

Common sense reform for working Ohio: Refundable EITC would help clean up unfair tax code

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Ohio's tax system is both regressive and *inadequate* to meet our needs. Tax cuts have overwhelmingly favored the wealthiest taxpayers. The richest 1 percent of Ohioans, on average, pay about 6 percent of their income in state and local taxes, the bottom fifth of earners, on average, pay nearly double that amount.¹

The Earned Income Tax Credit (EITC) is one way the state can clean up our tax code, while also encouraging work and injecting money into local economies that need a boost. But Ohio's existing credit is too weak to help the workers who need it most. Tax modeling from the Institute on Taxation and Economic Policy (ITEP), a national organization with a sophisticated model of the state tax system, shows that Ohio's current EITC reaches only about 8 percent of the state's neediest working families and 11 percent of middle income workers. A 20 percent, refundable, non-capped, EITC would extend the credit's reach to more than a third of the state's poorest (38 percent) and increase the amount available to all eligible claimants. These changes would mean far fewer working Ohioans would be taxed into poverty. The largest tax cut, an average savings of \$620, would go to workers on the cusp of poverty, earning between \$21,000 and \$39,000 a year. These changes would require an estimated \$414 million in state income tax credits, a reasonable expenditure to support labor market participation and local spending and to bring some balance to the \$3 billion in cuts Ohio has already enacted over the past dozen years.

Ohio's EITC is too weak to work

Ohio's current EITC does very little for those claiming the credit and nearly nothing for the poorest working Ohioans. Those with less than \$10,000 in taxable income do not receive anything from the credit because it is not refundable.² According to modeling done by ITEP, 92 percent of Ohioans who

¹ See, Policy Matters Ohio, "Wealthy not paying fair share of state and local taxes," April 2016, available at <http://www.policymattersohio.org/blogpost-taxes-april2016>.

² The low-income tax credit eliminates state personal income tax liability for Ohioans with \$10,000 or less in taxable income. As Ohio's EITC is not refundable and those claimants have no tax due, they do not benefit from the credit. Some data from the Ohio Department of Taxation shows that some claimants with less than 10,000 received the credit. Tax Table Y-1 for Tax Year 2014 for example reports that 233 tax returns with taxable incomes less than \$10,000 claimed \$26,229 in EITC credits. The same report cautions: "Deduction and credit amounts are as claimed on each individual

EITC Impact

Ohio's tax cuts have shorted the state budget. Low- and middle-income families pay more of their income in taxes than their wealthier counterparts do and many struggle to move up in our economy.

The EITC can help. The credit encourages work, helps keep families out of poverty, and can help bring some balance to the tax code. But Ohio's credit is too weak to work.

Common sense reform is needed. Policymakers should fix Ohio's EITC and put it on par with other states' credits.

- Make the credit refundable;
- Eliminate the cap; and
- Raise the amount of the credit.

These changes would mean working poor families would get income support.

earn less than \$21,000 a year – including the poorest workers in the state – see no benefit from the credit. For the 8 percent that does benefit, the average tax cut is only \$70. Only a small share of middle income Ohioans, who make an average of \$49,000 a year, see benefits from the EITC, while a whopping 89 percent of this group sees none. For the 11 percent that does get a cut, it averages just \$113. Those who are on the cusp of poverty, earning between \$21,000 and \$39,000, see the most gain from the existing EITC, but even that is small.³ About 22 percent in this income group see a tax cut, averaging about \$142.

	Poorest Ohioans	Low-income Ohioans	Middle-income Ohioans
Income range	Less than \$21,000	\$21,000-\$39,000	\$39,000-\$60,000
Average income	\$13,000	\$29,000	\$49,000
Share receiving EITC tax cut	8%	22%	11%
Average EITC tax savings	\$70	\$142	\$113
Share left out	92%	78%	89%

Source: Institute on Taxation and Economic Policy, December 2016. Covers Ohio residents only and is based on 2016 income. Percentages rounded. Income ranges are income quintiles. The top two quintiles, those earning more than \$60,000, are not shown because very few returns in those income ranges are eligible for the EITC.

