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Ohio's Changing Fortunes: Can the State's Economy Overcome the Tax Burden?

By
Chris Atkins,
Staff Attorney

Curtis Dubay,
Staff Economist

Introduction

In 1971, Ohio lawmakers voted to impose a tax on the income of all individuals and corporations in Ohio. When the votes were cast, Ohio was a low-tax state. But the course set by lawmakers in 1971 would radically transform Ohio into a high-tax state over the next 35 years.

In 1970, Ohio had the 4th lowest state and local tax burden in the country, according to data on income and taxes from the Department of Commerce.[1] As recently as 1980, Ohio had the nation's 7th lowest tax burden. In the early 80s, however, Ohio lawmakers began a series of tax increases that would trigger a precipitous climb to almost the top of the state and local tax burden rankings. In 2006, Ohio ranked third, with only Maine and New York's residents paying heavier state—local tax burdens.

Ohio lawmakers have raised taxes recently as well. Indeed, they have done so no less than four times in the past five years. Even when lawmakers tried to reform Ohio's tax system in 2005—perhaps a tacit admission that taxes were too high—they still ended up raising taxes overall in the short term and imposing a new business tax that could seriously harm the competitiveness of Ohio's tax system.

Ohio lawmakers still have much work to do to reverse these historical trends. Entrepreneurial lawmakers would be well advised to look to the state's taxation of general sales as well as its taxation of property and other assets. Both of these systems are ripe for reform.

The data from 1970 to 2006 are clear: Ohio—which once could boast of a low tax burden—now has one of the highest.

In 1970, Ohio had the 4th lowest state-local tax burden in the country, but in 2006, Ohio is 3rd highest. Only the residents of Maine and New York pay more.

Methodology

We use three metrics to assess Ohio's tax system. First are our own estimates of each state's combined state-local "tax burden" (taxes paid as a percentage of income) which are based on income and tax data from the Department of Commerce's Bureau of Economic Analysis. Secondly, we cite the final tallies of tax collections in each state as reported by the Census Bureau; and finally, we cite our own *State Business Tax Climate Index* which brings a more qualitative approach to measuring the tax competition among the states. By any measure, Ohio has become a high-tax state where, all else being equal, economic activity is likely to lag.

[1] Calculations by Tax Foundation. See http://www.taxfoundation.org/taxdata/show/474.html

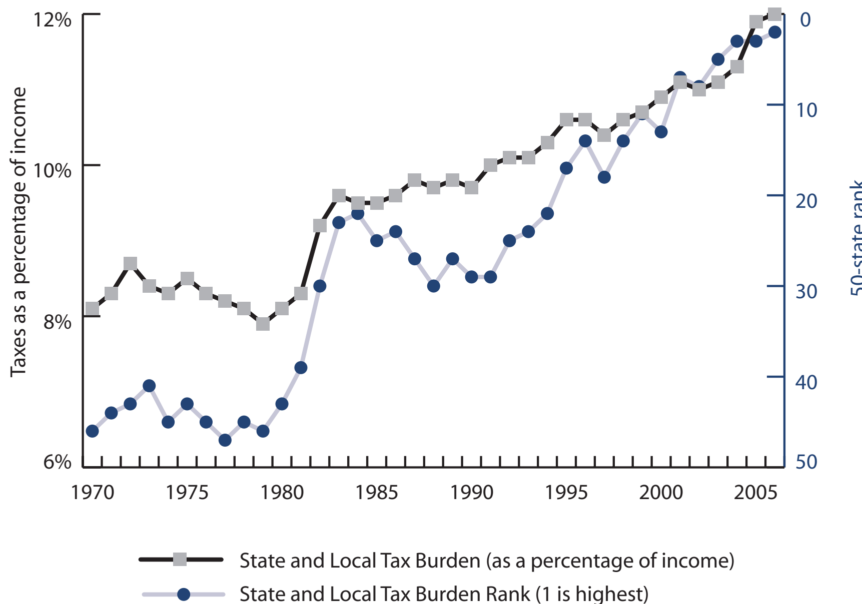
Ohio's Tax Burden: Rising Steadily Since 1970

In the most recent Tax Foundation rankings of state-local tax burdens, Ohio taxpayers were found to be paying 12 percent of their income in taxes to state and local governments, the third highest percentage in the country. During 2006, only the residents of Maine (13.5%) and New York (12.9%) paid more.

Historical data on income and taxation at the Department of Commerce's Bureau of Economic Analysis have enabled us to calculate these state-local burdens back to 1970. That is a good year to start tracking state and local tax burdens because the series covers most of the years during which the states have been required to fund Medicaid (roughly one-third of state spending today).

The tax burdens are expressed as a percentage of income – all taxes paid divided by all income earned. Adjustments are made to account for substantial taxes paid out of state so that each dollar of "burden" counts in the state of the taxpayer who paid it, not in the state of the tax collector who received it. The Tax Foundation then ranks the tax burdens from highest (1) to lowest (50).

Chart 1: Ohio's Transformation from a Low-Tax to a High-Tax State (1970-2006)



Source: Tax Foundation

In 1970, Ohio was a low-tax state. The state-local tax burden was 8.1 percent of income, and only three states had lower tax burdens. In 36 years Ohio has made the unsettling climb into the upper echelons of taxation, and its citizens now pay the 3rd highest state and local tax burden (see Tables 1 and 2 and Chart 1).

Ohio's upward movement in the burden rankings is unique because its 44-rank increase is far and away the largest. Louisiana (rank increase of 33), Connecticut (25) and Rhode Island (23) are the only other states with tax

Table 1
Ohio's State-Local Tax Burden as a Percentage of Income
1970-2006

Year	State-Local Tax Burden	National Rank
1970	8.1%	47
1971	8.3%	45
1972	8.7%	44
1973	8.4%	42
1974	8.3%	46
1975	8.5%	44
1976	8.3%	46
1977	8.2%	48
1978	8.1%	46
1979	7.9%	47
1980	8.1%	44
1981	8.3%	40
1982	9.2%	31
1983	9.6%	24
1984	9.5%	23
1985	9.5%	26
1986	9.6%	25
1987	9.8%	28
1988	9.7%	31
1989	9.8%	28
1990	9.7%	30
1991	10.0%	30
1992	10.1%	26
1993	10.1%	25
1994	10.3%	23
1995	10.6%	18
1996	10.6%	15
1997	10.4%	19
1998	10.6%	15
1999	10.7%	12
2000	10.9%	14
2001	11.1%	8
2002	11.0%	9
2003	11.1%	6
2004	11.3%	4
2005	11.9%	4
2006	12.0%	3

Source: Tax Foundation

burden rankings that increased by more than 20 places.

Table 2
Ohio Moves from 4th Lowest to 3rd Highest State and Local Tax Burden 1970 and 2006

