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Analysis finds that cutting Ohio's tax on capital gains would be costly, 92% of Ohioans would get nothing

Cutting the Ohio income tax on capital gains would be costly and most of the gains would go to the most affluent Ohioans, while 92 percent of Ohio taxpayers would get nothing at all.

Those are among the conclusions of an analysis performed for Policy Matters Ohio by the Institute on Taxation and Economic Policy, a nonprofit research organization in Washington, D.C., that has a computer model of the tax systems of all the states. ITEP also analyzed and came to similar conclusions with House Bill 98, which would allow elderly Ohioans to reduce the income-tax rate on all unearned income, including capital gains.

The analysis on excluding all capital gains from the income tax indicates that roughly three-quarters of such a cut would go to Ohioans in the top 1 percent of the income spectrum, with income of at least $321,000 a year. They would average a tax cut of more than $6,500 a year.

By contrast, lower- and middle-income taxpayers would reap very little; a full exclusion of capital gains from the state income tax would mean an average tax cut of just $2 a year for middle-income taxpayers. Altogether, the bottom four-fifths of Ohioans, who make less than $75,000 a year, would receive only 2 percent of the total tax cuts.

Even if not initiated immediately, a capital gains cut also would tear a hole in future budgets. ITEP calculated that reducing the capital gains rate to 1 percent would cost the state nearly $400 million a year in revenue, while eliminating it altogether would bring the annual loss to more than $480 million.

Capital gains are the profits one realizes from selling assets such as stocks, bonds, businesses, investment real estate, art or antiques. The table below shows how different income groups would fare if state income taxes on capital gains were eliminated:

Analysis of Excluding Capital Gains from Ohio Income Tax

Ohio Residents, 2010 Income Levels							
2010 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $18,000	$18,000 - $32,000	$32,000 - $49,000	$49,000 - $75,000	$75,000 - $$136,000	$136,000 - $321,000	$321,000 Or More
Average Income in Group	$11,000	$24,000	$40,000	$61,000	$96,000	$194,000	$880,000
Tax as % of Income	—	–0.0%	–0.0%	–0.0%	–0.1%	–0.2%	–0.7%
Average Tax Change	$ -	$ (2)	$ (2)	$ (9)	$ (56)	$ (297)	$ (6,533)
Percent of Total Tax Change $	—	0%	0%	2%	9%	13%	74%

SOURCE: Institute on Taxation and Economic Policy Microsimulation Tax Model, March 2011

Only eight of the 41 states with income taxes currently offer substantial tax breaks for income derived from capital gains. Some of these states have reduced or eliminated these tax breaks. Rhode Island eliminated its special rates for capital gains income in 2010.

There is little connection between lower capital gains taxes and economic growth at the national level. [1]

Cutting capital gains taxes at the state level is especially unlikely to improve economic growth. That's because such taxes apply to investments whether they are made in the state where the investor lives or not. If Ohio offers an exclusion on capital gains, Ohio investors get the same tax cut whether they invest in Ohio or anywhere else. They will invest where they can get the highest return, and that won't be affected by a lower capital gains tax in Ohio.

Affluent Americans are actually slightly less likely to live in states without an income tax than in states with such a tax. According to the Center on Budget and Policy Priorities, a Washington, D.C., research organization, a slightly smaller share of all taxpayers with income over $200,000 in 2005 lived in states without income taxes than the share of all taxpayers in those states.

In addition, because of the interaction of the federal tax code, a cut in the state tax rate on capital gains would lead to higher federal tax bills and a greater flow of income out of the state to the federal government. It would reduce the deductions that can be itemized on federal tax returns, leading ITEP to estimate that what Ohioans would save in state income tax from an exclusion of capital gains would be reduced by $73 million a year.

