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Budget and tax

Rebalance the income tax to build a better Ohio for everyone

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Policy Matters Ohio

Introduction

Ohioans are taking care of each other, wearing masks, donating funds and food, and caring for family and friends in need. But none of us, even doing all we can, are able to build the bridge to recovery. The pandemic and recession have shown the importance of public services, from public health monitoring, testing and tracing to foodbanks and unemployment compensation. It's harder in Ohio than elsewhere because policymakers let important public services erode for years, even before Governor DeWine slashed $776 million out of the 2020 budget in May.

For the past 15 years state lawmakers cut income tax for the wealthiest people and corporations at the expense of things that benefit everyone, like public education, infrastructure and public health programs. Now the wealthiest 1% of Ohioans pay over $40,000 a year less in state taxes, on average, than they did in 2005. People in the middle pay about the same and at the lower end, they pay more. Now Ohio's state and local tax system is upside down: The poorest Ohioans pay almost double the share of their income in state and local taxes as the wealthiest. This happens as the latest census data on income and poverty shows that despite overall economic improvements last year, poverty remained unacceptably high, particularly in households headed by Black (28.7%) and Hispanic (31.1%) women.[1] These groups also suffer higher unemployment and the harshest economic setbacks in the pandemic recession.[2]

Ohio policymakers can use public resources to make life better for all Ohioans

46 states spend more per capita on public health; Ohio is 47th in pulling down federal public health funds.

42 states have healthier residents and health disparities here are increasing sharply.

Inequitable state school funding was found unconstitutional in 1997; lawmakers have yet to make a fix.

36 states have better rates of high school graduation; 46 do better in graduating Black teens.

Ohio ranks 35th in college affordability but 44th in terms of affordability for students of modest income.

The share of Black undergraduates in Ohio's public universities dropped by 15.4% since 2010.

30 states do better in child health in the 2020 Annie E. Casey Foundation ranking.

Ohio had the third highest Black infant mortality rate in the nation in 2018 and ranked 40th among the states in white infant mortality.

Only two states make it harder to get childcare aid than Ohio.

For source info, see Appendix 1.

[1] Shields, Michael, "New Census data show improvements in historic expansion," Policy Matters Ohio, September 15, 2020 at https://bit.ly/30yS3li

[2] Rockeman, Olivia, Reade Pickert and Catarina Saraiva, "The First Female Recession Threatens to Wipe Out Decades of Progress for U.S. Women," Bloomberg News, September 30, 2020 at https://bloom.bg/2GnPge4

There are many policy initiatives that can help. One is better tax policy. Better tax policy can also help Ohio pay for long-eroded services. Because of the many years of income tax cuts, Ohio has $7 billion less – every year - for schools, public health, children's services, financial aid, infrastructure and other important public services[3] and has fallen in quality of life indicators. (See box for details.)

We outline in this paper how state lawmakers' tax cutting strategy was sold as the best way to spur the creation of jobs, but it didn't work: Ohio's rate of job growth continues to lag that of the nation. Research by the Institute on Taxation and Economic Policy (ITEP) demonstrates that states with the highest income tax rates have done slightly better than states with no income taxes.

In this year of pandemic and recession, long-term disinvestment in public services - from outdated public health information technology[4] to inadequate technology and staffing in the unemployment compensation system[5] – have hindered timely responses to immediate, pressing needs. State lawmakers need to restore investment to address those needs, boost productivity and protect Ohioans from the next crisis.

At the time this paper is posted, the state Office of Budget and Management has not revised its forecast budget deficit of $2.4 billion in fiscal year 2021, which ends next June.[6] If Governor DeWine and Ohio lawmakers resort to more spending cuts to handle the shortfall, they will hurt struggling families and eliminate jobs that stabilize many middle-income households. In a recession, public sector job loss ripples through the community and damages local economies. Tax increases on high-income people who aren't living paycheck-to-paycheck and who have, as a group, rebounded from the recession, are less economically damaging. A cut to the state's budget that causes layoffs of teachers, for example, hurts their families and the local economy as they reduce purchases of groceries, gasoline, childcare and other basic necessities. [7] A tax increase on wealthy people has less impact because it falls on savings or investments instead of spending into the local economy.[8] This is why New Jersey just raised income tax rates on its wealthiest residents in the pandemic recession.[9] Illinois, Arizona, New York, California and Rhode Island are considering or in the process of doing so.[10] Other states have proposals to strengthen the tax structure in various ways.[11]

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[3] Institute on Taxation and Economic Policy (ITEP), data provided to Policy Matters Ohio on September 24, 2020.
[4] "Flying Blind with Old technology," The Toledo Blade, August 14, 2020 at https://bit.ly/2FMvFEf.
[5] Sweigart, Josh, "Ohio's unemployment system is called broken: Readers want answers," Dayton Daily News, April 23, 2020 at https://bit.ly/33YtfdF.
[6] The actual deficit for 2021 remains to be seen ("Outlook for next Fiscal Year, Next Budget, Remains Foggy," Gongwer Ohio, September 18, 2020 at https://bit.ly/2RSNp2S, behind paywall); original forecast was over $3 billion for the two-year, 2020-21 budget period (Ghose, Carrie, "Here's how big a bite Covid-19 is taking out of Ohio's budget for the coming year," Columbus Business First, June 10, 2020 at https://bit.ly/3mOso84.)
[7] Richards, Kitty and Joseph E. Stiglitz, "Doesn't feel like a recession? You should be paying more in taxes," New York Times, September 3, 2020 at https://nyti.ms/3jbHv92.
[8] Johnson, Nicholas, "Budget cuts or Tax Increases at the State Level: Which is preferable in a weak economy?" Center on Budget and Policy Priorities, April 10, 2010 at https://www.cbpp.org/research/budget-cuts-or-tax-increases-at-the-state-level.
[9] King, Kate, "New Jersey Lawmakers Pass Budget with Heftier Millionaires Tax," Wall Street Journal, September 24, 2020 at https://on.wsj.com/2Smmwou.
[10] Wiehe, Meg and Carol Davis, "The Rich Are Weathering the Pandemic Just Fine: Tax Them," ITEP, September 3, 2020 at https://bit.ly/3crEFdw; See also Davis, Carl, "Another Reason to Tax the Rich? States with High Top Tax Rates Doing as Well, if Not Better, than States Without Income Taxes," September 23, 2020, ITEP, at https://bit.ly/33SKEEs.
[11] "State Rundown 9/23: Tax Justice Advanced in New Jersey, On the Ballot in Illinois," ITEP, September 24, 2020 at https://bit.ly/2RWITRg.

In this paper, Policy Matters Ohio outlines our second tax proposal this year, to rebalance the state income tax to make it more fair and to raise revenues to build toward an equitable recovery and a brighter future for all Ohioans. This plan would not raise taxes on 97% of Ohioans, and would provide a tax cut to 13% of lower and middle income households:

- Reduce the business income deduction, often known as the LLC loophole, from $250,000 to $100,000 and eliminate the preferential top rate on income over the cap.
- Restore the rate on the top income tax bracket to 7.5%, as it was under Republican Governor George Voinovich.[12]
- Create a new tax bracket with a rate of 8.5% on income over $500,000.
- Add a 10% refundable option to the state Earned Income Tax Credit (EITC) to allow the poorest families to benefit.

In July we proposed closing or limiting ineffective tax loopholes to raise $600 million to prevent another round of budget cuts like the governor imposed in May, as the recession slammed the economy.[13] In this paper we propose rebalancing Ohio's income tax to make it fairer and raise $1.94 billion to strengthen public schools and prevent ongoing harmful budget cuts that could prolong the recession.

Why does Ohio need a new tax plan?