A more effective EITC would support workers left out of the recovery.

Bringing Ohio's credit in line with the majority of other state EITCs would mean more money in the pockets of Ohio workers. It would help keep low-income workers in the labor market and offset some of the disproportionate tax load carried by these workers. State EITCs are modeled on the federal credit, because it is effective at promoting these policy goals.⁴ Currently, 26 states and Washington D.C. have EITCs.⁵ All but four state EITCs are refundable. The average size is 17 percent of the federal credit.⁶ Nearly all preserve the federal credit's long phase out to avoid benefit cliffs and unintentional disincentives. Some states have tiered credit systems offering more to some claimant

return before application to income or tax liability. They therefore may exceed the amount necessary to reduce each taxpayer's taxable income or tax liability to zero. In other words, the amounts listed here may overstate the amount of each deduction or credit that was actually used." Other tax reports issued by Department of Tax, for example the 'all filers' detailed report (Table 23), do not include these claimants.

³ The poverty threshold for a family of four in 2016 was \$24,230. See, Department of Health and Human Services, Computation for the 2016 HHS Poverty Guidelines at <https://aspe.hhs.gov/computations-2016-poverty-guidelines>, accessed January 17, 2017.

⁴ In 2016, about 939,000 Ohioans claimed \$2.3 billion in federal EITC, with the average return around \$2,449. See, IRS, Statistics for Tax Returns with EITC, available at <https://www.eitc.irs.gov/EITC-Central/eitcstats>, accessed January 25, 2017.

⁵ National Conference of State Legislatures, "Tax Credits for Working Families," July 2016, available at <http://www.ncsl.org/research/labor-and-employment/earned-income-tax-credits-for-working-families.aspx>, accessed January 4, 2017.

⁶ Author calculation based on data from National Conference of State Legislatures, average amount based on non-tiered credits.

classes, but Ohio uses a taxable-income cap to cut short the phase-out of the EITC.

Ohio struggles with declining labor force participation. The number of Ohioans working or looking for work has fallen by 265,000 since the start of the 2007 recession.⁷ A significant portion of families living in poverty are working families (46 percent)⁸ and poverty remains above pre-recession levels.⁹ Our out-of-balance state tax system has been made more so by years of tax cuts that have gone primarily to the affluent. The EITC is designed to help address each of these problems. Yet, Ohio's credit remains one of the weakest in the nation. Seven states have expanded their EITCs since 2013 and two have made their state credits refundable.¹⁰

Ohio should align its EITC with most other state credits to clean up our tax code and give back to working people. A refundable, non-capped, EITC that is 20 percent of the federal credit would provide 38 percent of Ohio's poorest with a tax cut. The eligible workers would see an average cut of \$451. Many workers in this income category do not earn enough to pay Ohio income taxes, so most of this cut would be returned to these taxpayers in the form of a tax refund. The vast majority of this money would be put to use in the local economy, purchasing essentials and making repairs.

For low-income Ohioans, those with an average income of \$29,000, an improved EITC would be a buffer against falling below the poverty line.¹¹ The federal credit is one of the most effective anti-poverty policies on the books. In Ohio, ITEP estimates that the federal credit alone helped more than 265,000 people earn their way out of poverty last year.¹² The existing state credit does little to leverage the positive effects of the federal EITC, and does nothing for 78 percent of Ohioans earning between \$21,000 and \$39,000, many of whom are hovering at or near the poverty line. Bringing the state EITC in line with other state credits would deliver the greatest benefits to this group of workers. A third of Ohioans in this income range (30 percent) would receive a tax cut. Those receiving a credit would see an average tax cut of \$620. Not all of the tax cut would be returned as a tax refund, as many in this income quintile have state income tax liability, but for many the credit would be a substantial income supplement that could help families in precarious financial situations move away from the poverty line.

⁷ Hannah Halbert, Job Watch, January 2017, available at <http://www.policymattersohio.org/jobwatch-dec16>, referencing labor force decline between Dec. 2007 and December 2016.

