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Ohio's Local Income Taxes: Complex and in Need of Reform

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Chairman Beck, Ranking Member Letson, Members of the Committee:

My name is Scott Drenkard, and I'm an economist at the Tax Foundation. For those unfamiliar with the Tax Foundation, we are a non-partisan, non-profit organization that has monitored fiscal policy at all levels of government since 1937. We have produced the Facts & Figures handbook since 1941, we calculate Tax Freedom Day each year, and have a wealth of data, rankings, and other information at our website, www.TaxFoundation.org. We are guided by the principles of sound tax policy: simplicity, neutrality, transparency and stability.

I'm pleased to have the opportunity to speak today with regard to H.B. 5, a bill to reform elements of Ohio's municipal tax system. While we take no position on the bill, I hope to give some perspective based on our research.

In 2011, we wrote a paper on city- and county-level income taxes, and found that of the 17 states that rely on local income taxes, Ohio has among the highest rates. In 2010, local income tax collections as a percentage of state personal income were 1.06 percent. The only state with higher effective rates is Maryland.

However, sound tax policy is not just about how much money is collected. It is about collecting revenue for necessary government services in the most efficient way possible. Ohio's municipal tax system is far from that ideal. H.B. 5 does a great deal to remove some of the complexity built into Ohio's municipal tax system. I'm hoping it represents a start to a movement by lawmakers to make the code more sensible and user-friendly.

Simplifying Income Tax Filing

Today, I'd like to do something I normally don't get the chance to do, and that is say something nice about Maryland's tax system. Maryland is similar to Ohio in that the state leans heavily on local income taxes to fund government, but it does so in a way that generally minimizes taxpayer headache. If you look at their state income tax form, the entirety of the compliance with the local income tax is handled on just a few lines of the form. Taxpayers simply multiply their taxable income from line 21 (their taxable income) by the percentage corresponding with their locality, which is conveniently located in the instructions, then subtract out two credits for low income individuals. H.B. 5 does not get Ohio to this standard quite yet, but this just illustrates that local income taxes can and should be just that easy.

Figure 1: Maryland Local Income Taxes on the State Form

LOCAL TAX COMPUTATION

29. Local tax (See Instruction 19 for tax rates and worksheet.) **Multiply line 21 by your local tax rate** .0 __ __ __ or use the Local Tax Worksheet 29

30. Local earned income credit (from Local Earned Income Credit Worksheet in Instruction 19) 30

31. Local poverty level credit (from Local Poverty Level Credit Worksheet in Instruction 19) 31

32. Total credits (Add lines 30 and 31) 32

33. **Local tax** after credits (Subtract line 32 from line 29) If less than 0, enter 0 33

By contrast, Ohio law makes individuals fill out additional forms detailing their local income tax liability. Sometimes individuals fill out multiple forms, and businesses often do. Frustratingly, these tax bills are often trivial, meaning that municipalities are contributing a great deal to compliance costs, which economists will tell you are just a tax burden that doesn't even collect any revenue.

What's worse is that each of these jurisdictions has what we call local "base autonomy." That means that each locality is permitted to come up with their own calculation of taxable income and their own collection requirements. This is especially problematic if the localities don't treat credits for taxes paid to other jurisdictions in the same way. In Ohio, it's entirely possible to pay local income taxes on the same dollar to more than one jurisdiction. This is an affront to the time-honored principle of avoiding double taxation.

There are nine states that have local base autonomy for their sales taxes, and we track that variable and it counts against those states in our annual calculation of the State Business Tax Climate Index. We actually don't even track base autonomy in local income taxes, and truthfully, that's because we didn't even know that any state had competing local income tax bases until I was asked to testify here today. H.B. 5 doesn't move to an entirely uniform base for local income tax collections, but it is a start.

Net Operating Loss Carryforwards

One of the elements of uniformity that the bill would bring is in the treatment of net operating loss carryforwards. NOL carryforwards are an important element of any tax code because they promote neutrality between businesses and individuals that have different income flow patterns.

The fact that taxes are collected once a year is just a tool to help with budgeting; but not all businesses operate on a 365 day income model, and it's important to adjust for this fact of economics. Some entrepreneurs take years building up start-up capital and sustaining little profit with hopes of obtaining larger profits in the future. NOL carryforwards help smooth this income inconsistency so we don't harm new innovative enterprises. H.B. 5 ensures that carryforwards are at least offered for five years.

The Casual Entrant Exemption

One of the other components of this bill that deserves praise is the reform of the "casual entrant" exemption, which is necessary to bring tax complexity under control. Currently, businesses are forced to withhold income taxes in multiple jurisdictions even when their employees spend just a few days working there. I've heard horror stories of service professionals in Ohio that end up with over 20 W-2s at the end of the year.

My intuition tells me that many businesses simply don't bother with going through the trouble of withholding in all the jurisdictions their employees might visit and instead just hope their books don't get audited. This is a great example of tax law that undermines voluntary compliance. Businesses want to pay all the taxes that are due, but simply find that too difficult.

H.B. 5 extends this casual entrant exemption to 20 days, alleviating some of this pressure. However, I think the measure could go somewhat further. In Pennsylvania, localities simply tax non-residents based on their primary place of employment, and this cuts down on a tremendous amount of additional paperwork. I think that is a viable model for states that have local income taxes, and one that Ohio should take under strong consideration.

Conclusion

In closing, while I'll be the first to admit that administrative tax changes like those in H.B. 5 are not the most scintillating discussion topic, I'm pleased to see this committee taking a serious look at making the local income tax structure in the Buckeye State more sensible. It will reap huge benefits. Thank you for your time and consideration; I look forward to your questions.

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