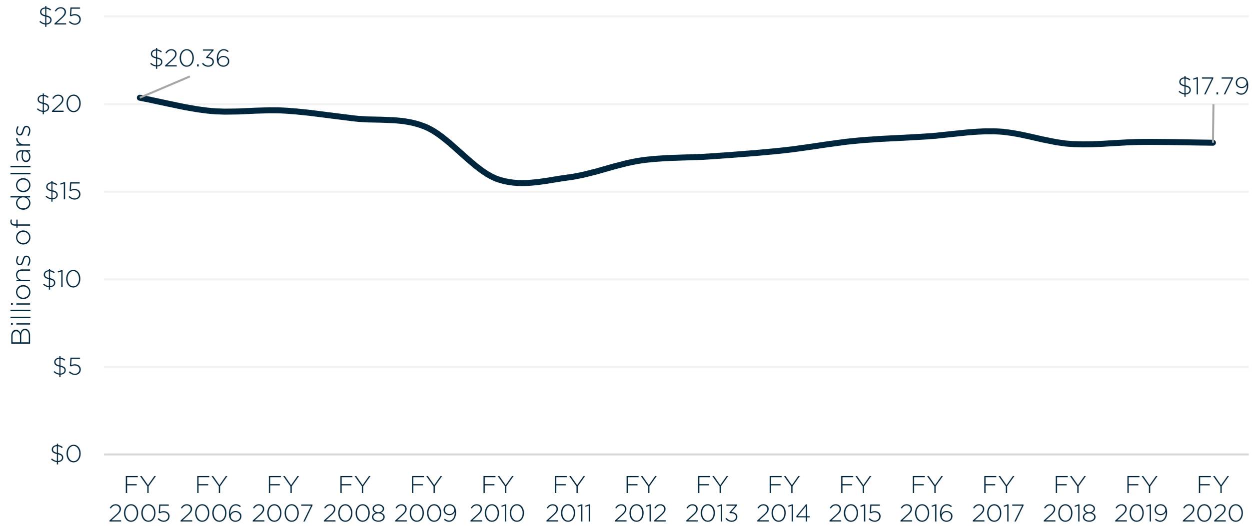
Ohio's lawmakers prioritized tax cuts, which benefitted the wealthiest, for the past 15 years, starting with a phased-in 20% rate reduction that began in 2005. This and other tax cuts have prevented our state from investing to keep up with the growth of the our economy. State source General Revenue Fund (GRF) investments have fallen by 20%, from 4.5% of state GDP in FY2006 to 3.6% in FY2020.[14] Chart 1 shows how state-source expenditures in the General Revenue Fund fell by 13%, adjusted for inflation, over the past 15 years.

[12] Under Governor George Voinovich, the General Assembly created a new bracket for income in excess of $200,000, effective starting in 1993. The tax rate associated with this new bracket was 7.5%. https://bit.ly/2HOM4Fo Subsequent tax cuts have reduced it to 4.797%, while inflation adjustment means that this year it applies to income over $221,300.
[13] Patton, Wendy and Piet van Lier, "Cuts, Costs and CARES Act funds" Policy Matters Ohio, August 26, 2020 at https://bit.ly/34nT2vR. The June report also included reducing the LLC loophole, which is not counted in the $600 million figure above.
[14] United States Bureau of Economic Analysis, GDP by state at https://www.bea.gov/data/gdp/gdp-state.

Chart 1

State-source GRF investments have fallen over time

Billions of dollars, adjusted for inflation: 2006 dollars



Source: Policy Matters Ohio, based on Ohio Legislative Service Commission historical state expenditures, Table 2 (state-source GRF, LGF and LPEF). Adjusted for inflation using R-CPI_U-RS.

Ohio entered the pandemic recession with insufficient revenues and eroded public services, from public health to schools. To build toward a future with more opportunity for all Ohioans, policymakers must create a more equitable tax structure to support the investments needed to meet immediate needs, as well as to start to fix long-standing problems in school finance and other needs.

Ohio's unfair tax structure

Fifteen years of income tax and other cuts, like the elimination of the corporate profits and other business taxes, have disproportionately benefitted the wealthiest Ohioans and produced a tax system that falls more heavily on low-income working Ohioans, many of whom are Black, working moms. The latest census data on income and poverty shows that despite overall economic improvements last year, poverty remained unacceptably high for people in households headed by Black (28.7%) or Hispanic (31.1%) women.[15] This is the group that is suffering the most, with higher unemployment and the harshest economic setback in the pandemic recession.[16] There are many policy initiatives that can help. One is better tax policy.

The Institute on Taxation and Economic Policy (ITEP) analyzed the major changes in Ohio's tax system since 2005 for Policy Matters, including changes to the personal income tax, sales

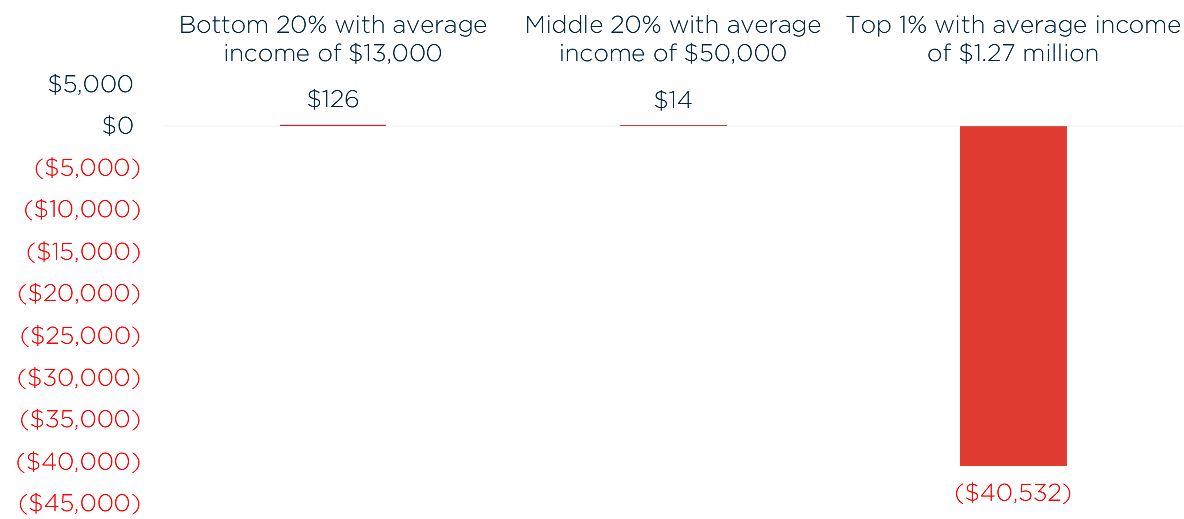
[15] Shields, Michael, "New Census data show improvements in historic expansion," Policy Matters Ohio, September 15, 2020 at https://bit.ly/30yS3li
[16] Rockeman, Olivia, Reade Pickert and Catarina Saraiva, "The First Female Recession Threatens to Wipe Out Decades of Progress for U.S. Women," Bloomberg News, September 30, 2020 at https://bloom.bg/2GnPge4.

tax, cigarette tax, business taxes, and other changes. The analysis presented in Chart 1 (and all other analysis in this paper) are based on 2019 income levels. Their analysis found that these major changes have provided the top 1% of earners, who make at least $490,000 a year and have an average income of $1.27 million, with an average cut of $40,532 a year. That compares to an average increase of $14 for the 20% of filers in the middle of the income ladder, who make between $40,000 and $61,000, and an average increase of $126 for those with the lowest 20% of incomes, who make less than $22,000 a year (Chart 2). While the pandemic recession has affected incomes this year, upper income taxpayers by and large have not been severely affected, so their tax savings are probably still similar to the amounts shown here.

Chart 2

Tax policy changes from 2005-2019: Low-income pay more, middle-income pay about the same, wealthiest enjoy huge benefit

Average annual change for tax filers grouped by income level, 2005-2019



Source: Policy Matters Ohio, based on data for Ohio residents provided by the Institute on Taxation and Economic Policy, September 24, 2020. Based on 2019 income levels.