⁸ Working Poor Families Project, Population Reference Bureau analysis of 2014 American Community Survey microdata. In 2014, the poverty threshold for a family of four was \$24,008.

⁹ Hannah Halbert, "New Census data: Incomes up, poverty down for most in Ohio," September 2016, available at <http://www.policymattersohio.org/ohio-acs-sept2016>, accessed January 17, 2017. Citing update to American Community Survey data for Ohio. The 2015 poverty rate for Ohio was 14.8 percent. More than a third of African-Americans (32.5 percent) and more than a quarter (26.4 percent) of Latino Ohioans were poor in 2015.

¹⁰ These states include the following: Oregon, 6 to 8 percent, and 11 percent for families with kids under 3; Iowa, 14 to 15 percent, Maryland 25 to 26 percent, with planned increases that will raise the credit to 28 percent by 2018; Massachusetts 15 to 23 percent, New Jersey, 20 to 35 percent; Rhode Island, 10 to 15 percent, plus refundability; Maine, refundability; California, enacted credit. See, J.B. Wogan, "The Rise of a Bipartisan Tax Break for the Working Poor," *Governing*, December 2016, available at <http://www.governing.com/topics/finance/gov-earned-income-tax-credit-states.html>, accessed January 4, 2016.

¹¹ The poverty line for a family of four in 2016 was \$24,300. U.S. Department of Health and Human Services. Modeling to estimate the share of Ohioans lifted out of poverty by a reformed credit was unavailable at time of publication but the average income for workers in the second income quintile is near the poverty threshold.

¹² ITEP estimate calculated for Policy Matters Ohio.

EITC expansion would also benefit some middle-income Ohioans with earnings closer to the state's median wage.¹³ An additional 3 percent of those squarely in the middle, who have an average income of \$49,000, would see an average tax cut of \$312. These improvements would cost an estimated \$414 million per year in tax revenue. Table 2, describes these improvements.

	Poorest Ohioans	Low-income Ohioans	Middle-income Ohioans
Income range	Less than \$21,000	\$21,000-\$39,000	\$39,000-\$60,000
Average income	\$13,000	\$29,000	\$49,000
Share receiving tax cut after reforms	38%	30%	14%
Change from share of those getting existing credit	+30 percentage points	+8 percentage points	+3 percentage points
Average EITC tax savings after reforms	\$451	\$620	\$312
Change from existing credit	+\$381	+\$478	+\$199

Source: Institute on Taxation and Economic Policy, December 2016. Covers Ohio residents only and is based on 2016 income. Percentages rounded.

The EITC model is a proven policy tool to build an inclusive economy. Children in households that receive the federal EITC are born healthier, do better in school, have higher college attendance rates and even earn more as adults, compared with their counterparts whose families don't get the credit.¹⁴ A reformed Ohio EITC would leverage all these benefits and send \$414 million back to communities that need support. The money would keep bills paid and kids in clothes, pay for child care that allows a parent to work, repair vehicles needed to get to work, and take some of the sting out of Ohio's low-wage economy.

The state legislature made \$3 billion in annual tax cuts primarily for corporations and the wealthy on the promise that those cuts would speed job growth. Instead, Ohio has underperformed the nation.¹⁵ This tax year, Ohio is projected to spend \$8.8 billion in tax expenditures.¹⁶ The so-called "small business" investor income tax deduction, which is claimed by investors in partnerships, S Corporations, sole proprietorships and other entities, was created in 2013 and just its expansion two

¹³ The median household income in Ohio was \$51,075 according to 2015 American Community Survey, 1-year estimates.

¹⁴ Chuck Marr, Chye-Ching Huang, and Arloc Sherman, "Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds," Center of Budget and Policy Priorities, April 15, 2014, available at www.cbpp.org/cms/index.cfm?fa=view&id=3793, accessed May 20, 2014.

¹⁵ See, Hannah Halbert, Jobwatch, *supra* at note 7.