State	1970 Tax Burden	Rank	2006 Tax Burden	Rank	Percentage Increase (1970-2006)	Rank Change (1970-2006)
Alabama	8.2%	46	8.8%	46	7.3%	0
Alaska	11.3%	6	6.6%	50	-41.6%	-44
Arizona	10.8%	10	10.1%	32	-6.4%	-22
Arkansas	8.3%	45	10.3%	27	23.5%	18
California	10.9%	8	10.9%	15	-0.8%	-7
Colorado	10.0%	25	9.8%	38	-2.3%	-13
Connecticut	8.9%	34	11.3%	9	27.4%	25
Delaware	7.7%	50	8.4%	48	8.5%	2
Florida	8.8%	36	9.7%	39	10.3%	-3
Georgia	8.7%	41	10.4%	25	20.0%	16
Hawaii	10.7%	12	11.7%	5	9.5%	7
Idaho	9.7%	27	10.2%	31	5.0%	-4
Illinois	10.1%	22	10.9%	14	7.6%	8
Indiana	9.5%	30	11.0%	12	14.8%	18
Iowa	10.8%	11	10.4%	26	-3.8%	-15
Kansas	10.0%	24	10.7%	18	7.3%	6
Kentucky	8.9%	32	10.7%	20	19.5%	12
Louisiana	8.4%	44	11.0%	11	31.7%	33
Maine	10.8%	9	13.5%	1	25.0%	8
Maryland	10.0%	26	10.7%	19	7.5%	7
Massachusetts	10.3%	18	10.3%	28	-0.7%	-10
Michigan	10.0%	23	10.8%	16	7.6%	7
Minnesota	10.5%	14	11.9%	4	13.3%	10
Mississippi	10.3%	19	10.2%	29	-0.8%	-10
Missouri	8.7%	39	9.9%	34	14.4%	5
Montana	10.4%	16	9.5%	42	-8.6%	-26
Nebraska	10.3%	17	11.6%	6	12.3%	11
Nevada	10.2%	21	9.5%	43	-6.7%	-22
New Hampshire	8.6%	42	7.3%	49	-14.9%	-7
New Jersey	8.9%	33	10.8%	17	21.1%	16
New Mexico	10.2%	20	9.9%	36	-2.8%	-16
New York	12.3%	2	12.9%	2	4.9%	0
North Carolina	8.7%	37	10.5%	23	19.5%	14
North Dakota	11.4%	5	9.8%	37	-14.1%	-32
Ohio	**8.1%**	**47**	**12.0%**	**3**	**48.1%**	**44**
Oklahoma	8.0%	48	9.6%	40	20.0%	8
Oregon	9.7%	28	9.9%	35	2.1%	-7
Pennsylvania	8.7%	38	10.4%	24	20.2%	14
Rhode Island	9.5%	31	11.5%	8	20.5%	23
South Carolina	8.5%	43	10.2%	30	20.4%	13
South Dakota	12.1%	3	9.2%	45	-24.3%	-42
Tennessee	8.7%	40	8.6%	47	-0.5%	-7
Texas	7.9%	49	9.4%	44	18.0%	5
Utah	10.5%	15	10.5%	22	0.8%	-7
Vermont	12.3%	1	11.1%	10	-9.6%	-9
Virginia	8.9%	35	9.5%	41	7.1%	-6
Washington	10.5%	13	10.9%	13	3.6%	0
West Virginia	9.6%	29	10.6%	21	10.1%	8
Wisconsin	11.8%	4	11.6%	7	-2.4%	-3
Wyoming	11.1%	7	10.1%	33	-9.0%	-26

Source: Tax Foundation

Some other states did move rapidly down in the rankings. South Dakota (42 rank decrease), North Dakota (32), Wyoming (26), Montana (26), Nevada (22) and Arizona (22) all saw their tax burden rankings fall more than 20 places.

In 2006, Buckeyes will pay 12 percent of their income to fund state and local government. This 48.1 percent increase from 1970 is larger than for any other state in this time span, far ahead of Louisiana, Connecticut and Maine, which increased by 31.7 percent, 27.4 percent and 25.0 percent respectively (see Table 3). Only one other state in Ohio's region—Pennsylvania—saw an increase in its tax burden that exceeded 20 percent.

It is rare for a state to move from the ranks of the least taxed (somewhere in the bottom 10) to the most heavily taxed (somewhere in the top 10), even over a 36-year period. Louisiana (44th to 11th) and Connecticut (34th to 9th) came close, but Ohio was the only state in the country that truly went from one extreme to the other.

Ohio's Tax Burden in Regional Context

Ohio's steady rise to the top of the tax burden rankings means that it now has the highest tax burden in its region. Ohio's regional neighbors all moved up in the rankings as well—though none as much as Ohio. Indiana's tax burden ranking increased 18 places (the 5th most between 1970 and 2006), Pennsylvania increased 14 places (12th most), Kentucky increased 12 places (12th most), West Virginia increases 8 places (15th most), and Michigan increased 7 places (19th most). Meanwhile, Ohio went

Table 3
States with the Largest Percentage Increase in Tax Burden Since 1970

State	Percentage Increase	Rank
Ohio	48.1%	1
Louisiana	31.7%	2
Connecticut	27.4%	3
Maine	25.0%	4
Arkansas	23.5%	5
New Jersey	21.1%	6
Rhode Island	20.5%	7
South Carolina	20.4%	8
Pennsylvania	20.2%	9
Oklahoma	20.0%	10

Source: Tax Foundation

from the lowest tax burden in the region to the highest.

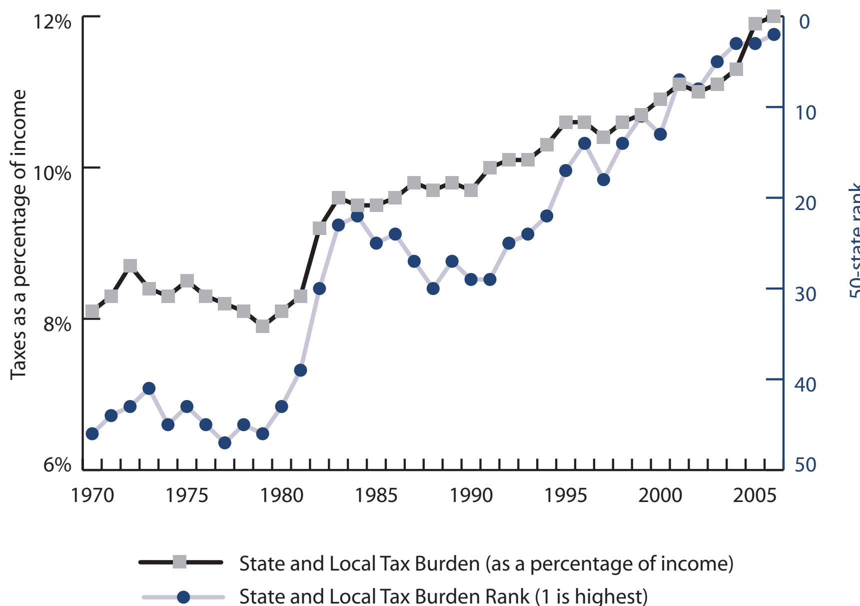
While Ohio lawmakers recently passed a tax reform measure that was designed to increase the competitiveness of Ohio's tax system (this tax reform plan is covered in more detail below), it did nothing to reduce Ohio's tax burden. Thus, Ohio will continue to have higher tax burdens than its regional neighbors absent efforts like the proposed Ohio tax and expenditure limitation.

Table 4
Ohio's Tax Burden Compared to Regional Neighbors

State	2006 Tax Burden (as a Percentage of Income)	Regional Rank
Indiana	11.0%	2
Kentucky	10.7%	4
Michigan	10.8%	3
Ohio	12.0%	1
Pennsylvania	10.4%	6
West Virginia	10.6%	5
Regional Average	10.7%	

Source: Tax Foundation

Chart 2: Ohio's Tax Burden Increases Compared to Regional Average



Source: Tax Foundation

Ohio's 12.0 percent tax burden is a full one percent of income higher than the second most highly taxed state in the region, Indiana (see Table 4). Indiana's cost of government (11.0 percent of income) is slightly ahead of Michigan (10.8 percent). The regional average tax burden is 10.7 percent.

Most states' tax burdens are grouped closely together, so small changes often cause a state's ranking to jump or fall several places. For example, if Indiana's 2006 tax burden were 10 percent of income instead of 11 percent, its ranking would fall from 12th highest to 33rd highest—a 21-place drop in the rankings.

Until the mid-1990s, Ohio was in a position where it could have passed tax reforms that moved it rapidly toward the regional average, but the current disparity between Ohio (12.0%) and the region (10.7%) is not one that will be easy to bridge.

Ohio's Tax Collections Increasing in Census Estimates

The Census Bureau's most recent tally of state-level tax collections comes from fiscal year 2005 (July 2004 through June 2005). Local taxes are excluded, and the time frame is 18 months earlier than the Tax Foundation's burden estimates for calendar year 2006, but the trend lines point in the same direction.

According to Census data, Ohio's per capita state tax collections ranked 41st in 1993 (the earliest year for which data is available), but increased to 27th highest in 2005. The 14 rank increase is the 3rd largest in the time period (see Table 5).

