	
Increase state's severance tax rate to 2.75 percent of all gross receipts Implement new $8 million per new well drilled (applicable for three years) Implement exclusion from all severance taxes for small conventional gas producers Distribute 25 percent of new oil revenues to local governments in oil and gas producing regions	$874 million tax hike
Gross Receipts Taxes	
Increase Commercial Activities Tax (CAT) rate by 15 percent from 0.26 percent to 0.30 percent	$743 million tax hike
Total Revenue Impact (FY 2015-17)	**$174 million cut**

1 Scott Drenkard, *Ohio Tax Reform Package Keeps Getting Worse*, Tax Foundation Tax Policy Blog, June 20, 2013, http://taxfoundation.org/blog/ohio-tax-reform-package-keeps-getting-worse.
2 John L. Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, Tax Foundation Background Paper No. 53 (Jan. 2007), http://taxfoundation.org/article/gross-receipts-taxes-state-government-finances-review-their-history-and-performance.
3 2014 Mid-Biennium Review, *Tax Cuts for Growth*, http://transforming.ohio.gov/TaxCuts.aspx.
4 H.B. 472, 130th General Assembly, Reg. Sess. (Ohio 2014), http://legiscan.com/OH/text/HB472/2013.

While income tax rate cuts are beneficial fiscal policy, there is little here in the way of base reform. For example, the state would retain all nine of its income tax brackets (see Table 1). Additionally, while the formula for sound tax reform would be to offset rate cuts with base broadening that improves neutrality, this proposal exclusively relies on opaque and politically expedient tax hikes to make the ledger add up.

Table 1: Proposed Ohio Income Tax Bracket Changes

	Current Rate	Proposed Rate		
Bracket	2014	2014	2015	2016
$0	0.534%	0.515%	0.491%	0.483%
$5,200	1.068%	1.031%	0.983%	0.967%
$10,400	2.137%	2.062%	1.965%	1.933%
$15,650	2.671%	2.578%	2.457%	2.417%
$20,900	3.204%	3.092%	2.947%	2.900%
$41,700	3.739%	3.608%	3.439%	3.384%
$83,350	4.272%	4.122%	3.930%	3.867%
$104,250	4.960%	4.786%	4.563%	4.489%
$208,500	5.392%	5.203%	4.960%	4.880%

Note: Brackets adjusted for inflation each year.

The most damaging of these offsets is the increase in the state's Commercial Activities Tax (CAT). While the tax rate of 0.26 percent seems small, gross receipts taxes like the CAT are levied so many times along the production process that effective rates are many times higher. Ohio is one of just five states with gross receipts taxes like this, and of those states, Virginia, Texas, and Washington have all seen calls for reform in the last year.[5]

Placing additional weight on tobacco taxes to fund government services is another poor budget strategy. Because cigarette consumption has decreased steadily since the 1960s, tobacco revenues cannot be used as a long-term funding source.[6] New taxes on electronic cigarettes are also misguided, as research often finds them to be less harmful than incinerated tobacco.[7]

Moving the Discussion Forward

While the above proposals leave much to be desired, an appetite for tax reform appears to be present in Ohio. As such, the list below details recommendations

5 *See* Scott Drenkard, *Perry Calls for Reforms of Texas' Margin Tax*, Tax Foundation Tax Policy Blog, Apr. 18, 2013, http://taxfoundation.org/blog/perry-calls-reforms-texas%E2%80%99-margin-tax; Scott Drenkard, *Virginia Gubernatorial Candidates Eye Cumbersome Tax Code*, Tax Foundation Fiscal Fact No. 376 (July 15, 2013), http://taxfoundation.org/article/virginia-gubernatorial-candidates-eye-cumbersome-tax-code; Jason Mercier, *Senate Work Session Focuses on WPC B&O Reform Proposal*, Washington Policy Center Blog, Mar. 28, 2013, http://www.washingtonpolicy.org/blog/post/senate-work-session-focuses-wpc-bo-reform-proposal.

