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Tax & Budget

Senate tax plan: A step backward

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Tax policy in the budget for 2020-21:

Moving into the home stretch

Key findings

- The Senate budget bill would leave the $250,000 business income deduction in place. It also would eliminate the special 3% rate on such income starting in 2020 and the two bottom brackets of the state income tax. In addition, its bill phases in an 8% across-the-board rate cut, larger than the one in the budget bill approved by the House.
- While eliminating the bottom two tax brackets helps some moderate- and low-income taxpayers, the 8% rate cuts skew the overall benefits to those making much more: 62% of the Senate bill's tax cuts would go to the fifth of tax filers making $101,000 or more; nearly a third goes to the top 5%, who make more than $208,000.
- The House plan's tax increases for many of the richest Ohioans are reduced in the Senate plan, which cuts taxes by well over $300 million a year, compared to $108 million under the House plan.
- Most middle-income taxpayers will get a cut that they'll barely notice: An average of $68 for those receiving a cut among the middle fifth of tax filers, who make between $42,000 and $63,000 a year.
- The Senate and House plans are remarkably similar in that the poorest fifth of Ohioans would see very modest gains. More than three-quarters of this group, who pay the largest share of their income in taxes of any income group, would not see any reduction in taxes under either plan.
- If the proceeds from the Senate's elimination of the special 3% rate were used to add a refundable 10% Earned Income Tax Credit (EITC), more working low-income Ohioans would benefit. The estimated cost of $170 million a year could be paid for from the elimination of the 3% special rate on passthrough business owners making more than $250,000.

INTRODUCTION

An important part of the debate on Ohio's budget bill has focused on tax policy and the income-tax break for owners of passthrough businesses, so named because the income is taxed under the personal income tax as it passes through to the owners. Currently, such owners don't have to pay state income tax on the first $250,000 in such income,[1] and benefit from a special, 3% rate paid on business income above that amount, which otherwise would be taxed at nearly a 5% rate. This tax break, which costs over $1 billion a year, is often known as the LLC loophole. In its budget bill, the House reduced the $250,000 deduction to $100,000 and eliminated the special 3% rate, while cutting overall rates by 6.6% and eliminating the bottom two brackets of the tax. The Senate budget bill would leave the $250,000 deduction in place. It also would eliminate the special 3% rate starting in 2020 and the two bottom brackets of the state income tax. In addition, its bill phases in an 8% across-the-board rate cut, larger than the one in the budget bill approved by the House. This report examines the effects of the Senate plan on Ohioans of different income levels, compared to what the House approved and today's tax structure.

While both the House and Senate plans direct most of the tax cuts to those with higher than average incomes, the Senate plan directs a larger share to that group. Only a relatively small amount goes to the lowest-income Ohioans in both plans. The Senate and House plans are remarkably similar in that the poorest fifth of Ohioans would see very modest gains. More than three-quarters of this group, who pay the largest share of their income in taxes of any income group, would not see any reduction in taxes under either plan. The richest Ohioans would pay more under the House plan because of its reduction in the business income deduction, a step in the direction of fairness. These tax increases for many of the richest Ohioans are dramatically reduced in the Senate plan, which cuts taxes by well over $300 million a year, compared to $108 million under the House plan.[2] The Senate plan would not reverse most of the tax shift to the poorest Ohioans that has taken place since 2005; in fact, it would provide the most in dollar terms to those who on average had already gained from the state's tax changes over the past 15 years.

These conclusions are based on an analysis of the tax changes for Policy Matters Ohio by the Institute on Taxation and Economic Policy (ITEP), a Washington, D.C., based nonprofit with a sophisticated model of the state and local tax system.

If the proceeds from the Senate's elimination of the special 3% rate were used to add a refundable 10% Earned Income Tax Credit (EITC), more working low-income Ohioans would benefit and those who received it would benefit more. ITEP estimates this would cost about $170 million a year. Even with the rate cuts in the Senate plan, the elimination of the 3% rate would nearly pay for that. In addition, instead of keeping the deduction as it is, the General Assembly should approve the House proposal to limit the LLC loophole and spend the proceeds investing in essentials like child care and aid to foodbanks.