Taxpayers are often confronted with Census Bureau ranks of state-level tax collections and Tax Foundation burden rankings, which are not comparable. The Census Bureau's figures are not tax burdens; they are simply tax collections per capita.

The burden faced by taxpayers is best expressed as a percentage of income because residents in a particular state could pay a large amount in taxes, but because income in that state is also high the burden actually imposed by the tax level is not onerous. Thus, the Tax Foundation compares tax collections to income

Table 5
Census Bureau Rankings of Per Capita State Tax Collections Shows Ohio's Tax Collections Surging Since 1993

State	1993 Rank	2005 Rank	Change from 1993 to 2005	Rank of the Change
Alabama	44	44	0	18
Alaska	1	8	-7	44
Arizona	26	40	-14	49
Arkansas	33	18	15	2
California	10	9	1	15
Colorado	45	47	-2	31
Connecticut	3	4	-1	23
Delaware	4	5	-1	23
Florida	36	37	-1	23
Georgia	37	42	-5	39
Hawaii	2	2	0	18
Idaho	27	30	-3	34
Illinois	31	29	2	14
Indiana	34	31	3	11
Iowa	21	33	-12	48
Kansas	29	32	-3	34
Kentucky	18	23	-5	39
Louisiana	47	36	11	6
Maine	16	19	-3	34
Maryland	14	14	0	18
Massachusetts	6	7	-1	23
Michigan	24	15	9	7
Minnesota	5	6	-1	23
Mississippi	42	39	3	11
Missouri	46	46	0	18
Montana	25	35	-10	47
Nebraska	32	24	8	8
Nevada	11	28	-17	50
New Hampshire	49	48	1	15
New Jersey	9	10	-1	23
New Mexico	13	20	-7	44
New York	7	11	-4	37
North Carolina	19	25	-6	42
North Dakota	28	21	7	9
Ohio	41	27	14	3
Oklahoma	30	34	-4	37
Oregon	35	41	-6	42
Pennsylvania	20	22	-2	31
Rhode Island	15	12	3	11
South Carolina	38	43	-5	39
South Dakota	50	50	0	18
Tennessee	43	45	-2	31
Texas	48	49	-1	23
Utah	39	38	1	15
Vermont	22	1	21	1
Virginia	40	26	14	3
Washington	8	17	-9	46
West Virginia	23	16	7	9
Wisconsin	12	13	-1	23
Wyoming	17	3	14	3

Source: Tax Foundation

and calculates the burden faced by residents in each state.[2]

The most recent year's Census rankings also exclude local taxes, which the Tax Foundation incorporates in its tax burden figures. This is important because many states accomplish at the local level what others accomplish at the state level. Since there is a high degree of fiscal integration between state and local governments, it makes sense to consider them together when gauging the tax burden.[3]

For example, if just the state-level statutory sales tax rates of New York and Connecticut are compared it appears Connecticut's 6 percent rate is much higher than New York's 4 percent rate. However, the average county-level local option sales tax rate (which is often used to fund state directives or mandates) in New York is almost 4 percent, meaning the average sales tax rate in New York is approximately 8 percent. Connecticut does not allow local option rates. So when both state and local taxes are considered it is clear New York's sales tax rate is higher.

The Census Bureau does provide local tax collections by state, which can be ranked. According to the Census Bureau, 44 percent of all taxes collected in Ohio were collected at the local level in 2002, the 10th highest percentage nationally.

In 1992, the earliest available data, Census figures show that Ohio had the 22nd highest level of per capita local tax collections (see Table 6). In 2002 Census figures show that Ohio's per capita local tax collections increased to 11th highest. This 11-rank increase was the second largest in the 10-year span (Maine rose 17 places).

Distinguishing Between Different Measures of the Tax Burden

The Education Tax Policy Institute (ETPI) issued a report in July 2004 criticizing the Tax Foundation's state and local tax burden estimates for Ohio.[4] In its report, ETPI examines state and local tax collections reported by four groups, all of which are based on state and lo-

[2] A longer discussion of the difference between burdens and collections can be found at http://www.taxfoundation.org/publications/show/1656.html

[3] Local collections from Census were only available for 2002 until May 2006 when data from 2003 and 2004 were reported.

[4] See *Ohio's Tax Ranking: Setting the Record Straight,* Education Tax Policy Institute (July 26, 2004), located at http://www.etpi-ohio.org/Library/IssBrf/OhioTaxRanking.pdf. It should be noted that the ETPI is directed by a group of Ohio school districts and other local government entities.

cal tax collection figures from the Census Bureau: the Federation of Tax Administrators,

Table 6
Ohio Per Capita Local Tax Collections are also Rising Rapidly Since 1992

State	1992 Rank	2002 Rank	Change from 1992 to 2002	Rank Change
Alabama	44	43	1	24
Alaska	5	6	-1	37
Arizona	27	29	-2	41
Arkansas	48	50	-2	41
California	20	19	1	24
Colorado	8	5	3	13
Connecticut	4	3	1	24
Delaware	46	47	-1	37
Florida	18	21	-3	43
Georgia	28	20	8	4
Hawaii	36	46	-10	46
Idaho	42	41	1	24
Illinois	6	7	-1	37
Indiana	34	28	6	6
Iowa	29	26	3	13
Kansas	17	22	-5	44
Kentucky	45	44	1	24
Louisiana	33	31	2	17
Maine	25	8	17	1
Maryland	7	4	3	13
Massachusetts	14	10	4	11
Michigan	10	37	-27	49
Minnesota	24	32	-8	45
Mississippi	49	48	1	24
Missouri	30	27	3	13
Montana	39	40	-1	37
Nebraska	21	14	7	5
Nevada	32	23	9	3
New Hampshire	2	15	-13	47
New Jersey	3	2	1	24
New Mexico	47	45	2	17
New York	1	1	0	35
North Carolina	40	38	2	17
North Dakota	38	33	5	9
Ohio	**22**	**11**	**11**	**2**
Oklahoma	43	39	4	11
Oregon	9	30	-21	48
Pennsylvania	23	17	6	6
Rhode Island	13	12	1	24
South Carolina	41	36	5	9
South Dakota	26	24	2	17
Tennessee	37	35	2	17
Texas	15	13	2	17
Utah	35	34	1	24
Vermont	12	42	-30	50
Virginia	16	16	0	35
Washington	31	25	6	6
West Virginia	50	49	1	24
Wisconsin	19	18	1	24
Wyoming	11	9	2	17

Source: Tax Foundation

Congressional Quarterly, the Ohio Department of Taxation and the Ohio Public Expenditure Council.

According to the ETPI report, each of the four groups ranked Ohio 20th in per capita tax collections, and either 20th or 22nd as a percentage of income.[5] Noting that the Tax Foundation ranks Ohio's state and local tax burden 11th highest per capita and 3rd highest as a percentage of income, the ETPI report concludes that the Tax Foundation has overstated Ohio's state and local tax burden.

The ETPI report's criticism is not persuasive for several reasons. First, the report compares Tax Foundation figures from 2004 with other groups' figures from 2000. Because Ohio's tax burden rose considerably between 2000 and 2004, this is an illegitimate comparison. A more correct comparison would be between fiscal year 2000 tax collections from the groups listed above with Tax Foundation tax burden estimates for calendar year 2000. As illustrated in Table 7, when Tax Foundation figures are compared to other sources on a same-year basis, there is substantially less difference between the figures.

Table 7
When Compared on a Same—Year Basis, Tax Foundation Figures are Similar to Census Bureau Figures Used by Other Organizations

Organization	Per Capita Rank	Percent of Income Rank
Federation of Tax Administrators, 2000	20	20
Congressional Quarterly, 2000	20	20
Ohio Department of Taxation, 2000	20	20
Ohio Public Expenditure Council, 2000	20	22
Tax Foundation tax burdens, 2004 (as cited in ETPI report)	11	3
Tax Foundation tax burdens, 2000 estimate at the time the ETPI report was published	17	12

Source: Tax Foundation; Education Tax Policy Institute

Second, the ETPI report gives the appearance that the four groups cited calculate

[5] The Ohio Public Expenditure Council ranks Ohio 22nd in tax collections as a percentage of income, most likely due to the use of a different measure of income than the other groups.

independent estimates of Ohio tax collections. In fact, all four groups employ the same Census Bureau figures, and do not independently measure state and local tax collections. The ETPI report never makes this clear to readers, giving the impression that each of the four groups independently reached similar conclusions that are different from those of the Tax Foundation. In fact, because all four groups rely on data from the same source, it is unsurprising that they all differ from Tax Foundation figures by similar amounts.