The wealthiest 1% of Ohioans are also enjoying a federal tax cut worth $42,277, on average, as a result of the federal tax overhaul of 2017. Those in the middle got a tax cut of $703, on average, and the lowest income tax filers, $77.[17]

Today Ohio's tax system is weighted against low- and middle-income Ohioans, who pay a higher share of their income in state and local taxes than wealthy Ohioans (Chart 3). The bottom 20% of non-elderly residents paid 12.3% of their income in state and local taxes, nearly twice as much as the top 1% of earners, who paid 6.5%. This is because sales, excise and property taxes fall more heavily on those at the bottom of the income scale. Chart 3 shows, in

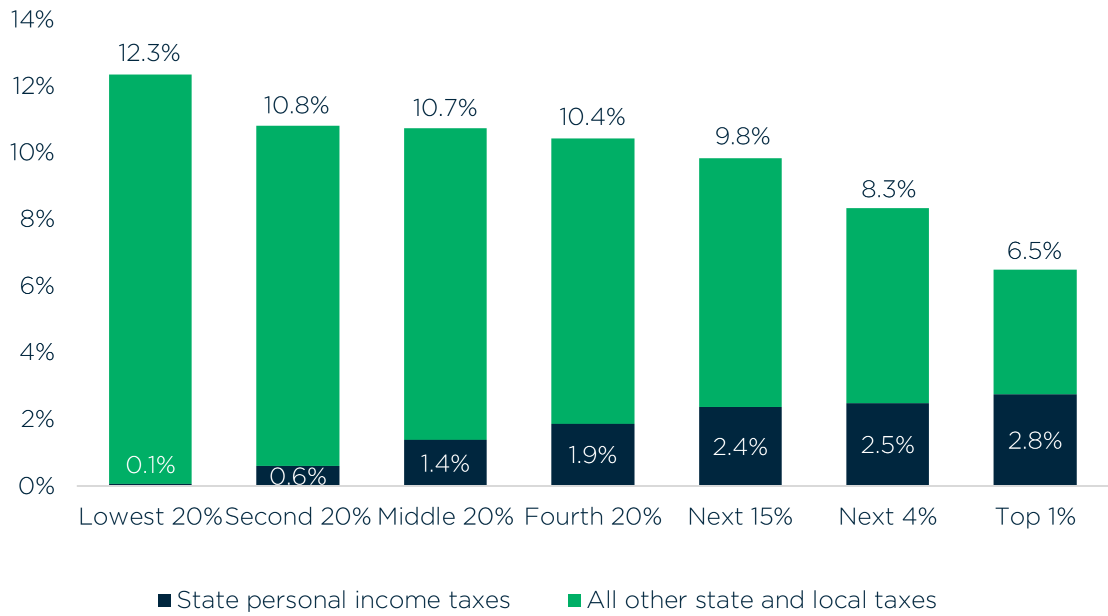
[17] Based on e-mailed data from Aidan Davis of ITEP with Wendy Patton, October 14, 2020.

the blue parts of the bars, how Ohio's state income tax is the only component of the tax system that reduces this inequality, because it is based on ability to pay.[18]

Chart 3

Income tax helps offset Ohio's upside-down state and local tax structure

Total state and local taxes as a share of income



Source: Policy Matters Ohio, based on data from the Institute on Taxation and Economic Policy for Ohio ("Who Pays? A Distributional Analysis Of The Tax Systems In All 50 States," October 2018). This chart shows the share of income paid in state and local taxes by non-elderly Ohio residents based on 2017 income levels.

To raise revenues and make the Ohio tax structure fair, Policy Matters proposes restoring the 7.5% top tax rate[19] on the top bracket of income ($221,300 in 2020)[20] and adding a new 8.5% rate on income over $500,000 a year, which would affect only the wealthiest 1% of Ohioans. We propose reducing the LLC loophole, a tax break on a certain type of business income, from $250,000 to $100,000 and eliminating the preferential rate on income over the cap.

The change in the LLC loophole proposed here is based on the reduction passed by the Ohio House of Representatives in the current budget. The Senate concurred with part of the House measure: It initially voted to eliminate the preferential top rate for business income over $250,000.[21] But the governor didn't agree.[22] Ultimately the budget bill passed with a very small reduction in the LLC loophole targeted at attorneys and lobbyists; even this was

[18] Chart 2 does not include the tax changes of House Bill 166, the budget bill for state fiscal years 2020 and 2021, which contained more income tax cuts, which made Ohio's tax code incrementally more inequitable. See Schiller, Zach, "Ohio taxes shift away from the wealthy: The pattern repeats," Policy Matters Ohio, Aug. 8, 2019, at https://bit.ly/3dpzons.
[19] The 7.5% bracket was established under Governor George Voinovich. See Schiller, Zach and Wendy Patton, "Overhaul: A plan to rebalance Ohio's income tax," Policy Matters Ohio, June 25, 2018, at https://bit.ly/2Q7MHwu.
[20] Ohio Department of Taxation at https://tax.ohio.gov/wps/portal/gov/tax/individual/resources/annual-tax-rates.
[21] Schiller, Zach, "LLC loophole should be trimmed," Policy Matters Ohio, July 8, 2020 at https://bit.ly/3ldNvPu.
[22] Ludlow, Randy, "Ohio House restores tax cuts to lobbyists, lawyers; ends 'tampon tax'," October 11, 2019 at https://bit.ly/33tUOMP.

repealed within months.[23] The House measure should have been passed then, and it should be taken up now.

Ohio's regressive tax structure is especially damaging to Black and brown Ohioans because of a history of discrimination in labor markets, housing, incarceration and other factors, as well as ongoing structural barriers to opportunity. Analysis by ITEP found that Black and Hispanic Ohioans are much more likely than whites to be among the poorest fifth of the population and thus face much higher tax rates than the richest fifth. ITEP found that 25% of Black and 29% of Hispanic Ohioans are in the poorest fifth, whose average total state and local taxes amounted to 12.3% of their income in 2018. Only 12% of Black and 12% of Hispanic Ohioans are in the top fifth of all earners, who averaged just a 6.5% tax rate. By contrast, as Chart 4 shows, 16% of white Ohioans are in the poorest fifth and 24% are in the richest fifth. Ohioans of Asian descent are even more likely to be among the top income group, and less likely to be in the poorest fifth.[24]

Table 1

Income groups show racial disparity in Ohio

Race distribution by income group

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%
White	16%	3%	20%	23%	24%
Black	25%	25%	23%	16%	12%
Asian	18%	13%	18%	18%	33%
Hispanic	29%	23%	20%	17%	12%

Source: Policy Matters Ohio, based on ITEP data from July 2, 2020. Represents Ohio residents and 2019 income groups.

Ohio's tax system should be rebalanced, so it is not as weighted against low-income Ohioans. We propose to expand the state EITC in a way that reaches the poorest Ohio families, who currently do not benefit from Ohio's EITC.

The EITC is a federal tax credit for low- and moderate-income working people. A recipient's EITC amount depends on their income, marital status, and number of children. Working people receive the credit beginning with their first dollar of earned income; the amount of the credit rises with earned income until it reaches a maximum level and then begins to phase out at higher income levels. The federal EITC is "refundable," which means that if it exceeds a low-wage worker's income tax liability, the IRS will refund the balance.[25] Unlike most states with such credits, Ohio excludes many thousands of the poorest families because its EITC is not refundable.

In 2019, the federal EITC boosted the incomes of 21% of women of color, helping 9 million families. It helps offset the legacy of long-term discrimination and ongoing structural barriers to opportunity that continue to hold down earnings of Black and Latinx workers.[26]

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[23] Schiller, Zach, "House votes to restore business income tax break," Policy Matters Ohio, October 10, 2019 at https://www.policymattersohio.org/press-room/2019/10/10/house-votes-to-restore-business-tax-break.
[24] Schiller, Zach, "State tax structure contributes to racial inequity," Policy Matters Ohio, January 11, 2019 at https://bit.ly/2F0hdrL.
[25] Marr, Chuck and Yixuan Huang, "Women of Color Especially Benefit from Working Family Tax Credits," Center on Budget and Policy Priorities, September 19, 2020 at https://bit.ly/3jypD8A.
[26] For example, people of color are far likelier than white people to work in low-paid occupations, work part-time or part-year instead of full-time and year-round, and have lower wages within a given occupation; Ibid.