6 *See* David Brunori, *Smoke 'Em if You Got 'Em*, Tax Notes Today, Apr. 15, 2013 [subscription required]. http://services.taxanalysts.com/taxbase/magdailypdfs.nsf/PDFs/139TN0302.pdf/$file/139TN0302.pdf; Scott Drenkard & Noah Glyn, *Cigarettes and Preschoolers Don't Go Together*, Tax Foundation Fiscal Fact No. 390 (Aug. 14, 2013), http://taxfoundation.org/article/cigarettes-and-preschoolers-don-t-go-together.

7 Zachary Cahn & Michael Siegel, *Electronic Cigarettes as a Harm Reduction Strategy for Tobacco Control: A Step Forward or a Repeat of Past Mistakes?*, 32 Journal of Public Health 16-31 (2011), http://www.palgrave-journals.com/jphp/journal/v32/n1/pdf/jphp201041a.pdf.

for policymakers, journalists, and taxpayers as they start conversations about how Ohio can improve Governor Kasich's 2014 plan to make it more competitive and pro-growth. Many of these suggestions could be done in a revenue-neutral fashion, and all suggestions are sourced to larger works for further study.

Corporate Taxes

- *Repeal the CAT:* Ohio is one of just five states to levy a gross receipts tax, which they call the Commercial Activities Tax (CAT). Gross receipts taxes are widely criticized by economists because they result in "tax pyramiding," the double and triple taxation of business inputs as they move through a production chain.[8] As a component of 2013 tax changes, the state lowered the exemption of the tax, meaning more of the Ohio economy is subject to it, amplifying its distortive effects.

  Instead of increasing the CAT rate as the 2014 plan proposes, a prudent change would be to move to taxing services through the sales tax instead of gross receipts (detailed below), as this would remove tax pyramiding concerns and not unduly burden businesses with cyclical income or low profit margins.

- *Eliminate Credits and Lower Rates:* The Ohio tax code has generous credits for all three generally-applicable categories: jobs, research and development, and investment. While these credits lower the tax burden of select businesses engaging in favorable activity, they also mean the overall tax rate must be higher to bring in revenue. Sound tax reform would mean eliminating these privileges to broaden the tax base and then lowering tax rates to make the state more competitive.[9]

- *Repeal Local Corporate Income Taxes:* Ohio is one of very few states that allows municipalities to levy corporate income taxes, which stack on top of the already problematic statewide CAT. Revenue from these taxes is highly volatile, which means municipal planning is very difficult, and compliance with corporate income taxes is incredibly arduous.[10] Municipalities should lean on more traditional local revenue streams like property taxes to fund essential government functions.

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8 John L. Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, Tax Foundation Background Paper No. 53 (Jan. 2007), http://taxfoundation.org/article/gross-receipts-taxes-state-government-finances-review-their-history-and-performance.

9 Scott Drenkard & Joseph Henchman, *2014 State Business Tax Climate Index*, Tax Foundation Background Paper No. 68 (Oct. 9, 2013), at 15, http://taxfoundation.org/sites/taxfoundation.org/files/docs/2014TaxFoundationIndex_FINAL.pdf.

10 David Brunori & Joseph J. Cordes, *The State Corporate Income Tax: Recent Trends for a Troubled Tax* (Aug. 15, 2005), http://www.americantaxpolicyinstitute.org/pdf/StateCorpTax%208-15-05%20_2_.pdf.

Individual Taxes

- *Reform Local Individual Income Taxes:* Ohio has the most complex and unnecessarily burdensome local income tax system in the country.[11] In the long run, the system needs to be entirely restructured to comport with standards of other states that levy such taxes (which are few).[12] The state considered H.B. 5 in 2013 which proposed some of these simplifications, but the bill has since been largely stripped of many of the beneficial elements included in proposals.[13] While comprehensive simplification is needed (e.g., making local taxes easy enough to include on the state's tax return, as Maryland does), moderate reforms are also possible in the interim:
    - Require local income calculations to start with taxable income as defined on the Ohio state tax return (Localities currently define their own income base)
    - Establish a statewide standard mandating that income may not be subject to taxation in more than one jurisdiction (fixing what is referred to as the cross-credit problem)
    - Establish a strong, bright-line visitor's exemption (30 days) before which no income tax is due
- *Repeal Last Year's Pass-Through Carve Out:* A hallmark element of Governor Kasich's 2014 tax package is getting the top income tax rate below 5 percent. Further income tax rate cuts would be easier from a revenue perspective if policymakers repealed last year's generous exclusion for pass-through income and applied that revenue to rate cuts.[14]
- *Consolidate Income Tax Brackets:* While income tax rate cuts have been a component of both last year and this year's proposals, policymakers could increase simplicity and decrease labor distortions by consolidating brackets and considering a move to a single tax rate structure. Standard deductions could be adjusted to retain progressivity of the code.[15]