Third, the ETPI report makes the elementary mistake of confusing the "legal incidence" of taxes with their "economic incidence," which is a distinction that is crucial for the economic analysis of tax burdens. The legal incidence of taxes falls on those with the legal obligation to remit tax payments. In contrast, the economic incidence falls on those who bear the true economic burden of taxes. In general, the legal and economic incidence of a tax is substantially different, making it important to adjust raw tax collection figures—which reflect legal incidence only—to better reflect the true tax burden.

The Census Bureau figures reported by each of the groups in the ETPI report measure only the legal incidence of state and local taxes. Census Bureau figures do not attempt to allocate tax collections based on the economic incidence of those taxes. As a result, they do not provide policymakers with information about the actual tax burden borne by residents in state and local areas. Census Bureau figures report only the dollar amounts of taxes received by state and local governments. They do not report the amount of taxes borne by individual taxpayers, which is the more relevant measure for economic analysis of the impact of taxes on state and local economies.[6]

The ETPI report ignores this distinction. The report criticizes the Tax Foundation for adjusting state and local tax collections to better reflect the economic incidence of severance taxes, corporate taxes and tourism taxes. In fact, Tax Foundation adjustments to better reflect the economic incidence of taxes are an essential step that is routinely done by economic analysts, including those at the Congressional Budget Office, the U.S. Treasury Department and Urban-Brookings Tax Policy Center. Because Census Bureau tax collections reflect only the legal incidence of taxes, it is incorrect to compare them directly to Tax Foundation tax burdens.

Finally, the ETPI report fails to account for other important differences between Tax Foundation and Census Bureau figures. First, Tax Foundation tax burdens are based on the normal calendar year from January to December, while Census Bureau tax collections are based on the fiscal year used by most states, from July to June. This difference in timing does not allow the figures to be directly compared, as done in the ETPI report. In addition, when calculating taxes as a percentage of income the Tax Foundation employs Net National Product from the Bureau of Labor Statistics, while the Census Bureau uses Personal Income, which accounts for some of the difference between the figures.

Because the ETPI report mischaracterizes the Tax Foundation's methodology, its criticism of Tax Foundation state and local tax burden figures is unpersuasive.

Why is Ohio a High-Tax State?

What accounts for Ohio's transformation from a low-tax state in 1970 to a high-tax state in 2006? The answer lies in a combination of factors, including a series of general tax increases and uncompetitive sales and wealth tax systems.

In 1971, Ohio enacted taxes on both corporate and individual income, and these definitely laid the groundwork for Ohio to become a high tax state. However, Ohio did not truly begin its upward progression on tax burden measures until 1981 (see Chart 2) when it began to institute a series of sales and income tax increases.[7] In 1981, Ohio increased its sales tax rate from 4 percent to 5 percent and increased corporate income tax rates. In 1982, a series of increases in the individual income tax

[6] See Gerald Prante and Andrew Chamberlain, "Economic vs. Legal Incidence: Comparing Census Bureau Figures with Tax Foundation Tax Burdens." *Tax Foundation Fiscal Fact No. 59* (June 9, 2006).

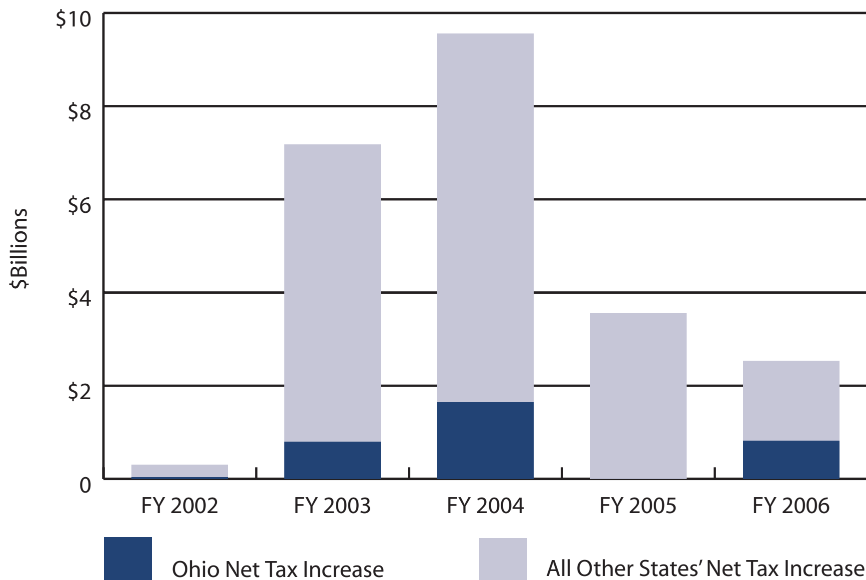
[7] See Ohio Department of Taxation, *2004 Annual Report*, located at http://tax.ohio.gov/documents/publications/2004_Annual_Report/tax_ar_2004.pdf.

Table 8
Ohio Enacts $3.3 Billion in Tax Increases from FY2002 to FY2006
$Millions

Fiscal Year	Sales	Personal Income	Corporate Income	Tobacco	Motor Fuels	Other Taxes	Fees	Ohio Net Tax Increase	U.S. Net Tax Increase	Ohio's % of Total
2002	(1.5)		34.4					32.9	303.8	10.8%
2003	185.1	108.0	216.0	288.3				797.4	7,179.4	11.1%
2004	1,309.1		24.2		129.9		184.1	1,647.3	9,550.3	17.2%
2005								0.0	3,558.0	0.0%
2006	703.1	(321.0)	30.0	473.2		(72.5)	11.3	824.1	2,532.1	32.5%
Total	2,195.8	(213.0)	304.6	761.5	129.9	(72.5)	195.4	3,301.7	23,123.6	14.3%

Source: National Association of State Budget Officers (NASBO) *Fiscal Survey of States* (December 2001-2005)

Chart 3: Ohio Tax Increases Compared to Total State Tax Increases



Source: NASBO

were adopted, including a temporary surtax of 90 percent (made permanent in 1984), two new brackets above $80,000, and other surtaxes. This series of tax increases appears to be the catalyst that pushed Ohio into the echelon of high tax states.

The tax-raising trend has continued in recent years. Ohio lawmakers have raised taxes four times in the past five fiscal years for a total of over $3.3 billion. These four tax increases covered almost every major tax category (see Table 8).

To put these tax increases into a wider perspective, it is necessary to compare them to total state tax increases as well as Ohio's share of the economy and the total population. On all three measures, Ohio's tax increases were large.

Ohio's recent tax increases equaled over 14.3 percent of all state tax increases during the same period (see Table 8 and Chart 3). In FY 2006, Ohio's tax increases (over $800 million) accounted for almost one-third of the total state tax increases (over $2.5 billion) in the entire U.S. If Ohio's population were 14.3 percent of the nation, or if Ohio's economy were 14.3 percent of the national economy, then tax increases of 14.3 percent would not be out of line. But Ohio's share of the population is 4.0 percent, and its share of the economy is 3.7 percent.[8] Overall, then, the Ohio tax increases were about three times larger than what prevailed nationwide.