Most Ohioans - 97% - would not be affected by the revenue raising measures in this plan: The increase in the top rate, the new income tax bracket and the reduction of the LLC loophole. However, all Ohioans would enjoy what the $1.94 billion in new revenues would mean for the state: good schools in all communities, regardless of local wealth; well-funded public health programs that keep communities safe; more affordable higher education options and more. The proposed addition of a refundable option to the state EITC would make the tax structure fairer. The vast majority of revenue raised would be from Ohio's wealthiest 1% of tax filers, who would still enjoy thousands of dollars a year in reduced taxes as a result of earlier state tax cuts and the 2017 federal tax cuts.[27]

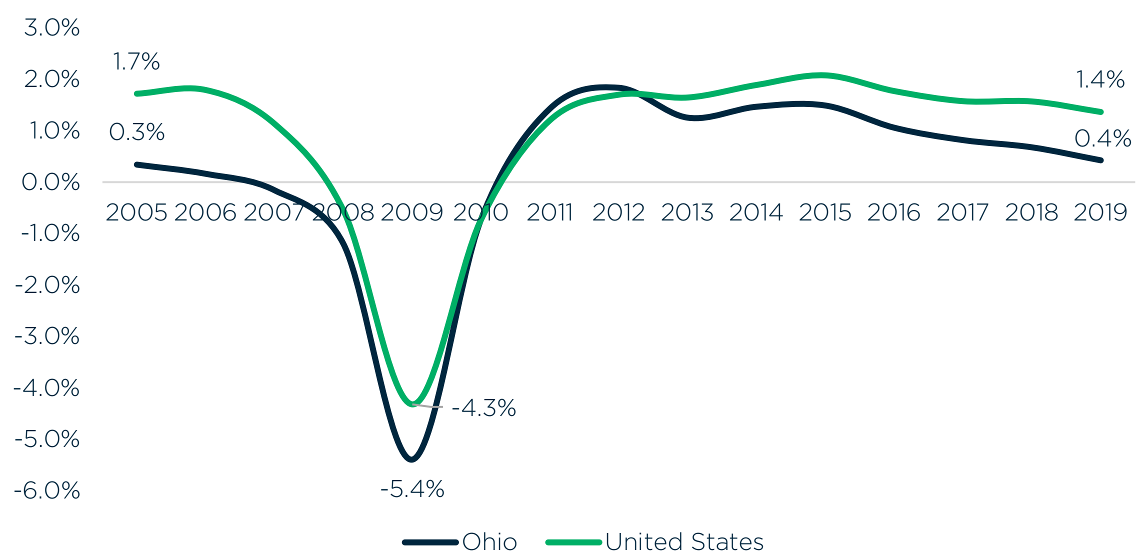
Tax cuts and the sluggish Ohio economy

Ohio lawmakers justified income tax cuts by claiming lower taxes on the wealthy were the best way to create jobs. That hasn't happened. Chart 4 shows Ohio lagged national rates of job growth both before the 2007-2009 recession — when state lawmakers started chopping the personal income tax — and after. Ohio lost a greater share of jobs than the nation during the recession. State job growth since the recession officially ended in 2009, at 4.3% between 2009 and 2019, less than half that of the nation (9.7%), with a widening gap in the rate of employment growth in each year since 2013. Of course, things will change with the pandemic recession, and outcomes in terms of employment are uncertain until the data for 2020 is available.

Chart 4

Tax cuts have not spurred job growth in Ohio relative to the nation

Rate of growth in employment, Ohio vs. U.S.



Source: Policy Matters Ohio, based on Economic Policy Institute analysis of data from U.S. Bureau of Labor Statistics, Current Employment Statistics: https://swx.epi.org/.

[27] E-mailed information from ITEP's Aidan Davis to Wendy Patton, October 13, 2020.

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Ohio lawmakers based their long-term strategy of cutting income taxes, which benefitted the wealthiest households, on decades-old economic theory linking the well-being of the rich to economic growth.[28] Real-time analysis of actual state economic performance undercuts the outdated theory.

For example, ITEP compared indicators of economic performance between 2009 and 2019 in nine states with no personal income taxes at all, and in nine states with the highest top tax rate on personal income. They looked at growth in state Gross Domestic Product (GDP - a measure of the economy); per-capita GDP and average income. They found the group of states with the highest personal income tax rates outperformed the states with no personal income tax on all three measures (Chart 5). Further, in 2019, just before the start of the pandemic, the official unemployment rate was slightly lower in the states with high top income tax rates (3.4%) than in the no-tax states (3.8%).

While Chart 5 shows a slight advantage among states with the highest income tax rates compared to those without any personal income tax, it also illustrates the basic truth that income taxes are simply not all that relevant in state economic performance. The differences between the two groups are slight. On the other hand, state investment in education, infrastructure, and other public services funded with income taxes can have a strong impact on productivity and economic performance.[29] Moreover, a graduated income tax system, including higher top tax rates, can make the tax structure more fair and reduce income inequality.[30]

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[28] Mazerov, Michael, "Academic Research Lacks Consensus on the Impact of State Tax Cuts on Economic Growth: A Reply to the Tax Foundation," Center on Budget and Policy Priorities, June 17, 2013 at https://bit.ly/33Od4PY.

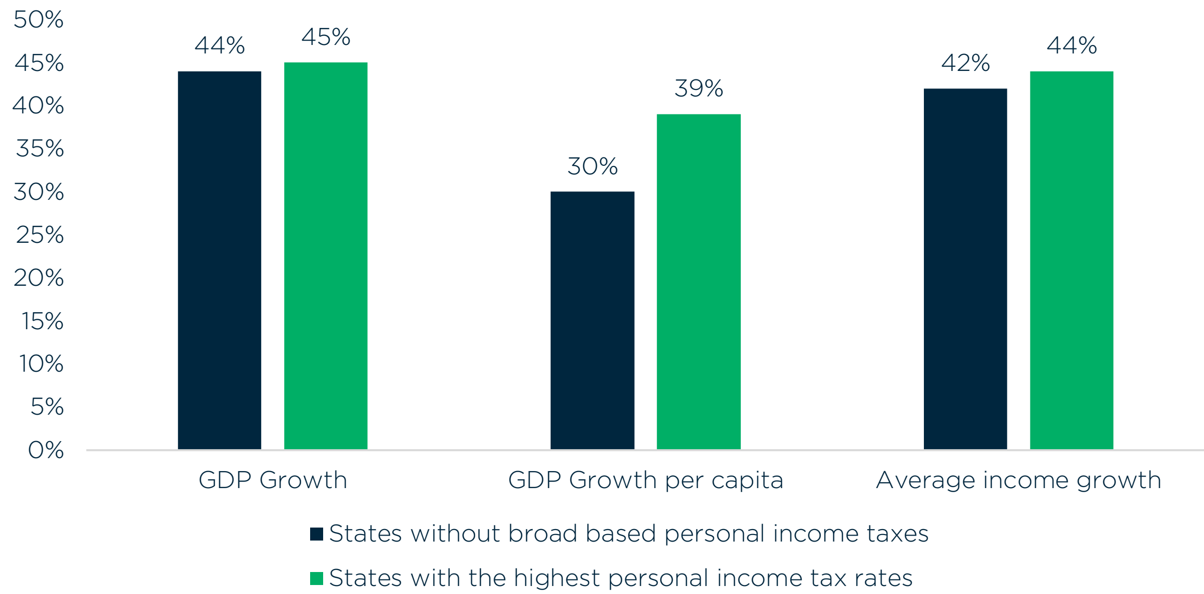
[29] For example, an econometric analysis of the impact of the Medicaid Expansion commissioned by Policy Matters Ohio found 54,000 jobs are supported across all sectors as the result of billions of federal dollars that support that program; see Patton, Wendy and Amanda Woodrum, "Medicaid supports Ohio jobs," Policy Matters Ohio, November 2018 at https://bit.ly/2ROXgH4 and Jackson, Victoria, "Investing for Growth," Policy Matters Ohio, February 18, 2019 at https://bit.ly/3kIF6TK. See also Berger, Noah and Peter Fisher, "A Well-Educated Workforce Is Key to State Prosperity," Economic Policy Institute, August 7, 2013 at https://bit.ly/33Xh8gM and Bivens, Josh, "Public investment: The next 'new thing' for powering economic growth," Economic Policy Institute, April 18, 2012 at https://bit.ly/3iZ3kZp.