¹⁶ See, Wendy Patton, Billions in tax breaks, little accountability," Policy Matters Ohio, February 2016, available at <http://www.policymattersohio.org/taxbreaks-feb2016>, accessed January 17, 2017. Analysis of Ohio tax expenditures based on the state's tax expenditure report.

years later is expected to drain the state budget by about half a billion dollars a year.¹⁷ Nearly half (47 percent) of it in 2015 went not to the smallest businesses but to the 8 percent of claimants with deductions of more than \$100,000. Nor has its creation produced a significant increase in employment at small businesses hiring employees for the first time.¹⁸ Eliminating or limiting this deduction would offset much of the cost of an EITC expansion. Other exemptions also warrant scrutiny. For instance, the grain handler's exemption to the Commercial Activity Tax (CAT) is eroding revenue that could support EITC expansion or other investments.¹⁹ The exclusion, which was opposed by the Ohio Manufacturers' Association, exempts for-profit grain handlers from the CAT. Closing this loophole would add an estimated \$14 million to the budget. These are only a couple of examples demonstrating how tax cuts have restricted the state's ability to make investments that matter to future prosperity, including education, higher education, infrastructure and basic local services. Closing unproductive tax loopholes would help cover the EITC expansion while making the tax code reflect Ohio's commitment to working families.

Why does Ohio's EITC fail workers?

When the Ohio EITC was enacted legislators made three policy decisions that limited the credit's effectiveness. The Ohio credit is not refundable. It has an odd income cap that interrupts the benefit cliff smoothing effect that is an integral part of the federal credit and nearly all other state models. The credit is also smaller than average state credits. Reforming these three provisions is necessary to deliver the changes described above.

Refundability

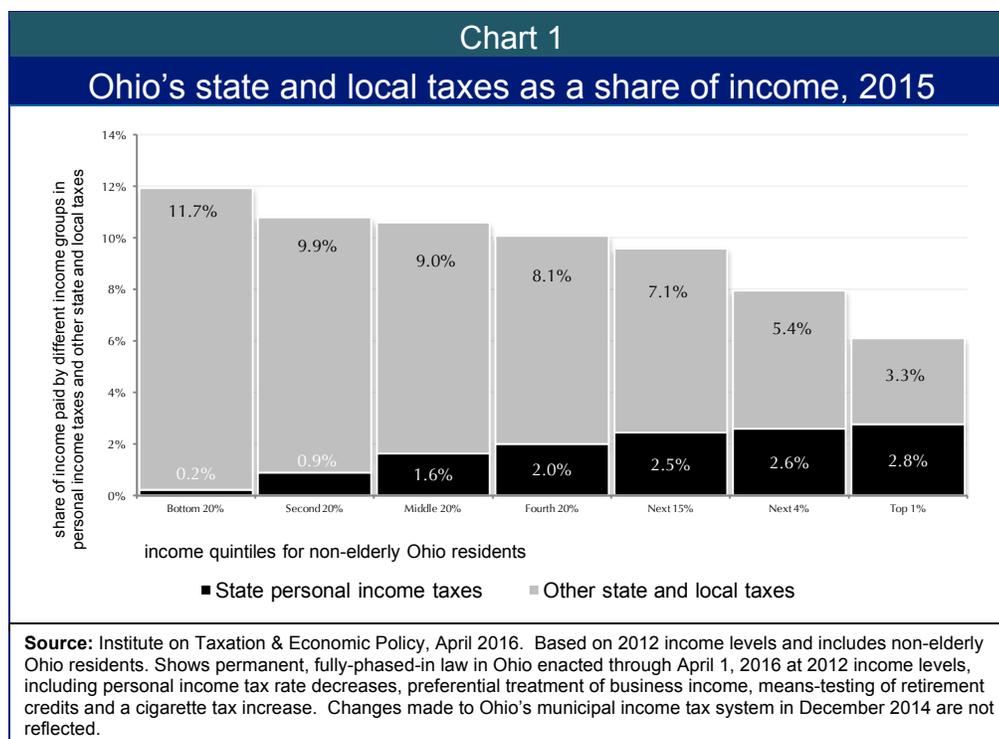
Unlike the federal EITC and the vast majority of other state EITCs, Ohio's credit is nonrefundable, meaning the credit can only reduce tax liability.²⁰ Refundability allows workers to get the full value of their credit regardless of their income tax liability. In refundable states, the amount of the credit that exceeds the taxpayer's state income tax liability is returned to the claimant as a tax refund. For example, the average Ohio EITC tax cut for a worker earning between \$21,000 and \$39,000 is just \$142. If the claimant has only \$100 in tax liability, then the remaining \$42 of EITC is just lost. In a refundable state, the \$42 would be returned to the claimant in the form of a tax refund check. Refundability is necessary to improve EITC targeting and impact. Lack of refundability is the primary reason Ohio's EITC fails to reach the workers most in need of help and why it fails to help rebalance our unfair system.