The recent Ohio tax increases were also large compared to other states, whether exam-

Table 9
Ohio's Recent Tax Increases Were Well Above Per Capita U.S. Average State Tax Increase

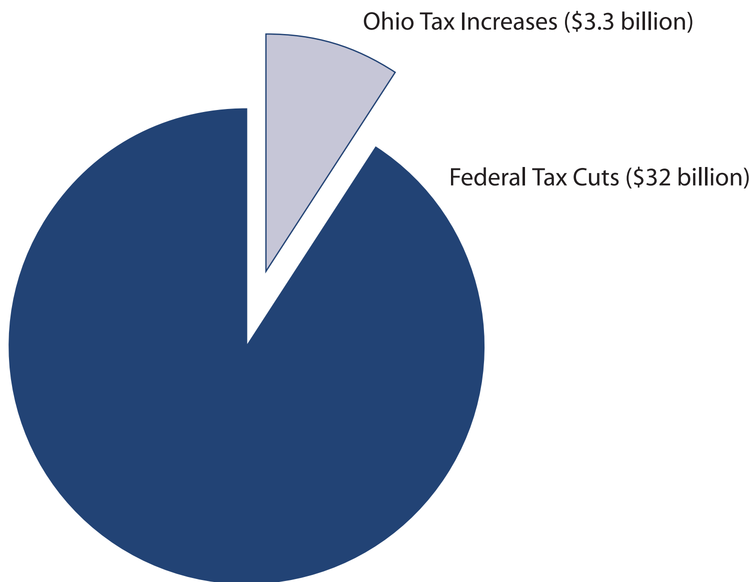
Year	Ohio Nominal Per Capita Tax Increase	National Average Nominal Per Capita Tax Increase	Total Difference
FY 2002	$2.89	$0.02	$2.87
FY 2003	$69.92	$0.50	$69.42
FY 2004	$144.10	$0.66	$143.44
FY 2005	$0.00	$0.24	$(0.24)
FY 2006	$71.89	$0.17	$71.71
Total	$288.79	$1.59	$287.20

Source: NASBO; Census Bureau

[8] Gross State Product (GSP) estimates are from the Bureau of Economic Analysis (BEA).

ined in total or per capita. Chart 3 shows data on the nominal tax increases from FY 2002 to 2006 in Ohio and all other states combined, and Table 9 shows data on the nominal per capita tax increase during the same period in Ohio and the average state. During this period, Ohio taxpayers saw per capita tax increases that were over $287 more than the national average. This reinforces the notion that Ohio lawmakers increased Ohio taxes during the recent recession far more than lawmakers in other states.

Chart 4: Ohio Tax Increases Take 10 percent of Bush Tax Cuts in Ohio (FY 2002-2006)



Source: NASBO; Department of Treasury

Table 10
Ohio Has Highest Combined Sales Tax Rate Among Surrounding States

State	State Rate	Weighted Average of County Rates	Combined Rate	Rank
Ohio	5.50	1.18	6.68	1
Indiana	6.00	0.00	6	3
Kentucky	6.00	0.00	6	3
Michigan	6.00	0.00	6	3
Pennsylvania	6.00	0.22	6.22	2
West Virginia	6.00	0.00	6	3
Average	5.92	0.23	6.15	

Source: Tax Foundation's 2006 State Business Tax Climate Index

While Ohio lawmakers were raising taxes on Ohio taxpayers, they were partially offsetting the effect of federal tax cut legislation passed by Congress and signed by President Bush. Chart 4 compares total Ohio tax increases in FY 2002—2006 with the total value of federal tax cuts attributable to Ohio over the same period. It shows that Ohio taxpayers saw 10 percent of the Bush tax cuts taken away by state tax increases.

Sales Tax System

A significant contributor to Ohio's status as a high-tax state is its sales and use tax system. A well designed tax system will have a low rate, apply to a broad base of consumer activities, and exempt business inputs from the tax base. Ohio's sales tax system compares unfavorably because it has a high rate and an uncompetitive base. For these reasons, Ohio's sales tax system ranks 45th out of 50 in the 2006 edition of the Tax Foundation's *State Business Tax Climate Index*.

Ohio's state sales and use tax rate is currently levied at a rate of 5.5 percent. Ohio's counties also levy local option sales taxes, and the weighted average of these rates is 1.18 percent. Combined with the state rate, Ohio has a combined rate of 6.68 percent. This combined rate is higher than the combined rate in any of Ohio's regional neighbors (see Table 10). The average combined rate in Ohio's region is 6.15 percent.

Ohio's sales tax—which was adopted on January 1, 1935—was initially levied at a rate of 3 percent.[9] This rate was unchanged until 1967, when the rate was raised to 4 percent. A temporary increase to 5 percent was adopted in 1982, and this increase was made permanent shortly thereafter. Another temporary 6 percent rate was adopted in the FY 2004 budget, and lawmakers permanently adopted a 5.5 percent rate as a result of tax reform legislation in 2005.

In 1967, Ohio added its first local rate: an optional 0.5 percent rate that could be levied at a county's discretion. In 1982, the state allowed a local county rate up to 1 percent, and in 1986 it was increased to 1.5 percent. The

[9] *See* Id. at 133-135.

state also allows additional local option rates for mass public transit purposes (see Chart 5).

In addition to high rates, Ohio also has an uncompetitive tax base because it fails to exempt a number of largely business-to-business transactions from its sales tax base (see Table 11). Out of the large number of tangible goods that are purchased largely as business inputs (e.g., manufacturing machinery and office equipment), Ohio has similar treatment to its neighboring states. On services, however, Ohio lags behind the region since it largely treats services as taxable, including cleaning, repair, and other professional services. On software, Ohio also lags the region since it includes custom software in the sales tax base.

Table 11
Ohio Lags Region in Excluding Business-to-Business Transactions from Sales Tax Base

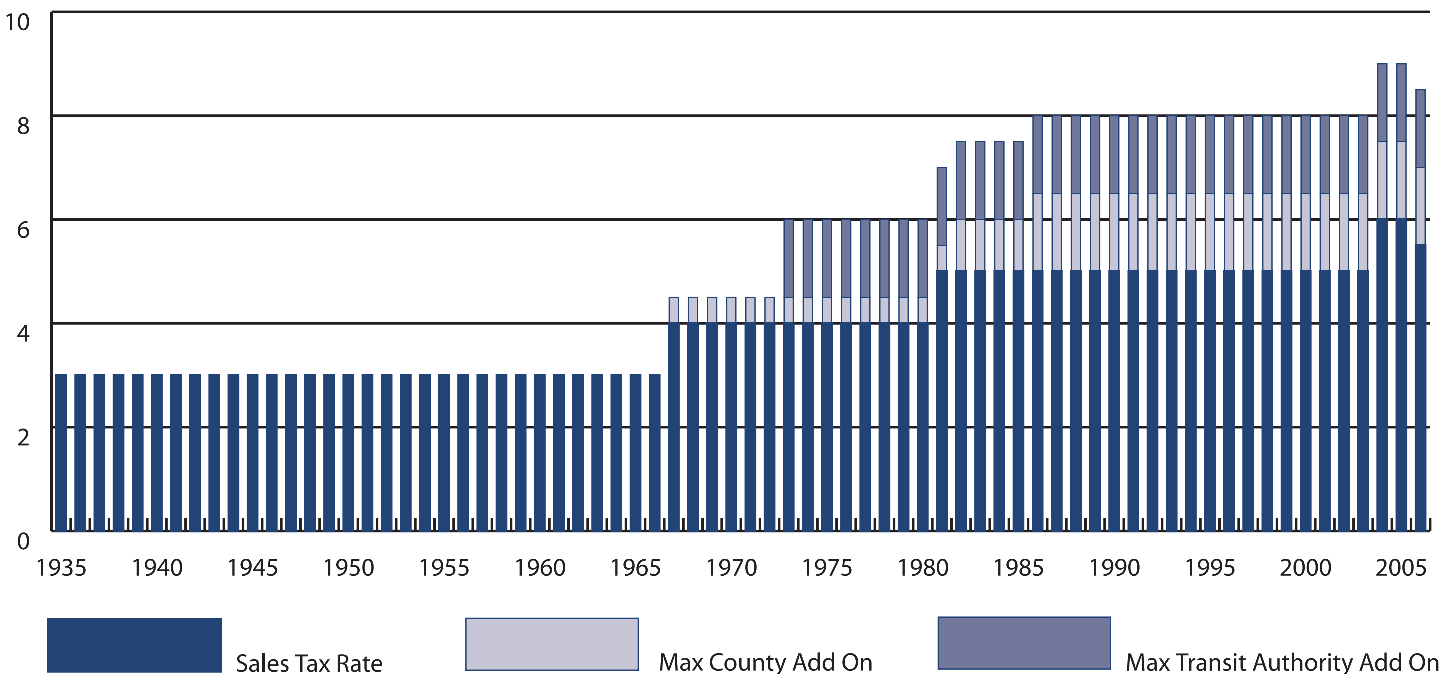
Business Input	Sales Tax Treatment in Ohio	Sales Tax Treatment in Majority of Surrounding States
Manufacturing equipment	Exempt	Exempt
Office equipment	Taxable	Taxable
General treatment of services	**Many Taxable**	Exempt
Cleaning	**Taxable**	Mixed
Transportation	**Taxable**	Exempt
Repair	**Taxable**	Mixed
Professional and personal services	Exempt	Exempt
Custom software	**Taxable**	Exempt
Modified software	Taxable	Taxable
Downloaded software	Taxable	Taxable
Motor vehicles	Taxable	Taxable
Rooms and lodging	Taxable	Taxable