[30] Adding higher income tax rates and strengthening the state EITC with a refundable option would reduce the racial inequity of Ohio's tax structure. See Schiller, Zach, "State tax structure contributes to racial inequity," January 11, 2019 at https://bit.ly/2G2KJ0c.

Chart 5

Economic growth slightly better in 9 states with high income tax rates than 9 states with no income tax

Growth of state GDP and income, 2009-2019



Source: Policy Matters Ohio, based on Institute for Taxation and Economic Policy, "Another Reason to Tax the Rich? States with High Top Tax Rates Doing as Well, if Not Better, than States Without Income Taxes," Sept. 3, 2020 at https://bit.ly/2FMCNR3.

Other states are rebalancing their tax systems and raising revenues

Other states are rebalancing their tax codes to address current needs and increase fairness. For example, the New Jersey governor and lawmakers have agreed on a tax plan that boosts taxes on residents earning more than $1 million a year, while providing aid to about 800,000 lower- and middle-income families.[31] Illinois residents will vote on a provision that would change the flat-rate income tax to one based on ability to pay.[32] Arizona voters will consider a change in the top rate to fund education;[33] similar discussions are ongoing in California, New York and Rhode Island.[34]

Revenues are needed in those states, like in Ohio, to help struggling families during the pandemic and recession. Upper-income earners have mostly rebounded from the recession, but the working class is far from recovered. Telecommuting eased the impact of COVID for

[31] Under the plan, the state's gross income tax rate on income between $1 million and $5 million would increase from 8.97% to 10.75%; people with income over $5 million already pay that top marginal tax rate. People earning less than $150,000 may see rebates of up to $500. See De Avilia, Joseph, "Top New Jersey Democrats Agree to Raise Taxes on Millionaires," Wall Street Journal, September 17, 2020 at https://on.wsj.com/360LXUp

[32] "Everything you need to know about the proposed graduated income tax," Chicago Tribune, February 20, 2020 at https://bit.ly/3kLSaaT.

[33] Gonzales, Angela, "Supreme Court allows tax increase proposal for education funding on November ballot, Phoenix business Journal, August 19, 2020 at https://bit.ly/3ngpj0F.

[34] Davis, Carl, "Another Reason to Tax the Rich? States with High Top Tax Rates Doing as Well, if Not Better, than States Without Income Taxes," Institute on Taxation and Economic Policy, September 23, 2020 at https://bit.ly/33WoUaT.

those with higher income and education.[35] A survey by the Federal Reserve found 63% of workers with at least a bachelor's degree were able to work from home, compared to just 20% with a high school degree or less and 27% with some college or an associate degree.[36] The Federal Reserve's wealth tracker illustrates that assets of the wealthiest 20% — who own the great majority of corporate equities, mutual fund shares and real estate[37] — have regained value after an initial pandemic plunge, restoring and then bolstering wealth.[38]

Pressures on Ohio's state revenues

Ohio families with modest and low incomes are struggling more than ever. During Ohio's slow recovery from the last recession, instead of hiring workers at competitive salaries with good benefit packages, corporations created more low-paying jobs without good benefits and leave.[39] Prior to the pandemic, six of Ohio's 10 biggest occupational groups left a full-time worker eligible for and needing SNAP food aid to feed a small family.[40] When employers don't pay a living wage for a day's work, working people depend on public services. Cutting taxes for the wealthy, even before this recession, reduced resources for public services that working people need.

That need is growing. In a recent briefing on the Ohio economy, Deputy Director Dan Baker of the Ohio Office of Budget and Management pointed out that low-wage workers making less than $27,000 a year are struggling the most in the pandemic recession. Baker said that with the end of federal economic stimulus aid, the Ohio economy will face headwinds: "…particularly, those on the lower end will face difficulties, putting pressure on state revenues."[41]

At the time this paper is posted economic stimulus aid from the federal government has ended, at least for now. State revenues must be strengthened to help struggling families and continue long-term investments in Ohio's people as federal aid evaporates. We are starting to see the "K-shaped" recovery in which wealthier people are relatively unscathed but people of modest or low income still struggle to meet basic needs.[42] This is not inevitable. Policy choices can foster a more equitable recovery. It starts with a tax system that is strong, fair and raises sufficient revenues to help people meet basic needs, and communities and the economy to rebound.

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[35] Bick, Alexander, Adam Blandin and Karel Mertens, "Work from Home After the COVID-19 Outbreak," Federal Reserve Bank of Dallas, June 2020 at https://bit.ly/3kFiX8X.
[36] Board of Governors of the Federal Reserve System, "Report on the Economic Well-Being of U.S. Households in 2019 - May 2020," https://bit.ly/2RVrR5G.
[37] Board of Governors of the Federal Reserve System, "Distributional Financial Accounts" at https://bit.ly/368hofw; see also Olick, Diana, "July pending home sales jump over 15% annually, as properties go under contract in record time," CNBC, August 27, 2020 at https://cnb.cx/3csRGns.
[38] Long, Healther, "The recession is over for the rich, but the working class is far from recovered," Washington Post, August 13, 2020 at https://wapo.st/35ZcCRx.
[39] Shields, Michael, "Reset and Unrig: State of Working Ohio 2020," Policy Matters Ohio, September 2020 at https://bit.ly/36oWCbE.
[40] Shields, Michael, "Working for less 2020," Policy Matters Ohio, May 1, 2020 at https://bit.ly/2FXe105.
[41] Advocates for Ohio's Future, "Covid 19"s impact on state budgets and services," September 18, 2020 at https://www.advocatesforohio.org/webinars.
[42] Saraiva, Catalina, "K-Shaped Recovery to Worsen Inequities in Jobs to Real Estate," Bloomberg, September 14, 2020 at https://bloom.bg/32Wkz8n.

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A plan to improve Ohio's tax system

Policy choices to build strong communities for all Ohioans and mitigate the pain for those who struggle start with strengthening the income tax to prevent further cuts of essential services and prevent layoffs among public sector workers, whose wages stabilize families and communities when the private sector economy falters. This is particularly critical for communities of color, as significant numbers of Black and Latinx people are employed in public sector jobs.[43] Ohio's lawmakers can start with eliminating tax breaks and implement some of the changes approved in last year's House budget bill. In July of 2020, Policy Matters Ohio recommended closing or narrowing unproductive tax loopholes to raise $600 million - in addition to reducing the LLC loophole, addressed in this paper.[44] In the plan outlined here, we propose raising another $1.94 billion by rebalancing and strengthening the state income tax. Together, these plans would raise $2.5 billion — more than the projected budget shortfall for the state. If they enacted our plan, Ohio policymakers could prevent cuts and make the investments needed so Ohio emerges from the pandemic recession stronger, more equitable and better prepared for the next shock.

Capping and reducing the "LLC loophole"

One of the biggest loopholes among Ohio's $9.8 billion in annual tax breaks is known as the "LLC loophole."[45] Ohio reduced taxes on business income from passthrough entities such as limited liability companies and S Corporations in 2013 and expanded this tax break since then. (They are known as "passthrough entities" because their profits are taxed under the individual income tax as they pass through to their owners.)

