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Most Ohio families lose under flat-tax proposal

Replacing Ohio's graduated income tax with a flat, 3.25 percent tax would increase taxes on most Ohioans, while costing the state nearly half a billion dollars in annual revenue. Meanwhile, the richest Ohioans would reap thousands of dollars on average in annual tax savings apiece.

The top 1 percent of Ohio taxpayers, those making more than \$295,000 a year, would on average save \$13,805 a year. Meanwhile, those in the middle fifth of the income spectrum – making between \$30,000 and \$46,000 a year – would average an annual tax increase of \$237. A flat tax would make middle-income Ohioans pay more, so upper-income Ohioans could pay less.

Those were among the findings of an analysis by the Institute on Taxation and Economic Policy (ITEP), a nonprofit, nonpartisan research group in Washington, D.C., with a sophisticated model of the state and national tax systems. The report was released today by Policy Matters Ohio.

The analysis compares a 3.25 percent tax with the state income tax as if all of the five-year, 21 percent tax cut the Ohio General Assembly approved last year had been fully phased in. It also retains credits and exemptions as written in existing law, with one exception: The current credit that allows those earning \$10,000 a year or less to pay no Ohio income tax is revised to assure that the same would be true under the flat tax.

Of course, a flat tax could also be written with different levels of exemptions and credits, which would affect the amount of taxes paid. More generous exemptions that would reduce the amount middle-income taxpayers lose from a flat tax would also further increase the state's revenue losses.

Overall, 61 percent of Ohio tax-filers would pay more in state income taxes if this flat-tax proposal were enacted, while only 16 percent would pay less. The remainder would see no change in their income-tax liability. The table below shows how such a tax cut would affect Ohio taxpayers at different income levels:

How we measured the cut

The impact of any Ohio income tax proposal depends on what an analyst measures it against. Tax changes enacted in 2005, which may be accelerated under a proposal now in the legislature, are scheduled to drop the top Ohio income tax rate from 7.5 percent to 5.925 percent by 2009 (and will drop the bottom tax rate from 0.743 percent to 0.587 percent). This already-enacted change means that the additional benefit from any future income tax cuts will be less and less as time goes on. A flat-rate 3.25 percent tax will benefit fewer and fewer Ohioans as the already-enacted income tax cuts continue to phase in. For this reason, we have measured the impact of the flat-tax concept compared to the "fully-phased-in" income tax rules as enacted by the legislature last year.

| Impact of a Flat 3.25% Income Tax on Ohio Taxpayers | | | | | | | |
|--|--------------------|----------------------|----------------------|----------------------|-----------------------|------------------------|-------------------|
| All Ohio Taxpayers, 2005 | | | | | | | |
| 2005 Income Group | Lowest 20% | Second 20% | Middle 20% | Fourth 20% | Next 15% | Next 4% | Top 1% |
| Income Range | Less Than \$17,000 | \$17,000 to \$30,000 | \$30,000 to \$46,000 | \$46,000 to \$71,000 | \$71,000 to \$128,000 | \$128,000 to \$295,000 | \$295,000 Or More |
| Average Income in Group | \$10,000 | \$23,000 | \$38,000 | \$57,000 | \$91,000 | \$180,000 | \$762,000 |
| Tax Change as a % of Income | 0.5% | 0.9% | 0.6% | 0.3% | -0.2% | -0.9% | -1.8% |
| \$ Average Tax Change | +\$51 | +\$219 | +\$237 | +\$154 | -\$142 | -\$1,593 | -\$13,805 |

Source: Institute on Taxation and Economic Policy, September 2006

A separate tax calculator prepared by ITEP spells out how Ohio taxpayers with different family sizes and incomes would fare under a flat Ohio income tax (unlike the model, the calculator covers only taxpayers under age 65 and excludes the state dependent care credit):

| Hypothetical family | Tax change |
|--|-------------------|
| Single man earning \$10,000, no children | \$0 |
| Married couple earning \$23,000, one child | + \$236 |
| Married couple earning \$38,000, two children | + \$225 |
| Single mother earning \$57,000, two children | +\$119 |
| Married couple earning \$91,000, two children | -\$172 |
| Married couple earning \$180,000, two children | -\$1,929 |
| Single man earning \$762,000, no children | -\$17,588 |

Source: Institute on Taxation and Economic Policy, September 2006

This tax cut would reduce annual Ohio tax collections by \$498 million. Ironically, most of the state tax savings would never flow to Ohio taxpayers in any event. Many Ohioans would have to pay higher federal taxes because they would have less state income tax to write off on their federal returns. The \$498 million state tax cut under this plan would be partially offset by \$272.8 million in federal income-tax increases for those who itemize on their federal forms. That would leave a net tax cut of just \$225.2 million for Ohioans from this plan—even though Ohio revenues would decline by the full \$498 million. In other words, Ohioans would save less than half of what the state of Ohio would lose in foregone tax revenues.

| | |
|----------------------|-----------------|
| State Tax Cut | \$498 million |
| Federal Tax Increase | \$272.8 million |
| Net tax change | \$225.2 million |

Another recent report from Policy Matters Ohio found that the size of a state’s public sector is not correlated with private-sector economic growth (See *State Economic Growth and the Public Sector*, September 2006, http://www.policymattersohio.org/state_economic_growth_2006.htm). Nor do states with lower state and local tax levels have higher per capita personal income or gross state product. This undercuts the notion that a tax cut resulting from a flat, 3.25 percent tax would provide Ohio with economic gains.

Flat-rate income taxes remain very much the exception among U.S. states. While only six states have flat-rate income taxes, 35 states and the District of Columbia have income taxes with graduated rates.

Policy Matters Ohio (www.policymattersohio.org) is a nonpartisan, nonprofit research institute with offices in Cleveland and Columbus. ITEP's Microsimulation Tax Model allows it to measure the distributional consequences of federal and state tax laws and proposed changes in them, both nationally and on a state-by-state basis. A description of the tax model can be found on ITEP's web site, www.itepnet.org.