Source: Tax Foundation's 2006 State Business Tax Climate Index

Business inputs should be excluded from the sales tax base because their inclusion causes "tax pyramiding"—i.e. the business pays tax for a service which it then uses to sell another service to a consumer, who then pays a "tax on a tax." There is almost unanimous agreement among economists that tax pyramiding gives companies an incentive to merge with their customers and their vendors, resulting in lower taxes but a less efficient, productive economy.

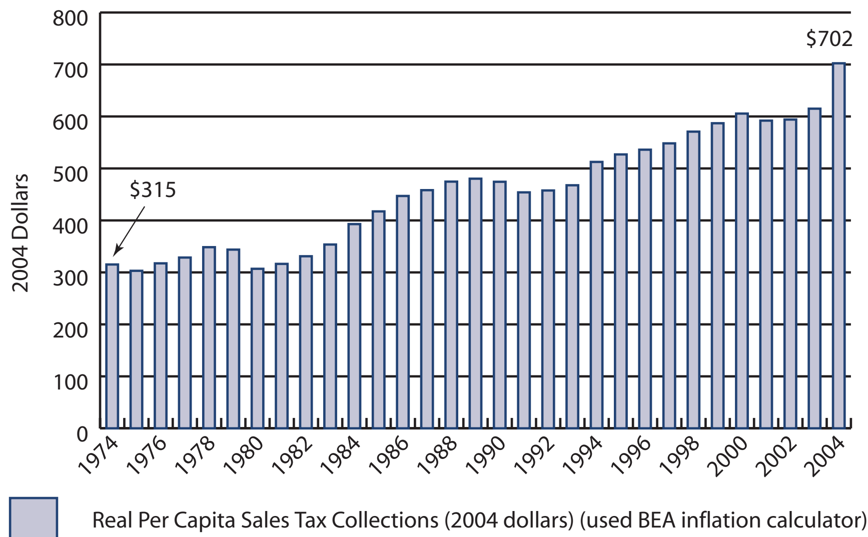
Because of its high sales tax rate and uncompetitive base, the Ohio sales tax collections have been steadily increasing (see Chart 6). Available data from 1974 to 2004 (roughly coinciding with the period in which Ohio's state and local sales tax rates were increasing) show a steady, upward march in real per capita sales tax collections in Ohio. In fact, even account-

Chart 5: Ohio's State Sales and Use Tax Rate Plus Maximum Local and Transit Authority Add Ons (1935-2006)



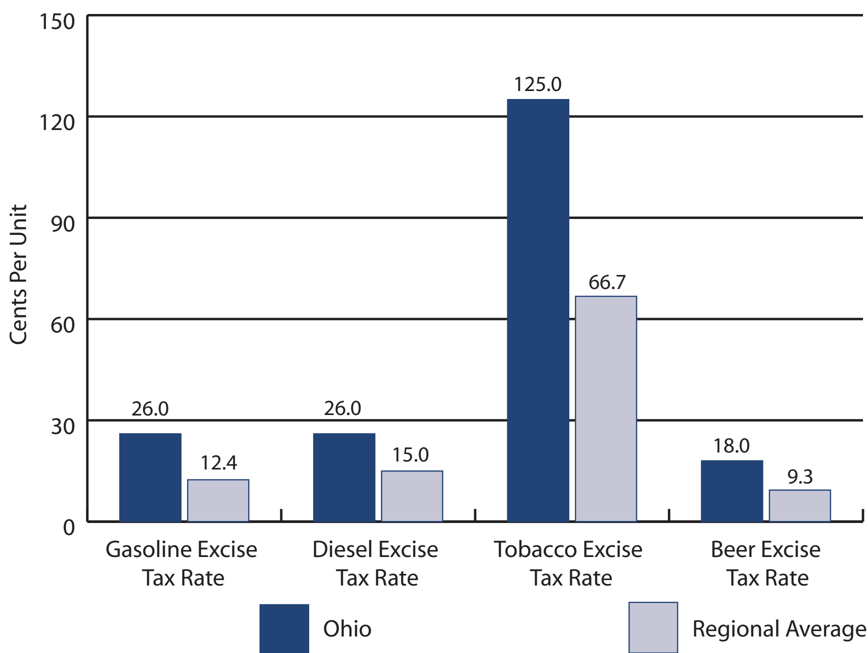
Source: Ohio Department of Revenue

Chart 6: Real Per Capita Ohio Sales Tax Collections (2004 dollars)



Source: Ohio Department of Revenue; Census Bureau; Bureau of Economic Analysis

Chart 7: Ohio Excise Tax Rates Exceed Regional Average



Source: Tax Foundation's 2006 State Business Tax Climate Index

ing for inflation, sales tax payments by Ohio citizens have doubled in the past 30 years, from just over $315 per person in 1974 to over $700 per person in 2004.

The biggest leap occurred in 2004, when the state raised the sales tax rate from 5 to 6 percent. In that year alone, Ohio's per capita sales taxes went from $614 to $702—rising almost $100 per person.

Excise Tax System

While Ohio has high sales tax rates and per capita sales tax collections, it also has high excise tax rates on gasoline and diesel of 26 cents per gallon. Excises on tobacco (125 cents per pack), and beer (18 cents per drink) also exceed the average levies in its region (see Chart 7).

Ohio lawmakers increased the cigarette excise rate twice in three years: first, by 31 cents in the FY 2003 budget, then by 70 cents in the 2005 tax reform plan.

Ohio lawmakers also raised the gasoline tax as part of a transportation package in the FY 2004 budget. The 6-cent increase was phased in through 2-cent incremental increases over a three-year period. Unfortunately, this tax increase has been followed by a period of rapid price increases caused by Middle East tensions and increased Asian demand.[10] The combination of high prices and higher taxes is an added drag on an already stressed Ohio economy.

Taxing Ohio Taxpayers' Assets

Ohio's wealth tax system—that is, the different ways in which Ohio taxes assets based on their value—also contributes to its high tax burden. Ohio taxes wealth in many ways, including general property taxes and a franchise tax on the net worth of corporations. Ohio also levies nearly every asset tax imaginable, including taxes on estates, intangibles, and inventories.

Even though many of Ohio's wealth tax levies might be individually justifiable, the competitiveness of Ohio's overall tax system is harmed by the fact that Ohio levies many more of them than its regional neighbors. For these

[10] See "Why Are Oil Prices So High?", *BBC News* (9/28/2004), located at http://news.bbc.co.uk/1/hi/business/3708951.stm.