¹⁷ *Id.*, See also, Legislative Service Commission, Comparison Document, H.B. 64 of the 131st Session of the General Assembly, As Enacted, p. 896, at <http://www.lsc.ohio.gov/fiscal/comparedoc131/en/comparedoc-hb64-en.pdf>. See also Office of Budget & Management, Tax Reform Scoring Sheet; FY 2016-2017 Operating Budget-All State Funds. The LSC pegged the additional cost at \$490 million in FY 2017, while OBM estimated it at \$558 million.

¹⁸ See Zach Schiller and Wendy Patton, Testimony to the 2020 Tax Policy Commission, Policy Matters Ohio, Sept. 26, 2016, p. 7, at <http://www.policymattersohio.org/2020testimony-sept2016>, accessed January 25, 2017.

¹⁹ *Id.* at Table 5. The exemption is projected to grow by 36 percent between 2014 and 2017.

²⁰ All but four state credits are refundable: Ohio, Delaware, Oklahoma, and Virginia.



Refundability is necessary to clean up our tax code. Without it, the EITC ignores all the other taxes these workers pay. These workers may not have high state income tax bills, but they are on average paying a higher share of their income in state and local taxes than the wealthy do. Chart 1 is based on an earlier ITEP analysis of the Ohio tax system that covers nonelderly Ohioans and uses slightly different income distributions. However, it makes clear that low- and middle-income Ohioans are paying more than their fair share because of how much they pay in other kinds of taxes.

ITEP estimates that the poorest Ohioans, who are largely excluded from the EITC, pay a small share of their income as state personal income taxes. Earlier ITEP analysis estimated 6.9 percent of their income was paid out in sales and excise taxes.²¹ Conversely, higher income Ohioans pay a much smaller share of their incomes in these taxes. These taxes have real impacts on family budgets. For example, a working mom with one child who earns \$13,000 pays an estimated \$244, about 1.9 percent of her annual income in state sales tax.²² Because the existing credit is non-refundable and the family did not earn enough to have state income tax liability to reduce, the existing EITC does

²¹ Institute on Taxation and Economic Policy, Who Pays? Ohio 2015, available at <http://www.itep.org/whopays/states/ohio.php>, accessed January 17, 2017. This analysis differs from Chart 1 because it includes state and local income taxes, raising the share spent on income taxes to 1.5 percent, from .02 percent. The analysis shows that the poorest workers are contributing to the state and local coffers in the form of general sales tax (2.9 percent) and other sales and excise taxes (2.0 percent). Also included is sales and excise taxes on businesses that are passed on to consumers (1.9 percent).

