EXECUTIVE SUMMARY OF: "REVENUE OPTIONS FOR OHIO'S FUTURE"
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This report presents an overview of Ohio's state and local tax system with an eye toward presenting policy options in the wake of the 2008-09 economic recession. We first provide some necessary context by considering Ohio's tax system and tax burden in comparison to those in other states, and also by summarizing and evaluating the performance of the broad package of tax policy changes implemented by House Bill 66 in 2004. We then take a detailed look at Ohio's three major taxes—the individual income tax, the general sales tax, and the property tax—in order to provide informed options about policy changes that could provide revenue flexibility going forward.

Ohio's state and local tax burden is similar to the national average and is also near the median of a set of benchmark states. State-level taxes in Ohio were a smaller share of the economy in 2009 than in 1994, and preliminary data suggest a continued decline in 2010. While the state-level tax burden in Ohio is the 17th lowest among all states (and is also very low relative to most of the benchmark states), it is important to recognize that local taxes contribute a relatively larger share of combined state and local taxes in Ohio than in most other states.

Tax revenues in Ohio were growing more slowly than the state's economy even before the recent recession. State tax revenues have shrunk by 14.6 percent during the recession. This impact has been much worse than the average state's 11.1 percent decline. The recession and H.B. 66 have resulted in Ohio's General Revenue Fund having about $3 billion less in revenue per year than would have been anticipated during the development of H.B. 66. Though tax revenues have begun to grow again, the effects of lower revenues on public service expenditures will be strongly felt with the expiration of the ARRA stimulus funds beginning in July 2011. Ohio and its leaders need to decide quickly whether the resulting decline in important public services is consistent with service demands by the state's citizens or if new revenue sources should be found.

H.B. 66 brought a variety of tax policy changes to Ohio, including the phase-out of the Tangible Personal Property Tax and Corporate Franchise Tax, the phase-in of the new Commercial Activity Tax (CAT), reductions in individual income and sales tax rates, and an increase in the cigarette tax rate, among other things. Assessment of the performance of H.B. 66 is difficult because the reforms were phased in between 2005 and 2009, which partially overlapped the recession, and the fact that it may simply be too early to fully evaluate the reforms. In general, we find that H.B. 66 reduced the overall progressivity of Ohio's tax system while generally improving efficiency by reducing distortions of economic activity. At the same time, while H.B. 66 likely led to improvements in overall tax compliance and administration, it also hindered the tax system's ability to keep up with the economy. Taxes imposed directly on businesses were increased via the CAT as the set of business taxpayers was dramatically expanded. On the other hand, elimination of the tax on business tangible personal property during a similar window of time resulted in a net reduction in business tax liabilities.

Income taxes are the largest source of state and local tax revenues in Ohio at 30.0 percent. Ohio's state-level individual income tax structure is not grossly out of line with most other income-taxing states. While Ohio has more tax brackets than most other states, the top rate is below the national median and average and also applies to a higher-than-typical starting income level of $200,000. The tax base is at least as broad as those in other states, in that federal adjusted gross income (AGI) is the starting point, exemption amounts are lower than national averages, and few deductions are permitted. Most policy actions that would increase conformity with individual income tax systems in other states, such as the provision of additional deductions or credits, would therefore be revenue-reducing, and many of them would not be good policy options for other reasons.

From the perspective of revenue productivity, broader taxation of Social Security, railroad retirement, and other retirement income sources would offer the most productive base-broadening option. Specifically, Ohio could realize up to $244 million per year in additional revenues if it removed the exemption for federally-taxable Social Security and railroad retirement income and another $120 to $135 million if it removed the retirement income tax credit. While such reforms would be admittedly politically unpopular, they could result in improvements in both equity and efficiency (by, for example, keeping relative taxes on workers low) without resulting in significant out-migration of retirees. That said, it appears that marginal tax rate increases would be more fruitful in terms of revenue enhancement. We estimate that returning to pre-H.B. 66 marginal tax rates would generate up to about $2.5 billion in new revenue. Limiting such a rate increase to filers with taxable income above $100,000 would generate up to about $1.6 billion. Reversing half of the H.B. 66 rate reductions to-date would generate up to about $1.0 billion.

Ohio's reliance on the sales tax is very similar to the national norm. Ohio's state sales tax rate is below the national median, but the combined state and local rate is at the national median. The base of taxable transactions is a relatively smaller share of the state's economy in Ohio than the national average, but it has not declined as rapidly as in most other states. Rapid growth in service consumption, much of which is not taxed, and robust expansion of remote sales have been the primary forces behind the narrowing of Ohio's tax base relative to the economy. Ohio taxes more services than many states but does not tax many of the more rapidly growing services. Ohio could help stabilize its sales tax base relative to the economy, improve revenue growth, and reduce the distorting effects that arise when goods are broadly taxed while many services are exempt if the taxation of services were broadened. Construction, marina, cable TV, sports, digital media, parking lots, amusements, and some professional services are among services that could be added to the base, though others can easily be identified. Any expansions of the base should be carefully designed to avoid greater taxation of business purchases. Restaurant takeout food could also be added to the base. Finally, Ohio could take stronger steps to seek better compliance with the sales tax on remote transactions, such as by becoming a full member of the Streamlined Sales Tax Governing Board.

Property taxes are the largest local government tax source in Ohio, just as they are in the rest of the country, though the share of revenues raised by the property tax is somewhat lower in Ohio than in the average state. Ohio's counties and other local governments differ radically in the effective tax rates that must be imposed to generate property tax revenues (because of the large variation in per capita property tax bases) and in the amount they actually raise from the property tax. The differences in revenue generation capacity are moderated to some extent by state programs, such as the evidence-based model used for education finance. Ohio's recent decision to narrow the property tax base to real property is good policy, though it has shifted property tax burdens relatively more towards households and away from business.

Three key issues are identified with the property tax. However, these are not easily addressed without comprehensive reform, and some fixes could require a constitutional amendment. First, the property tax is overly complicated and not transparent to taxpayers for reasons including the very large number of ballot initiatives and detailed funding options on which taxpayers are voting, the complex method of calculating gross and net tax rates using tax reduction factors, and the role of various tax credits. The result surely is that few taxpayers actually understand how their tax liability is being determined. Second, the property tax is strongly interconnected with education finance in ways that further complicate how the tax operates. Finally, the state has narrowed the property tax base in a variety of ways over the past several decades. The results have been greater stress on the state's fiscal condition because of reimbursements made to local governments, the requirement for higher tax rates to generate any given amount of revenue, and shifts in the relative tax burdens across businesses and households.