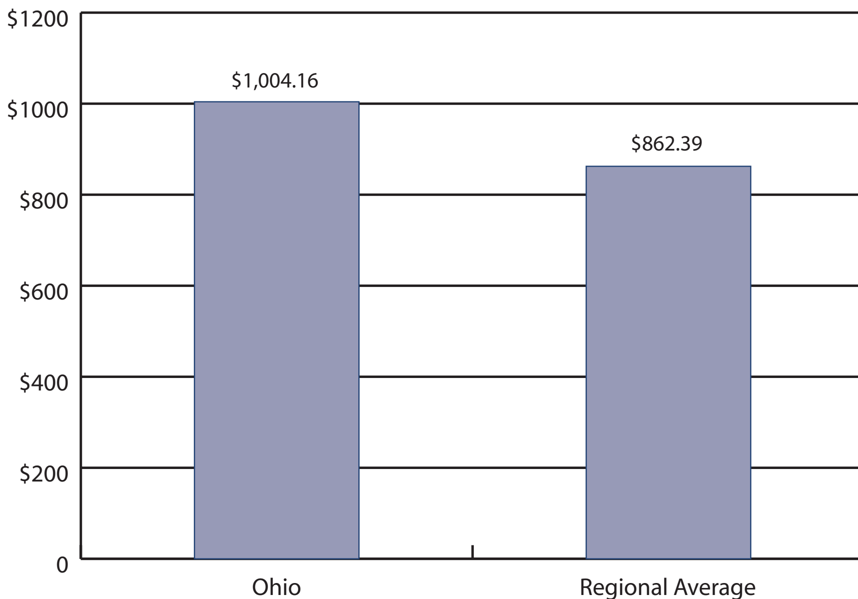
reasons, Ohio's wealth tax system ranks 48th out of 50 in the 2006 edition of the Tax Foundation's State Business Tax Climate Index. This ranking should improve in the near future, however, as Ohio lawmakers recently enacted a phase-out of the corporate franchise and inventory taxes.

Table 12
Ohio's Property Tax Collections Exceed Regional Average

State	Per Capita Property Tax Collections (FY 2005)	Regional Rank	Property Tax Collections as a Percentage of Income (FY 2005)	Regional Rank
Ohio	$ 1,004.16	3	2.97%	3
Indiana	$ 1,040.84	2	3.22%	2
Kentucky	$526.63	6	1.79%	6
Michigan	$1,127.95	1	3.26%	1
Pennsylvania	$941.09	4	2.57%	4
West Virginia	$533.65	5	1.97%	5
Regional Average	$862.39		2.63%	

Source: Tax Foundation

Chart 8: Ohio Residents Have Higher Property Tax Burden (Per Capita) Than Regional Neighbors (FY 2002)



Source: Tax Foundation's 2006 State Business Tax Climate Index

Property Taxes

The chief way that state and local governments tax wealth is through the property tax. Ohio's property tax collections—measured either on a per capita basis or as a percentage of income—are above average both regionally and nationally (see Table 12).

Ohio extracts an average of just over $1,000 from each person in the Buckeye State. In per capita terms, this ranks 3rd highest in Ohio's region, and 21st highest in the nation. Measured another way, in the most recent year's data, Ohio property tax payments equalled 2.97 percent of personal income, which ranks 3rd highest regionally and 19th highest nationally. Ohio's property taxes—measured either on a per capita basis or as a percentage of income—are well above the regional average (see Charts 8 and 9).

Franchise Taxes

Another way that Ohio taxes wealth is through a franchise tax on corporations. Ohio's franchise tax is an alternative calculation based on either net income or net worth—with the company paying whichever tax is higher.[11] Ohio law defines net worth as the total book value of a company's capital surplus.[12]

Table 13
Taxation of Corporate Net Worth in Ohio's Region

State	Corporate Net Worth Tax Rate	Rank
Ohio	0.400	3
Indiana	0.000	6
Kentucky	0.210	4
Michigan	0.000	6
Pennsylvania	0.699	2
West Virginia	0.700	1
Regional Average	*0.335*	

Source: Tax Foundation

Only four states in Ohio's region levy a corporate franchise tax measured by net worth. Of the four, Ohio has the third highest rate (see Table 13). Ohio's entire corporation franchise tax—measured either by net income or net worth—will be phased out through 2009 as part of the 2005 tax reform package. The tax

[11] Financial institutions always pay the net worth tax. *See* Ohio Rev. Code ß5733.06.

[12] See Ohio Rev. Code ß5733.05.

will be replaced by a tax on gross receipts (see section below for more details).

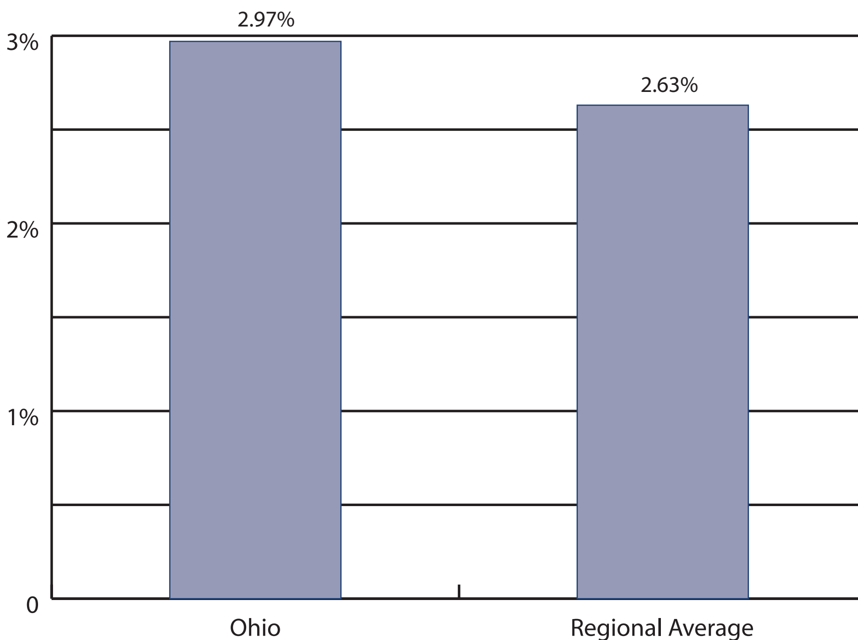
Transfer Taxes

Ohio also taxes wealth through the levy of taxes on asset transfers. The *2006 State Business Tax Climate Index* tracks seven asset transfer taxes commonly levied by state governments. Ohio levies five out of these seven asset taxes, and is one of only two states in its region to levy an estate tax (see Table 14). As part of the 2005 tax reform package, Ohio eliminated its tax on inventory, but it will not be fully phased out until 2009. At that point, Ohio will still levy four of the seven asset taxes covered in the *Index*; no state in its region currently levies more.

Ohio's estate tax was a two-tiered system. The first was a basic tax on estates, with rates ranging from 2 percent on estates under $40,000 to 7 percent on estates over $500,000.[13] The second tier was an additional tax that "picked up" the maximum allowable state credit on the federal estate tax return. Because—especially for larger estates—the federal credit was usually larger than Ohio's estate tax liability (calculated under tier one), this provided an additional source of estate tax revenue for Ohio.

When the federal government phased out the credit in 2005, Ohio responded by repealing its "pick-up" in a manner that conforms to the new federal estate tax laws. However, that still leaves Ohio with its own estate tax when only one other state in the region has one.

Chart 9: Ohio's Residents Pay Higher Property Tax Payments (as a percentage of income) Than Regional Neighbors (FY 2002)



Source: Tax Foundation's 2006 State Business Tax Climate Index

Table 14
Ohio's Treatment of Asset Transfer Taxes in Regional Context

State	Estate Tax	Intangible Property	Inventory	Real Estate Transfer	Inheritance	Generation Skipping	Gift
Ohio	Yes	Yes	Yes	Yes	No	Yes	No
Indiana	No	No	No	No	Yes	Yes	No
Kentucky	No	Yes	Yes	Yes	Yes	No	No
Michigan	No	No	No	Yes	No	Yes	No
Pennsylvania	Yes	Yes	No	Yes	Yes	No	No
W. Virginia	No	No	Yes	Yes	No	No	No
Majority	No	Mixed	Mixed	Yes	Mixed	Mixed	No

Source: Tax Foundation

Ohio Tax Reform: Assessing the Impact of House Bill 66

Last year, Ohio lawmakers implicitly acknowledged Ohio's status as a high-tax state by enacting a tax reform plan (contained in the state budget bill, H.B 66) that was designed to make Ohio a more attractive place for business investment. On signing the bill, Governor Taft remarked, "This historic tax reform plan creates a new business climate that will generate jobs, grow our tax base to support education and all public services and allow Ohio workers to support their family and their community."[14]

H.B 66 made the following major changes to the Ohio tax system:

[13] See 2004 Annual Report, supra note ___ (6), at 61-63.