ITEP's analysis

Upper-income taxpayers benefit more from across-the-board rate cuts than other taxpayers, because under a progressive tax system like Ohio's, they pay higher rates and those rates are cut more. That's why more of the tax cuts in the Senate plan go to affluent taxpayers than would under the House bill. ITEP found that 62% of the Senate bill's tax cuts would go to the fifth of tax filers making $101,000 or more; nearly a third goes to the top 5%, who make more

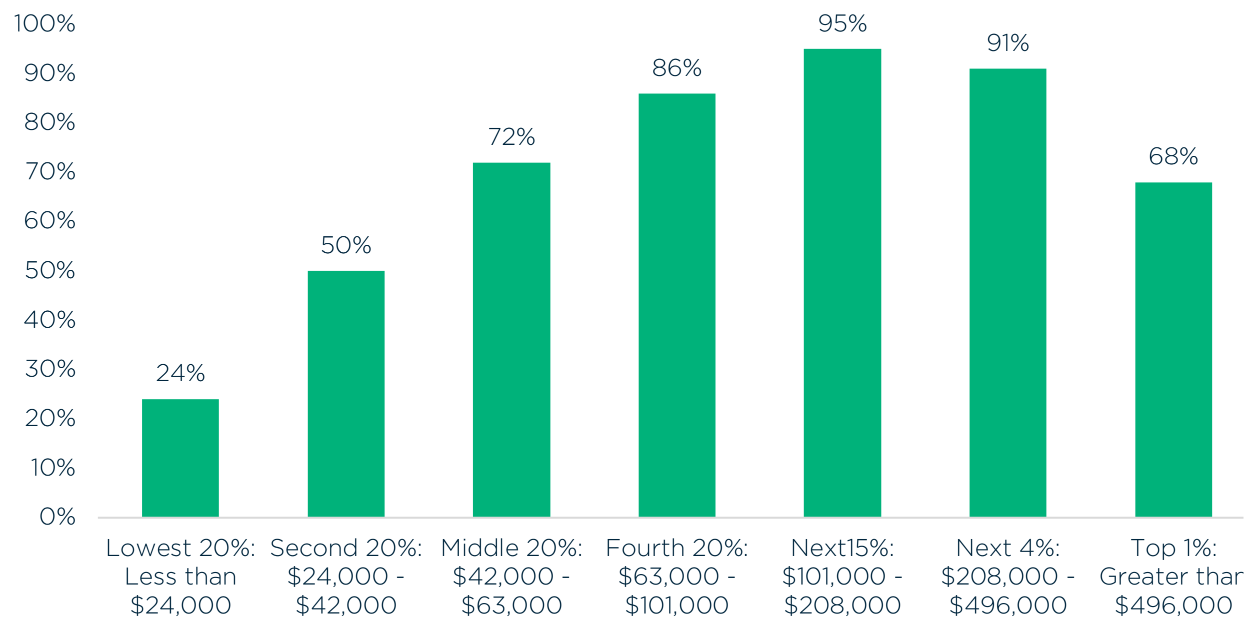
[1] The $250,000 is the amount of the deduction for single taxpayers and those who are married filing jointly. The amount is $125,000 for married taxpayers who file separately.
[2] Legislative Service Commission Comparative Documents for the House-approved version of House Bill 166 and the Senate substitute, at https://bit.ly/2Zolusa. As elsewhere in this report, this includes only the proposed changes in income-tax rates and brackets and the business income deduction.

than $208,000. While eliminating the bottom two brackets helps some moderate- and low-income taxpayers, the 8% rate cuts skew the overall benefits to those making much more. Most middle-income taxpayers will get a cut that they'll barely notice: An average of $68 for those receiving a cut among the middle fifth of tax filers, who make between $42,000 and $63,000 a year.

Overall, those in the top 1%, who make more than $496,000 a year, will pay very slightly more on average than they do now under the Senate plan. The elimination of the special 3% rate only affects those with more than $250,000 in business income, and virtually all those paying more under the Senate plan will be paid by those in the top 1%.[3] Despite that, fully 68% of those taxpayers in the top 1% will see a tax cut under the Senate plan. Chart 1 shows the share of Ohioans in each income group who will get a tax cut under the Senate plan. A greater share of the affluent taxpayers benefit than do those with the lowest incomes.

Chart 1

Share of those receiving a tax cut by income group under the proposed Senate tax plan



Source: Institute on Taxation and Economic Policy, June 13, 2019. Covers Ohio residents at 2019 income levels.

The next most affluent group of taxpayers after the top 1%, those in the next 4 percent who make between $208,000 and $496,000, will see an average tax cut of $573 under the Senate plan, far more than under the House bill. The House move to reduce the business income deduction to $100,000, omitted in the Senate plan, makes a major difference for many of Ohio's most affluent residents. Nearly two-thirds of those in the top 1% would pay more under the House plan, while only 32% would do so under the Senate bill.