Today, a taxpayer does not have to pay Ohio income tax on the first $250,000 in state tax on business income included with their personal income tax filing because of the way their business is organized. Lawmakers sweetened this tax break by giving those who claim this benefit a lower top rate on all such income over and above the $250,000 cap: 3% instead of the 4.797% top tax rate. As a result, the LLC loophole drains more than $1 billion annually from state revenues.[46]

> *Lawmakers should rebalance the state income tax by capping the LLC loophole at $100,000 and eliminating the preferential 3% top tax rate on additional earnings.*
>
> ***This would not impact 97% of Ohioans.***
>
> *It would raise hundreds of millions of dollars for public services and make the state and local tax structure more fair.*

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[43] Brown, Haley and Dean Baker, "Cutting State and Local Budgets is an Attack on the Country's Black Workers," Center for Economic and Policy Research, June 16, 2020 at https://bit.ly/2GPktap.
[44] Patton, Wendy and Zach Schiller, "Protect essential services with public resources," Policy Matters Ohio, July 7, 2020 at https://bit.ly/30A47cr.
[45] State of Ohio Tax Expenditure Report for fiscal years 2020-21 at https://bit.ly/34bZFl6.
[46] Schiller & Patton, "Overhaul: A plan to rebalance Ohio's income tax," Policy Matters Ohio, June 26, 2018 at https://bit.ly/30iO0Q0. See also Schiller, Zach, "Closing the LLC loophole," Policy Matters Ohio, May 29, 209, at https://bit.ly/2GKWFV9. The most recent estimate from the Ohio Department of Taxation pegged the cost at $1.1712 billion for Tax Year 2017. Email from ODT's Gary Gudmundson to Zach Schiller, Oct. 6, 2020.

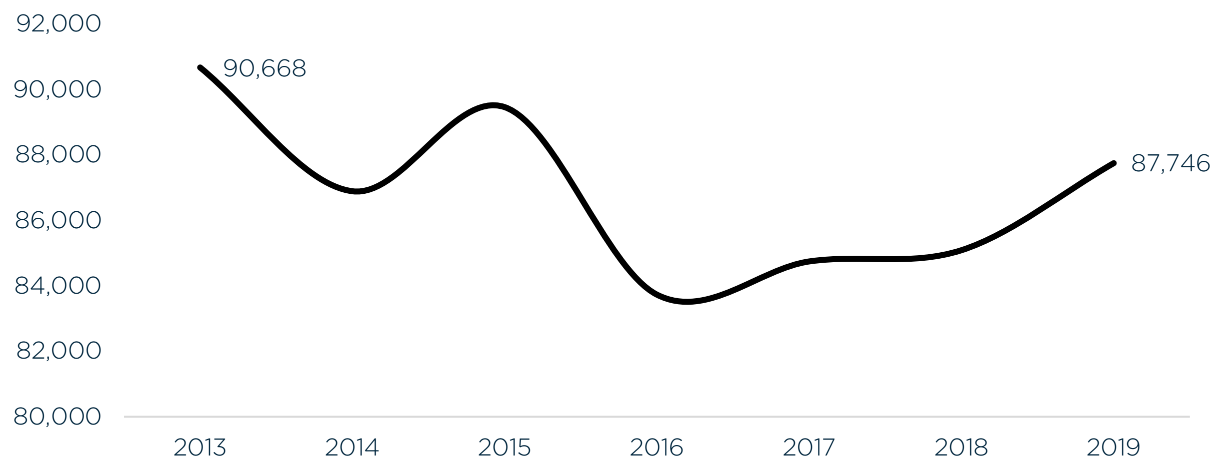
This tax break was touted as a tool to spur creation of new firms and to create jobs, but it has not done so. Most receiving the break save less than $1,000 a year.[47] Chart 6 shows that through 2019, the number of people hired on at new private sector establishments was lower in 2019 than in 2013, when the LLC loophole was first created.

The pandemic recession will of course have an impact on all economic figures; much of the data is not yet available. Chart 6 ends with data from 2019, a year of national growth, if weakening Ohio economic growth; the use of the LLC loophole likely also has declined since as the overall economy in Ohio has slowed.[48]

Chart 6

Hiring dropped in new private sector establishments since LLC loophole was enacted; rebound started in 2019 will be impacted by pandemic recession

New hires at new private-sector establishments in Ohio



Source: Policy Matters Ohio based on Bureau of Labor Statistics, Table 9. Private sector establishment births and deaths, seasonally adjusted.

The LLC loophole has been unsuccessful in achieving its original purpose. The House of Representatives in the Ohio General Assembly voted last year in House Bill 166, the current budget bill, to reduce the cap from $250,000 to $100,000 a year and eliminate the special rate of 3%. There was bipartisan consensus that it was time to limit this huge tax break. At the time, the Lima News reported Majority Whip Rep. Jay Williams (R-Nelsonville) said, "We would like to see something better than this that is tied to employment, that is tied to people keeping the money in their businesses. It's just hard to justify that you have somebody that's not employing anybody that is able to make $250,000 free money."[49] Cleveland.com quoted House Minority Leader Emilia Sykes, who said the business income write-off was a giveaway for high-wage earners. "The state's taxation scheme is rigged against working people and we need to fix it," she said. "In addition to [that] fact, the LLC is $1 billion we could use for

[47] See Ohio Department of Taxation, Tax Data Series, Table BID: Summary of the Business Income Deduction, Amount Claimed and Number of Returns, by Amount of Business Income Deduction Claimed and Residency Status, Tax Year 2018, at https://bit.ly/3clZAsS.
[48] Shields, Michael, "It's Official: 2019 worst year for Ohio jobs since recession," Policy Matters Ohio, May 6 2020 at https://bit.ly/33xxBcC.
[49] Kleeman, McKenzie, "Ohio lawmakers consider end of 'LLC loophole,' Limaohio.com, May 15, 2019 at https://bit.ly/34DdOYP.

funding our schools, Medicaid, our infrastructure, water quality, and I could go on and on."[50] The Senate did not vote for the reduced cap but embraced elimination of the preferential top rate. The governor opposed all of the changes, but legislators still made one small cut, eliminating the benefit for lawyers and lobbyists. Under pressure from the affected groups, they later repealed even that tiny reduction.[51]

The first step the General Assembly should take in rebalancing Ohio's upside-down tax code is adopting the changes to the LLC loophole initiated by the House in the last budget bill. It should be capped at $100,000 and the preferential top rate eliminated. With this change it would remain a tax break for small businesses and would not affect the 80% of Ohioans making less than $98,000 a year.[52] All but a tiny fraction of the tax increase would be paid by those in the top 5% of earners, making more than $205,000 a year. In fact, the top 1% would pay for fully 86% of the additional taxes collected, according to ITEP's analysis.

This change would raise hundreds of millions in new tax revenues and help to rebalance the income tax.[53]

Restoring the top tax bracket and adding a new tax bracket on the top 1% of income

Ohio lawmakers have whittled away at the top income tax rate for 15 years, reducing it from the 7.5% rate established by Republican Governor George Voinovich in the 1990s.[54] Overall, they have cut income tax rates by more than a third, in addition to creating the LLC loophole, significantly reducing the funds available for Ohioans' education, health care and public services.

The income tax plays a critical role in Ohio's public finance. It adds fairness to the state and local tax system, supports needed public services and is used to reduce property taxes. It provides financial stability to the revenue system and helps ensure that Ohio can pay its debts.[55]

It's now time for to reverse years of income tax cuts to avert major budget cuts and lay the groundwork for needed investments. Lawmakers can start by restoring the top tax bracket to 7.5% and imposing a new, 8.5% tax bracket on income over $500,000.

Ohio's income tax is based on a set of brackets. Everyone pays the same rate on their income in each bracket, but most people do not earn enough to reach the highest brackets. Table 2 gives the bracket amounts that will apply to 2020 income and shows the tax brackets proposed in our plan.

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[50] Peltzer, Jeremy, "Ohio lawmakers to seek an income-tax cut, but slash breaks for businesses, film industry," Cleveland.com, May 1, 2019 at https://bit.ly/30uRfUU.

[51] "The Ohio Legislature Repeals the Exclusion of Ohio Law and Lobbying Businesses from Ohio Business Income Deduction," Zaino, Hall and Farrin LLC, November 6, 2020 at https://bit.ly/36ijxW7.