[14] See http://www.governor.ohio.gov/releases/Archive2005/063005BudgetBill.htm.

- lowered personal income tax rates by 21 percent
- increased the cigarette tax to $1.25 per pack
- adopted a higher permanent sales tax rate of 5.5 percent
- enacted a multi-year phase-out of the state's corporation franchise tax in exchange for a new, phased-in tax on gross receipts
- started a multi-year phase-out of the tangible personal property tax and the inventory tax.

These changes were designed to "create a more competitive business climate."[15]

Ohio lawmakers have raised taxes no less than four times in the past five years.

It is obviously too early to tell whether H.B. 66 will succeed in its objective. but we can analyze H.B. 66 from the perspective of sound tax policy. On this ground, H.B. 66 is a mixed bag, with some positive changes, but not enough to expect that it will significantly change Ohio's status as a high-tax state.

Does H.B. 66 Qualify as Tax Reform?

At the outset, it should be noted that H.B. 66 was not tax reform in the true sense of the word. The objective of tax reform is to restore the tax system to an economically ideal state, where the tax code is purged of unnecessary tax credits and deductions and all taxpayers pay one low rate. This type of system is not only the most fair, but it is also the most competitive, since low rates and a broad base will—all else being equal—attract a diverse flow of business and capital investment.

With the possible exception of the new gross receipts tax, H.B. 66 did not make any significant changes to Ohio's tax base. It lowered some tax rates and raised others, but did not significantly broaden Ohio's tax base. Thus, it fails the first and most primary objective of fundamental tax reform.

That is not to say that all of the changes were bad. Changes likely to help the state's economy include:

- 21 percent reductions in Ohio's personal income tax rates (these were important because Ohio has nine personal income tax brackets with a top rate of 7.5 percent—the highest in its region)
- Elimination of the inventory tax (a punitive tax for businesses, especially during a recession when inventories can pile up)
- Elimination of the net worth component of the corporation franchise tax (a pro competitive move that is part of a growing trend in many states[16])

Changes that will hurt Ohio taxpayers include:

- An increase in the cigarette tax to $1.25 per pack (which will cause cross-border purchases and smuggling to rise, as well as extract revenue from a generally low-income segment of Ohio taxpayers)
- Adoption of a permanently higher sales tax (Ohio's sales tax system is already uncompetitive and the adoption of a permanently higher 5.5 percent rate continues this trend.)
- An overall increase in tax revenues (NASBO estimated that H.B. 66 raised Ohio tax revenues by over $800 million in FY 2006. True tax reform is revenue neutral.)

A Major Change That Is Difficult to Analyze

The major—and in many ways, central—component of H.B. 66 was the imposition of a new business tax called the Commercial Activities Tax (CAT). The CAT was adopted to replace the corporate franchise tax and the inventory tax. The CAT is levied on a business's gross receipts—that is, the total revenue the firm receives from the sale of its products or services. Under the corporation franchise tax, an Ohio

[15] See http://www.governor.ohio.gov/releases/Archive2005/020805SOS.htm.

[16] See, e.g., H.B. 2548, 2006 Leg. (Ks. 2006); H.B. 1619, 2006 Leg. (Mo. 2006).

company would pay tax either on its net income (revenues minus expenses) or its net worth (book value of its capital surplus).

Even when lawmakers tried to reform Ohio's tax system in 2005—perhaps a tacit admission that taxes were too high—they still ended up raising taxes overall and imposing a new business tax that could seriously harm the competitiveness of Ohio's tax system.

The adoption of gross receipts taxes by states is a growing trend. No fewer than four states have adopted some version of a gross receipts tax in recent years, including Kentucky (where the gross receipts tax is an alternative assessment), New Jersey (also an alternative assessment), Ohio (the CAT), and most recently, Texas. Of the four states that have adopted gross receipts taxes, Ohio's is the most comprehensive, since it is a stand—alone tax (unlike Kentucky and New Jersey) which allows no deductions (Texas allows a company to deduct either wages or cost of goods sold).

The CAT (and gross receipts taxes in general) gives rise to a host of potential problems, including:

- The nexus[17] standard for the CAT is possibly broader than the Constitution allows (the CAT purports to apply to those corporations who derive sales from Ohio without any physical presence)
- Tax pyramiding could be a problem (the tax applies at each stage of the production process without any adjustment for taxes previously paid for goods and services; this will distort business investment choices by creating an incentive for integration of the production process)
- Many businesses will have to pay the tax even when they are not profitable (since gross receipts are still received in years when expenses exceed revenues)[18]
- Even during boom times, businesses with low profit margins will pay a disproportionate tax compared to businesses with high profit margins. (Normal corporate income taxes hit profits, putting high- and low-margin firms on a level playing field.)

It is difficult to analyze the impact the CAT will have on Ohio's tax system. It certainly does broaden the Ohio tax base, permitting a lower rate, but the CAT base may actually be too broad, with the result that it will penalize some industries and let others off lightly.

This will certainly pose a problem for Ohio from a competitive standpoint, since most other states levy taxes on net income. Ohio tries to get around this problem by making physical investment irrelevant—i.e. the tax is due solely based on Ohio—based sales. It remains to be seen whether this approach will pass constitutional muster.[19]

For these reasons, Ohio lawmakers who think the CAT will improve Ohio's business tax climate are likely mistaken. In fact, the CAT could worsen the state's business tax climate and perpetuate Ohio's standing as a high-tax state.

[17] Nexus determines when a state may constitutionally compel a business to pay a tax. It typically involves a determination that the taxpayer's presence in a state is sufficient such that it is deriving sufficient benefits from the state to justify imposition of the tax.

[18] See Bernert, et al, *2005 Tax Reform: The Emergence of the CAT*, located at http://www.bakerlaw.com/PublicDocs/News/Alerts/TheEmergenceoftheCAT12305version2.pdf ("The CAT should provide greater stability to the tax system in that during economic downturns, the tax should remain relatively constant. Moreover, the tax will not be offset by net operating loss deductions on an ongoing basis. It is unknown how the existence of a tax that must be paid irrespective of profitability will affect investment decisions.").

[19] See generally Chris Atkins, *A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems*, Tax Foundation Background Paper No. 49 (September, 2005), located at http://www.taxfoundation.org/publications/show/1096.html.

Conclusion

The available data on the level of taxation in Ohio lead us to one inescapable conclusion: Ohio is a high tax state where, all else being equal, economic activity will lag.

If lawmakers want to reduce the tax burden, they should look to reduce sales and wealth taxes. These are the areas where Ohio's tax system compares unfavorably in the region.

Ohio has a high tax burden (measured either as a percentage of income or on a per capita basis), high sales tax rates, high excise tax rates, high property tax collections, and imposes many more asset transfer taxes than its regional neighbors.

The available data also clearly indicate that Ohio's policy choices in the past 36 years have played a role in Ohio's ascent to the top of the tax burden rankings. In the period covered by the data, Ohio has imposed a major tax on income, raised the rates of that tax, raised state and local sales tax rates, and raised the excise levies on tobacco and gasoline. Even in the midst of reforming the state's tax system last year, Ohio lawmakers still raised taxes overall.

What should happen from here? If lawmakers want to reduce the tax burden, they should look to reduce sales and wealth taxes as the areas where their tax system compares unfavorably in the region. They may also have to revisit the Commercial Activities Tax (CAT) if, as seems likely, it turns out to do more harm than a conventional corporate income tax. A constitutional tax and expenditure limitation, which would restrict the growth in the state's budget and therefore presumably taxes as well, is the only effort that would lead in that direction.

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Editor and Communications Director, Bill Ahern

Tax Foundation
2001 L Street, NW, Suite 1050
Washington, DC 20036
(202) 464-6200
(202) 464-6201 fax
www.TaxFoundation.org
TF@TaxFoundation.org