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11 Joseph Henchman, *Guess Which State Has the Worst Local Income Taxes*, Tax Foundation Tax Policy Blog, Sept. 23, 2013, http://taxfoundation.org/blog/guess-which-state-has-worst-local-income-taxes; Greg Lawson & Scott Drenkard, *In The State Tax Battle, The Tar Heels Soar Above The Buckeyes*, Forbes, Sept. 23, 2013, http://www.forbes.com/sites/realspin/2013/09/23/in-the-state-tax-battle-the-tar-heels-soar-above-the-buckeyes/.

12 Scott Drenkard, *Ohio's Local Income Taxes: Complex and in Need of Reform*, Testimony before Ways and Means Committee of the Ohio House of Representatives, May 7, 2013, http://taxfoundation.org/article/ohios-local-income-taxes-complex-and-need-reform.

13 Chris Stephens & Scott Drenkard, *Ohio House Ways and Means Considers Substantially Watered-Down Municipal Income Tax Reform*, Tax Foundation Fiscal Fact No. 401 (Nov. 4, 2013), http://taxfoundation.org/article/ohio-house-ways-and-means-considers-substantially-watered-down-municipal-income-tax-reform.

14 Scott Drenkard, *Ohio Tax Plan Broadens Sales Tax, Lowers Income Tax, Includes "Small Business" Gimmick*, Tax Foundation Tax Policy Blog, Feb. 11, 2013, http://taxfoundation.org/blog/ohio-tax-plan-broadens-sales-tax-lowers-income-tax-includes-%E2%80%9Csmall-business%E2%80%9D-gimmick.

15 *See* Joseph Henchman & Scott Drenkard, *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform* (Jan. 2013), at 33-34, http://taxfoundation.org/article/north-carolina-tax-reform-options-guide-fair-simple-pro-growth-reform.

Sales Taxes

- *Eliminate Tax on Business Inputs:* Ohio currently applies its sales tax to many business-to-business transactions, meaning that businesses have to pass on the costs of those sales taxes to final consumers. A well-structured sales tax would apply only to final consumer transactions.[16] In 2012, Ohio businesses paid $4.3 billion dollars in sales taxes on business inputs.[17]

- *Expand Sales Tax Base to Services:* Ohio currently does not tax many services in its sales tax, and this means that the goods sector of the economy bears a disproportionate burden from the sales tax and that the overall sales tax rate has to be much higher to bring in necessary revenue. As a component of overall tax reform, expanding the sales tax base to services is a neutrality-enhancing offset that can make rate cuts possible.[18]

Conclusion

2014 represents an opportunity for Ohio to tackle tough tax code problems that have been a drag on the state's fiscal structure for years. Governor Kasich's goal of enacting income tax cuts with revenue offsets is possible, but relying on tax gimmicks to close the revenue gap is not sensible tax policy. The proposals presented here, or any elements of them, would start Ohio down a path to fundamental reforms to the state's tax structure instead of tinkering at the edges.

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16 *See* Joseph Henchman & Scott Drenkard, Building on Success: A Guide to Fair, Simple, Pro-Growth Tax Reform for Nebraska (Oct. 2013), at 30-31, http://taxfoundation.org/sites/taxfoundation.org/files/docs/building_on_success_nebraska.pdf.

17 Ernst and Young & Council on State Taxation, Andrew Phillips et al., *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2012* (2013), http://www.cost.org/WorkArea/DownloadAsset.aspx?id=84767.

18 *See* Joseph Henchman & Scott Drenkard, Building on Success: A Guide to Fair, Simple, Pro-Growth Tax Reform for Nebraska (Oct. 2013), at 32, http://taxfoundation.org/sites/taxfoundation.org/files/docs/building_on_success_nebraska.pdf.