[52] Schiller, Zach, "Closing the LLC Loophole," Policy Matters Ohio, May 19, 2019 at https://bit.ly/3ij2wO1

[53] When the House recommended this reduction in 2019, the Legislative Service Commission estimated it might result in a revenue increase of $528 million.[53] Then the pandemic recession hit; Policy Matters Ohio downsized that estimate by the decline forecast in revenues to $450 million;[53] an August, 2020 analysis by ITEP suggests the downsizing of the LLC Loophole and elimination of the 3% preferential rate would bring in $480 million, based on 2019 income levels. While there is uncertainty generally around revenues in the pandemic recession, what is clear is that these provisions would raise hundreds of millions for essential public services, to prevent further cuts and to help make the overall tax structure less unfair.

[54] Schiller and Patton, Op. Cit.

[55] Schiller, Zach, "Ohio needs a strong income tax," Policy Matters Ohio, February 10, 2017 at https://bit.ly/2SarjJB

Table 2			
New tax rates would affect wealthiest Ohioans with income over $221,300			
Ohio tax brackets, 2020, and proposed changes			
Existing state income tax brackets in Ohio		Proposed state income tax brackets (Changes in bold)	
Ohio Taxable Income	Tax Calculation	Ohio Taxable Income	Tax Calculation
0 - $22,150	0	0 - $22,150	0
$22,150 - $44,250	$316.18 + 2.850% of excess over $22,150	$22,150 - $44,250	$316.18 + 2.850% of excess over $22,150
$44,250 - $88,450	$946.03 + 3.326% of excess over $44,250	$44,250 - $88,450	$946.03 + 3.326% of excess over $44,250
$88,450 - $110,650	$2,416.12 + 3.802% of excess over $88,450	$88,450 - $110,650	$2,416.12 + 3.802% of excess over $88,450
$110,650 - $221,300	$3,260.16 + 4.413% of excess over $110,650	$110,650 - $221,300	$3,260.16 + 4.413% of excess over $110,650
More than $221,300	$8,143.14 + 4.797% of excess over $221,300	**$221,300 - $500,000**	**$8,143.14 + 7.5% of excess over $221,300**
		More than $500,000	**$16,555+ 8.5% of excess over $500,000**

Source: Policy Matters Ohio based on data from the Ohio Department of Taxation.

The wealthiest 1% of Ohioans, earning more than $490,000 and with average annual earnings of $1.27 million, would contribute 83% of the revenue raised from these changes. The increase would represent just 1.3% of their income, on average. All of the rest would be paid for by those among the next 4%, earning $205,000 to $490,000, with an average income of $294,000. Some 38% of this group would see an income tax hike, which would average 0.3% of their annual income.

Some 97% of Ohioans would not be affected by the change to the LLC loophole and the increase in top rates. That includes everyone with income below $100,000. Only a tiny share of those earning between $100,000 and $205,000 could see an impact of changes proposed to the LLC loophole as described in the previous section but would not be affected by the two changes to top tax brackets proposed here.[56]

Making the tax structure fairer through a stronger EITC

The past 15 years of state tax cuts helped the wealthiest people in Ohio the most. Lawmakers also implemented and increased a state EITC, which — like 29 other states including Washington DC and Puerto Rico — is based on a percentage of the federal credit. The value of the tax credit is based on earnings and family size. It helps offset the higher share of income lower-income families pay in sales tax, payroll tax, property tax and other state and local taxes.

The federal EITC benefitted 887,000 Ohioans in 2019.[57] It promotes work and fuels the economy, expands economic security, increases children's educational performance and

Lawmakers should improve the state EITC by offering a 10% refundable option.

This would help rebalance Ohio's inequitable state and local tax structure.

It would cost an estimated $207 million and would be paid for by other measures in this tax plan.

[56] As mentioned earlier, however, a small share (.1%) of tax filers with income between $98,000 to $205,000 who claim the LLC loophole could see an average increase of $381 a year, but that is due to the change proposed in that tax break, not to a change in top tax brackets described in this section.
[57] Internal Revenue Service. "Statistics for Tax Returns with EITC" at https://bit.ly/3ndWIsJ.

attainment, improves health outcomes and provides short-term family security.[58]

The federal EITC is especially useful because it is refundable: When a family's credit exceeds their federal income tax liability, they receive the difference in a refund, so working people receive the full value of their credit.[59] Ohio's credit leaves out the most important part: refundability. That flaw keeps our EITC from living up to its poverty-fighting potential. Today, Ohio is one of just six states with an EITC that lacks refundability.

While some moderate-income Ohioans benefited when the state EITC was raised from 10% of the federal to 30%, that move expanded the benefit to just 1% more of the lowest-earning quintile of Ohioans and raised the average value of their credit by just $6.[60] The EITC would benefit more working Ohioans if people had an option between a 10% refundable EITC credit, and the existing state EITC. Claimants could choose which option works better for their return. This would allow the state EITC to help the poorest working families and those with more moderate incomes.

This policy would help 748,000 Ohio families. ITEP estimates that 37% of the lowest income families, earning no more than $22,000 a year (428,700 individual tax filers) would receive an average benefit of $230. Among the next fifth, earning $22,000 to $40,000, 19% (an estimated 219,300) would benefit, with an average credit of $324.

Refundability is not a new notion in Ohio's income tax. Ohio has a number of refundable credits, which aid few low income Ohioans.[61] Adding a refundability option to Ohio's EITC, set at up to 10% of the federal EITC, would cost $207 million, less than half of the funds that could be raised by reducing the size of the "LLC loophole" tax break.

Putting the plan together

When the three proposals here are put together — the reduction of the LLC loophole, increased top income tax rates and adding a 10% refundable option to the EITC — the Ohio tax structure is strengthened and rebalanced. Chart 7 illustrates how all elements of this proposal, taken together, affect people at the low end of the income scale, in the middle, and the wealthiest 1% of tax filers. The analysis is shown as a net impact in the context of 15 years of state tax cuts that primarily benefitted the wealthiest.

1) Limit the LLC loophole tax break to $100,000 and eliminate the preferential 3% top rate.

2) Restore the top personal income tax rate to 7.5%.

3) Add an 8.5% tax bracket at $500,000.

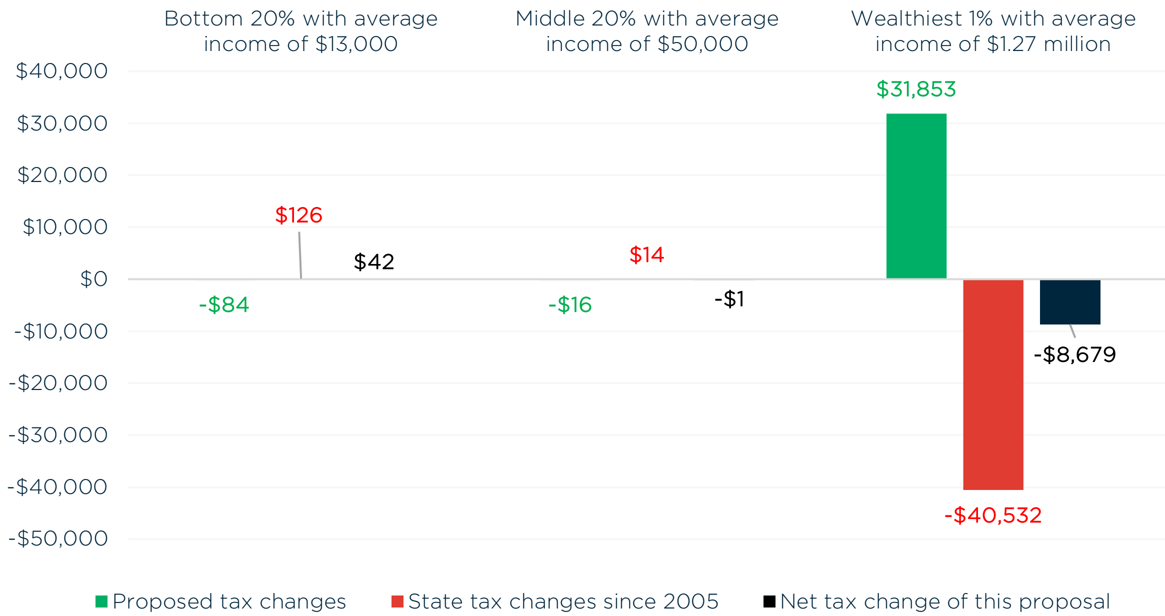
4) Provide a 10% refundable EITC option.