Ohio already has substantially reduced income taxes for the most affluent. In 2005, the General Assembly approved a tax overhaul that reduced income-tax rates by 21 percent. Because Ohio has a graduated income tax, much of this gain went to the wealthiest Ohioans. Those in the top 1 percent of the income spectrum on average are already set to enjoy a tax cut averaging $10,000 this year as a result

[1] See, for instance, Burman, Leonard and Kravitz, Troy, "Capital Gains Tax Rates, Stock Markets and Growth," *Tax Notes*, November 7, 2005, cited in Institute on Taxation and Economic Policy, "A Capital Idea," January 2011, p. 7.

of these already-enacted tax cuts, according to a previous ITEP analysis, and more than 40 percent of the total reduction is going to those making at least $135,000 a year.

The General Assembly also made it easier for Ohioans who spend much of their time out of state to avoid paying state income taxes, by loosening the residency requirement. However, Ohio's economy has continued to lose ground to the rest of the country. Meanwhile, revenue available for needed public services has been slashed.

House Bill 98

House Bill 98 would allow taxpayers 70½ and older to choose to have their unearned income taxed at a 1 percent rate beginning in 2013. Unearned income is any income other than wages, salaries, tips, deferred compensation, other employee compensation, or net earnings from self-employment. Thus, it includes capital gains, but also dividends and interest income.

For those older Ohioans with the lowest incomes, this would not be advantageous, since they pay a lower rate than that now. However, for those paying the top rate of 5.925 percent on income over $201,800, this would be a windfall.

ITEP's analysis of HB 98 covered Ohio residents age 71 and over, a slightly smaller group than those at least 70½. It found that half the tax cut would go to the less than 1 percent of older taxpayers with annual income of $321,000 or higher. Altogether, those taxpayers would average a tax cut of more than $3,000 a year.

Since HB 98 also would cut taxes on other unearned income besides capital gains such as dividends and interest, a somewhat greater share of taxpayers would benefit. However, the tax cuts would still be heavily concentrated among the most affluent older Ohioans. Only just over a third of all taxpayers age 71 and over would benefit from the tax reduction at all; 66.5 percent would not. Even those with incomes between $75,000 and $136,000 would receive on average just an $83 cut in annual income taxes.

Analysis of HB 98 (Optional 1% on Unearned Income for Those Over 70)

Ohio Residents, 2010 Income Levels							
Income Range	Less Than $18,000	$18,000 - $32,000	$32,000 - $49,000	$49,000 - $75,000	$75,000 - $136,000	$136,000 - $321,000	$321,000 Or More
Average Income in Group	$11,000	$24,000	$40,000	$61,000	$96,000	$194,000	$880,000
Tax Change as % of Income	—	–0.0%	–0.0%	–0.0%	–0.1%	–0.1%	–0.3%
Average Tax Change	$ -	$ (0)	$ (3)	$ (28)	$ (83)	$ (264)	$ (3,012)
Percent of Total Tax Change $	—	0%	1%	10%	21%	18%	51%

SOURCE: Institute on Taxation and Economic Policy Microsimulation Tax Model, March 2011

Note: Distribution of taxpayers 70 and above in income categories is not the same as for all taxpayers. For instance, Ohio seniors with income of $321,000 or more represent less than 1 percent of all seniors

House Bill 98 would cost about $325 million in lost annual tax revenue to the state, according to the ITEP analysis. Though that could slightly understate the total since it does not cover those between 70½ and 71, the Legislative Service Commission previously has estimated the revenue loss at roughly $360 million.

House Bill 98 also would add lines to the income-tax form and complicate the job of filling it out. That's because seniors would need to divide up their income between earned and unearned income, and figure their tax two different ways. Exemptions would be subtracted first from earned income, and if the exemption amount exceeds earned income, the excess is to be subtracted from unearned income. Individuals choosing the 1 percent rate on unearned income could not subtract the state's retirement income credit of up to $200.

Ohio does not tax Social Security benefits, and offers a $50 senior citizen credit.

Policy Matters Ohio is a nonprofit, nonpartisan research institute with offices in Cleveland and Columbus.