[3] As explained below, some of those with business income over $250,000 will actually pay less under the Senate plan to eliminate the special 3% rate. Others who have income between $250,000 and $496,000 have additional non-business income and will benefit from the rate cuts. As a result, on average, very few Ohioans with income below $496,000 will wind up paying more under the Senate plan.

Yet the end of the special 3% rate actually would produce an additional tax cut for some Ohioans making more than $250,000. This provision doesn't work the way you might think; it doesn't mean that these taxpayers are paying the top rate on all of this income, like others with income over $250,000. In fact, for some, it will be a rate cut. That's because someone with business income of $300,000 will still get the $250,000 deduction – and then will pay on the remaining $50,000 as if they have no other income. Such a taxpayer would pay far less in 2020 and beyond under the bill than if they were taxed at the top rate on this income, as they should be. While this ultimately means a fairly small number of taxpayers will get an overall tax cut, probably because most of them have other income, it needs to be modified so it does not favor some of these taxpayers with an additional rate cut.

Under both the House and Senate plans, the effect on the poorest Ohioans would be remarkably similar. Fewer than a quarter of these filers – the fifth making less than $24,000 a year – would benefit. As Table 1 shows, this group would get less than 10% of the total tax cut, and the average under both plans for those getting a cut would be $160 a year. One reason why the results are so similar is that while the Senate plan has a larger rate cut, it also sets a slightly lower threshold for when taxpayers would start having to pay taxes. The House bill set that at $22,250, while the Senate would keep brackets and personal exemptions from being adjusted for inflation for two years, and would thus set taxes to start at $21,750.

Table 1

How the House and Senate tax plans compare for the bottom fifth of Ohio earners

	House	Senate
Share receiving tax cut	24%	24%
Average tax cut for those receiving a cut	($160)	($160)
Share of total tax cut	8%	7%

Source: Institute on Taxation and Economic Policy, June 13, 2019. Ohio residents only who make less than $24,000 a year

Low-income Ohioans pay nearly twice as much of their income in state and local taxes as the richest Ohioans do.[4] But many pay little or no income tax. First, this is because it is a graduated tax, based on the ability to pay. It is also because the existing $10,500 threshold for paying the tax, plus personal exemptions and the existing, non-refundable state EITC, wipe out all or most income tax liability for many of the poorest taxpayers. For instance, a single working parent with two children and income of $20,000 pays no income tax now. This is why the House and Senate plans to cut income tax rates and to eliminate the bottom two brackets don't help the vast majority of the lowest-income Ohioans even while they reduce revenue for needed services.