[58] Caines, Roxy, "5 Ways the EITC Benefits Families, Communities, and the Country," Center on Budget and Policy Priorities, January 26, 2017 at https://bit.ly/2SevEeS.
[59] In other words, if the tax credit exceeds income tax liability, the difference flows through to the tax filer in a check from the government.
[60] Stein, Ben, "Refundability Now," Policy Matters Ohio, June 19, 2020 at https://bit.ly/3iklvHU
[61] The largest refundable tax credit is the Pass-through entity (PTE) credit (R.C. 5747.059). Investors in PTEs are eligible for a refundable credit equal to the taxpayer's proportionate share of the lesser of either the tax due or the tax paid by any qualifying entity for the qualifying taxable year of the qualifying entity which ends in the taxable year of the taxpayer. (See Oho Department of Taxation Annual report for FY2019 at https://bit.ly/3l3azR0.) In 2018, this credit cost the state $221.8 million; 85% share went to tax filers with annual incomes of over $500,000. (See Ohio Department of Taxation Tax Data Series, Individual income tax (Y1TY18) at https://bit.ly/34bujuD – refundable tax credits section starting at column FS).

Chart 7

The wealthiest 1% would still enjoy benefits from 15 years of state tax cuts

Net impact by group in context of state tax changes over time



Source: Policy Matters Ohio based on data provided by the Institute on Taxation and Economic Policy, August 26, 2020. Note: This table represents Ohio residents.

This plan improves fairness by reducing taxes for the lowest income group and raising revenue from the wealthiest. The benefit to people at the low end of the income scale is significant: 748,000 would benefit, including 37% of the lowest-income earners. Those in the middle, earning $40,000 to $60,000 a year on average, are typically not affected, although they will benefit from the improved public schools, public health and infrastructure investments this plan will support. The additional $31,853 the wealthiest 1% of Ohioans would pay, on average, represents just 2.5% of their annual income. Even with these tax increases, they still benefit from thousands in state and federal tax cuts. (See data table in Appendix 2).

All of these changes, taken together, raise a total of $1.94 billion for investment in Ohio and start to create a tax structure rebalanced for fairness. Just as other states move to use public policy to avoid deep budget cuts and plan for the future, Ohio should look to their progress and follow their example. It’s time for a turnaround and investment in the people, families, communities and state of Ohio.

Recommendations & conclusion

How do we build toward a more equitable recovery, in a recession that is making inequity in income, racial and every other category worse? Lawmakers can make policy choices that speed recovery for all Ohioans, not a select few. They can prioritize policies that strengthen opportunity, like providing good schools everywhere regardless of ZIP code and ensuring basic needs like housing, food and health care are available to all Ohioans in the pandemic recession.

This recession has exposed the cracks in essential government services created by years of eroded investment. The state pays little to support public health, and inadequate, outdated information technology in public health agencies throughout the state has hampered response to the deadly virus. State cuts in education are already causing hundreds of layoffs of administrators and professors, deepening recessionary conditions in college towns.

Instead of continuing to cut, Ohio's lawmakers need to raise sufficient revenues to meet immediate needs and restore services for the future. Wealth and employment continue to grow at the top end of the income scale, even as families of low and modest incomes struggle in the recession. Restoring tax rates on the wealthiest Ohioans can allow the state to address pressing needs and restore eroded services.

The plan proposed here — to reduce the LLC loophole, raise rates on the wealthiest Ohioans and make the tax system fairer by improving the EITC — will raise $1.9 billion, which will allow lawmakers to avoid further deep budget cuts and set the stage for a people's recovery. Policy Matters Ohio previously outlined an additional $600 million in revenues this year, mostly from eliminating or narrowing a variety of ineffective and special interest tax breaks. In future papers, we will outline other needed components to replace revenues lost over years of tax cuts, so as to allow the state to meet immediate needs, restore years of disinvestment and strengthen the state so the next crisis is met with better preparation.

Policy Matters Ohio

Appendices

Appendix 1: Sources of box on first page

46 states spend more per capita on public health; Ohio is 47th in pulling down federal public health funds. See Filby, Max, "Ohio spends less per capita on public health than nearly every other state," The Columbus Dispatch, April 2, 2020 at https://bit.ly/2RUHdHW.

42 states have healthier residents and health disparities here are increasing sharply. See Health Policy Institute of Ohio, Health Value Dashboard 2019 at https://bit.ly/3cKNSy1 and The Commonwealth Fund, "2019 Scorecard on State Health System Performance" at https://bit.ly/3kAdNLs.

Inequitable state school funding was found unconstitutional in 1997; lawmakers have yet to make a fix. https://ohiohistorycentral.org/w/DeRolph_v._State_of_Ohio.

36 states have better rates of high school graduation; 46 do better in graduating Black teens. Taken from National Center for Educational Data, Table 219.46 - Public high school 4-year adjusted cohort graduation rate (ACGR), by selected student characteristics and state: 2010-11 through 2017-18 at https://nces.ed.gov/programs/digest/d19/tables/dt19_219.46.asp.

Ohio ranks 35th among the states in affordability of public institutions of higher education. (The College Board at https://bit.ly/3hmtjJv); *44 states have public university systems that are more affordable to students of modest income*. https://irhe.gse.upenn.edu/affordability-diagnosis/state_reports.

The share of Black undergraduates in Ohio's public universities dropped by 15.4% since 2010. Ohio Department of Education, Student Diversity in Ohio Institutions of Higher Education at https://www.ohiohighered.org/data-reports/enrollment.

30 states do better in child health in the 2020 Annie E. Casey Foundation ranking; 2020 Kids Count Data Book at https://bit.ly/3cqsBt8.

Ohio had the second highest Black infant mortality rate in the nation in 2018. The state ranked 40th among the states in overall infant mortality in 2018 (in other words, 39 states did better than Ohio. See Centers for Disease Control at https://bit.ly/3cqskq6; Kaiser Family Foundation at https://bit.ly/3cs3Uwj and the Ohio Department of Public Health at https://bit.ly/3j0sR4G.

Only 2 states make it harder to get childcare aid than Ohio. National Women's Law Center, Early Progress: State Child Care Assistance Policies 2019 at https://bit.ly/3hX9rw7.

Policy Matters Ohio

Appendix 2: Data table

Table A							
Average tax changes in Ohio by income group: From state tax changes since 2005, federal tax changes in 2017 and the proposed Policy Matters Ohio revenue plan							
Income grouping	Lowest 20%	2nd lowest 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income range	$0-<$22,000	$22,000-<$40,000	$40,000 -<$61,000	$61,000 -<$98,000	$98,000 -<$205,000	$205,000 -<$490,000	$490,000 or more
Average income	$ 13,000	$ 31,000	$ 50,000	$ 77,000	$ 134,000	$ 294,000	$ 1,265,000
Average change in taxes as a share of total income							
State tax changes since 2005	1.0%	0.3%	0.0%	-0.4%	-1.1%	-2.1%	-3.2%
Tax changes from Policy Matters Ohio proposed revenue plan	-0.6%	-0.2%	0.0%	0.0%	0.0%	0.4%	2.5%
Net tax change as a share of income	0.3%	0.1%	0.0%	-0.4%	-1.1%	-1.7%	-0.7%
Average change in taxes owed							
Average change in state taxes since 2005	$126	$96	$14	-$310	-$1,406	-$6,082	-$40,532
Average tax changes from Policy Matters Ohio proposed revenue plan	-$84	-$61	-$16	-$16	$0	$1,186	$31,853
Net tax changes after Policy Matters Ohio tax plan	$42	$35	-$2	-$326	-$1,406	-$4,896	-$8,679

Source: Policy Matters Ohio based on data provided by the Institute on Taxation and Economic Policy, This table represents Ohio residents.