²² Estimate based on IRS 2015 Sales Tax Deduction Calculator, available at <https://apps.irs.gov/app/stdc/stdc.html>, accessed January 17, 2017. A taxpayer with two dependents with a similar income would be paying about \$258 in state sales tax. The calculator considers income, dependents, and locality to estimate the amount of state and local sales taxes that can be deducted from federal taxes. These examples are illustrative only.

nothing to offset these costs. By making the existing 10 percent EITC refundable, the state would return \$337 to this family, making it a little less expensive to be poor.²³

Other classes of Ohio taxpayers get refunds when their credits exceed their tax liability. Ohio already has refundable tax credits on the books for motion picture producers, historic building rehabilitators, and venture capitalists.²⁴ While tax data does not clarify how much these credits reduce tax liability and how much is actually returned to corporate claimants as a refund, it is clear they have a substantial impact on the state budget. Refundable credits to the personal income tax claimed by only 21,044 tax filers added up to more than \$133 million in 2014.²⁵ The average refundable credit was \$6,327 per claimant. More than a quarter of the credits were claimed by just 836 claimants with federal adjusted incomes greater than \$10 million.

Ohio also rewards corporations with refundable credits. In Fiscal Year 2016, more than \$122.5 million was claimed in refundable tax credits available to corporations to reduce the Commercial Activity Tax.²⁶ Nearly one-third of those refundable credits (29.8 percent) went to just 66 corporate tax filers, all of which had at least \$1 billion in tax receipts. That alone took more \$36.5 million out of the budget. Those corporations received, on average, a refundable tax cut of more than \$553,000, in addition to other income exclusions and non-refundable tax credits. As an industry, holding companies, corporations that manage other companies, received the highest average tax credit, spreading \$7.2 million in savings and refunds across just 860 claimants. Manufacturers claimed the highest total, more than \$59.9 million, but credits were distributed across more claimants making the average credit for that industry about \$3,220. Ohio offers no refundable tax credits for working class people.

²³ Ohio EITC estimate is 10% of federal EITC generated by the 2016 EITC calculator available at <http://www.eitcouthreach.org/help/>, accessed January 25, 2017.

²⁴ See, Ohio Department of Taxation, 2016 1040 Instructions Booklet, pg. 27-32, available at http://www.tax.ohio.gov/portals/0/forms/ohio_individual/individual/2016/PIT_IT1040_Booklet.pdf, accessed January 17, 2017. Lists all credits available to individual personal income tax filers. All refundable credits are limited to investors and pass-through entities. Nonbusiness credits that support people who work to earn income and credits designed to support families are all nonrefundable.

²⁵ Author calculation based on tax data reported by the Ohio Department of Taxation, Summary of Ohio Individual Income Tax Returns, Tax Year 2014, available at http://www.tax.ohio.gov/tax_analysis/tax_data_series/individual_income/publications_tds_individual/Y1TY14.aspx, accessed January 17, 2017. Total reflects amount in lines 23 and 73 in the 2014 tax forms. These lines include the following credits: business jobs credit, motion picture production credit, pass-through entity credit, historic preservation credit, financial institution tax credit. The Department of Taxation cautions data users that “[d]eduction and credit amounts are as claimed on each individual return before application to income or tax liability. They therefore may exceed the amount necessary to reduce each taxpayer’s taxable income or tax liability to zero. In other words, the amounts listed here may overstate the amount of each deduction or credit that was actually used.” The same applies to the Ohio EITC amounts reported in the summary.

²⁶ Ohio Department of Taxation, Commercial Activity Tax, Fiscal Year 2016, available at http://www.tax.ohio.gov/tax_analysis/tax_data_series/cat/publications_tds_cat/CAT12FY16.aspx.

Ohio's income cap shortchanges workers earning their way into the middle class.

The Ohio EITC is capped. A taxpayer with Ohio Taxable Income greater than \$20,000 can only claim an EITC that is half the amount she or he owes in state income taxes, after applying certain exemptions.²⁷ In other words, for those with taxable income over \$20,000, they can only claim half their tax liability in EITC, even if they are eligible for more. This policy choice means that workers who are earning their way into the middle class receive less EITC support than they should. The federal EITC was designed to have a long phase-out. So, as workers earned more they gradually lost EITC support. This phase-out is how the federal credit avoids creating a benefit cliff, where claimants lose more than they gain by adding hours or getting a raise. Ohio's cap cuts the phase-out short. According to ITEP's analysis, just removing the cap would have the biggest impact on low-income Ohioans (\$21,000-\$39,000). It would increase their average tax cut by \$94. Middle-income workers would also see an improvement, with an average tax cut increase of \$86. ITEP estimates that the cap alone keeps \$7.2 million in potential EITC out of taxpayer pockets each year.

