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The Ohio tax formula: make MORE, pay LESS

01/15/03

Zach Schiller

The state and local tax system is stacked against low- and mid dle-income Ohioans. The less you make, the greater the share of your income you have to pay. As upside-down as that may seem, it's getting worse.

So reported a recent study by the Institute on Taxation and Economic Policy, a Washington, D.C., research group. ITEP used a sophisticated model of all major state and local taxes to arrive at its results.

Non-elderly Ohio families that rank in the top 1 percent of the income range - those making \$261,000 a year or more - pay 9.7 percent of their earnings in state and local taxes. The lowest fifth of families - who make less than \$15,000 annually - pay 11 percent.

Why does this matter?

Because Gov. Bob Taft and Ohio legislators are busy analyzing the state's tax system, looking both at possible long-term changes to improve its structure and revenue-raising measures to plug a yawning budget gap. As they review the alternatives, they should look first to

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taxes that won't further reinforce this negative trend.

Actually, the disparity between what the wealthiest families and everyone else have to pay is even greater once federal itemized deductions are included. Taxpayers may deduct state and local personal income and property taxes when they pay their U.S. taxes. Upper-income taxpayers are more likely to itemize and take advantage of these deductions. Taking that into account, the lowest fifth of families pay more than half again as much of their income in state and local taxes as the top 1 percent do.

Sales and excise taxes are the main reason poor and middle-class Ohioans pay a greater share of their income in state and local taxes than the well-off. Naturally, low- and middle-income families spend more of their pay than rich families, who are able to save more. Partly because of that, the less affluent pay more of their incomes in sales and excise taxes. The lowest fifth of the state's families, which average just \$8,800 a year, pay 6.3 percent of their income in such taxes. For the top 1 percent, who average \$660,200, that figure is just 1 percent.

Property taxes are also a smaller drain on the finances of those at the top of the income spectrum.

Ohio's graduated income tax makes up for much of the inequality caused by sales, excise and property taxes. The poorest fifth of Ohio families pay 1.7 percent of their income in personal income taxes, compared to 3.9 percent for the middle fifth and 6.9 percent for the top 1 percent.

This leaves Ohio with a somewhat fairer tax system than the average state. But rising sales taxes over the past decade have been moving us in the opposite direction. That trend should be reversed. With the state needing new revenue, it should take the opportunity to rebalance the tax load.

One place to start is with the corporate franchise tax, which is Ohio's corporate income tax. Once a major source of state revenue, it has withered in recent years. Changes in state law that weakened the tax and wide-scale tax avoidance by multistate companies have contributed importantly to the decline.

Companies find legal ways around the tax. A common tactic involves shifting income to subsidiaries in other states that will not be taxed as heavily as Ohio affiliates would be. The Ohio Department of Taxation estimates that the state would take in roughly another \$200 million a year under the tax if it adopted a rule followed in California and 15 other states. That rule requires each company to report on its operations as a combined entity, eliminating transactions between various subsidiaries.

Another step could be adding a temporary surtax to the state personal income tax for the highest earners, or another bracket above the top one that now begins at \$200,000. On the other end of the scale, Ohio should join the 17 states that provide an earned income tax credit for low- and middle-income workers. These have made a difference elsewhere in equalizing tax burdens.

More regressive taxes may be needed to balance the state budget by the end of June and provide stable revenues in the future. But as the



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governor and legislators wrestle with how to close the budget deficit, they should keep in mind who is bearing the greatest burden in today's tax system. Perversely, it's those who can least afford it.

Schiller is research director of Policy Matters Ohio, a nonprofit research institute in Cleveland. The ITEP study is available on the Policy Matters Web site: www.policymattersohio.org

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