Making the credit refundable and eliminating the cap in the existing credit would make Ohio's EITC more meaningful to working families. The biggest beneficiaries of these changes would be low-income workers – those perilously close to, or in poverty. These two policy changes would cost an estimated \$178 million per year, nearly on par with what the state returned to corporations through refundable CAT credits last year. Table 3 shows how the Ohio credit would change if the existing 10 percent credit were made refundable and the cap were eliminated.

	Poorest Ohioans	Low-income Ohioans	Middle-income Ohioans
Income range	Less than \$21,000	\$21,000- \$39,000	\$39,000- \$60,000
Average income	\$13,000	\$29,000	\$49,000
Share receiving tax cut from reforms	34%	21%	5%
Average EITC tax savings from reforms	\$236	\$283	\$179
Change from existing credit	+\$166	+\$141	+\$66

Source: Source: Institute on Taxation and Economic Policy, December 2016. Covers Ohio residents only and is based on 2016 income. Percentages rounded.

²⁷ See, Hannah Halbert, "A Credit that Counts," Policy Matters Ohio, October 2013, available at <http://www.policymattersohio.org/eitc-oct2013>, p.4, discussing the Ohio EITC cap.

The Ohio EITC is too small, but refundability is essential

The Ohio EITC is just 10 percent of the federal credit. It is below the value of other state refundable EITCs, which average 17 percent of the federal credit.²⁸ However, just increasing the amount of the credit without addressing the other design flaws is not likely to make the credit more effective. In our prior report, we showed that increasing the EITC from 5 to 10 percent did nearly nothing for the poorest workers. At that time, ITEP modeling estimated that the change would only cover 3 percent of the poorest workers and provide an average tax cut to that group of only \$5.²⁹ Without correcting for refundability, increasing the Ohio EITC amount will do little to help the poorest workers.

Our EITC should be designed to accomplish three goals: to support people working and actively seek work when job opportunities are slim; to provide additional income that helps working people stay out of poverty; and to help make up for the fact that lower income Ohioans pay higher shares of their income in state and local tax than their wealthier counterparts. Our credit both in its design (lack-of-refundability and the cap), and in the amount, is just too flawed to address these challenges. A fully refundable, non-capped credit that is 20 percent of the federal credit would be large enough to be meaningful and bring our policy in line with high-performing state credits.

Rebuild our economy from the middle out: Start with EITC reform.

Ohio's recovery from the great recession worked for some, but for many working Ohioans the last decade has been a struggle. Poverty rates remain stubbornly high. Incomes haven't risen in real terms. The state has been unable to fully invest in programs that help families move ahead, like the EITC, transportation, and childcare supports. Instead of laying the foundation for shared prosperity, Ohio policymakers frittered our money away on tax cuts for the wealthy, in mistaken belief that such spending would support job creation. The EITC is a straightforward policy reform that could start turning Ohio away from trickle-down economic policy toward policies that build our economy from the middle out. These reforms will put more money into the pockets of people who work for a living. Ultimately, that cash will support the businesses working people frequent and those who provide the services they purchase. Unlike giveaways at the top, supports to working families send cash to the places that need it most.

Strong state EITCs can supplement the federal credit by offering an additional modest income boost to those struggling to get by on low-wage work. State EITCs can also help bring some measure of balance to the tax code and help prevent some workers from being taxed into poverty. But for state credits to accomplish these goals and effectively leverage the benefits provided by the federal EITC, they must be well designed. Ohio needs a refundable, non-capped EITC.

²⁸ Author's calculation based on information available at note 5, average includes non-tiered EITC amounts.

²⁹ Hannah Halbert, "Out-of-step: More needed to make Ohio EITC a credit that counts," August 2014, available at <http://www.policymattersohio.org/out-of-step-aug-2014>, accessed January 25, 2017.