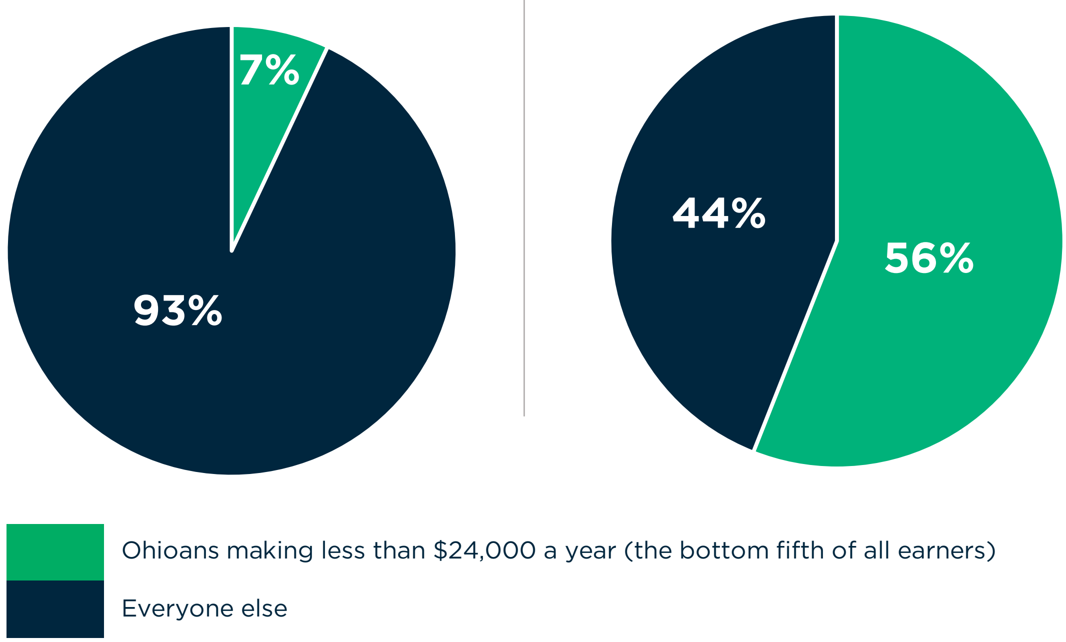
A refundable EITC

ITEP also reviewed the results of adding a 10% refundable EITC. Eligible filers would receive either that refundable credit or the 30% nonrefundable EITC, whichever is more. ITEP found that 56% of the tax cut that resulted would go to the poorest fifth of Ohioans, offsetting the disproportionate share of earnings they pay in state and local taxes other than the income tax and starting to rebalance Ohio's inequitable tax structure. That's far more than in the House or Senate plans. Chart 2 shows that under the Senate plan, by contrast to a 10% refundable EITC, just 7 percent of the benefit flows to Ohioans making less than $24,000 a year.

[4] Patton, Wendy, "Ohio state and local taxes hit poor and middle-income families the hardest," Policy Matters Ohio, Oct. 17, 2018, at https://bit.ly/2RctFJY

Chart 2

Share of total tax cut under Senate plan	Share of total tax cut with a refundable 10% EITC



Source: Institute on Taxation and Economic Policy, June 13, 2019. Ohio residents only

Some 33% of the bottom fifth of earners would get a tax cut with a refundable 10% EITC. And those among the group getting a tax cut would average a reduction of $248 with a refundable EITC, compared to just $160 under the House and Senate bills. Overall, including all tax filers making less than $24,000, the tax reduction under a 10% refundable tax credit would average twice as much as in either the House or Senate plans.

The federal EITC is the nation's most powerful anti-poverty program. It is only available to working families. The General Assembly passed a transportation budget that increased the state EITC to 30% of the federal credit. As helpful as the state EITC is, with that improvement, it does not do enough to help the poorest Ohioans because it is not refundable: Under current policy when the credit is in excess of state income tax paid, you get no refund.[5]

As described above, a refundable 10% EITC would do more for the poorest Ohioans than the Senate tax plan would. It also would focus tax cuts more among the bottom 60% of earners. Altogether, ITEP's analysis shows that these Ohioans, those making less than $42,000 a year, would get 82% of the refundable EITC. The same group would get just 12% of the tax cuts in the Senate bill. Clearly, a refundable EITC is much better targeted than the tax plan in the Senate bill.

[5] Stein, Ben, " Refundability Now," Policy Matters Ohio, June 4, 2019, at https://bit.ly/2lHda1p

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Moreover, ITEP found in a previous study that the poorest fifth of Ohioans on average saw by far the biggest boost in taxes from the major state and local tax changes over the past 15 years.[6] While numbers from that study are not exactly comparable to the analysis in this report, the Senate tax plan would reverse only about a quarter of the average tax increase experienced by the poorest Ohioans. By contrast, a refundable 10% EITC would save them double that amount. The refundable EITC does a far better job than the Senate tax plan of reversing the tax shift the state has seen.

Improving on the Senate tax plan

The finalized state budget should include the scaled-down version of the business income deduction proposed by the House. The tax break has not brought an increase in first-time hiring by new businesses, while the growth of passthrough entities has continued to trail the national average. Overall Ohio job gains have lagged behind the nation's. The forecast used by the state to put together its next two-year budget says that Ohio will continue to fall behind the country over the next two years in economic growth, personal income, nonfarm employment and retail and food service sales.[7]

The LLC loophole heavily benefits the most affluent. In 2017, just 7.4% of the tax filers who used the deduction, those claiming passthrough income of $200,000 or more a year, received 43.4% of the deductions—and that doesn't include the additional tax break for those making over $250,000.[8] This has further slanted our tax system in favor of those who need such treatment least. It should be repealed altogether. And the inclusion of rate and bracket cuts is a repeat of the tax policy that has failed the state since 2005 that should be rejected.

Short of eliminating the LLC loophole, cutting it back to $100,000 would be a win for Ohio. It would bring a measure of tax fairness, while generating needed revenue. In addition to adopting a 10% refundable EITC, reductions in this tax break could go toward meeting some of Ohio's unmet needs. For example, they could help underwrite a new school funding formula or other priorities.[9] We have previously identified a number of alternatives, including increasing eligibility for public child care, bolstering aid to local governments and boosting support for low-income college students.[10]

Under the Senate bill, a minority of the top 1% of Ohio earners, who average earnings of more than $1.2 million a year, see a tax increase. The revenues are spread so that most Ohioans who receive a tax cut will hardly notice it. Most of the poorest Ohioans get no benefit from it at all. The General Assembly should approve the changes in the LLC loophole in the House tax plan, but use them for a different purpose: Providing more meaningful tax cuts to the poorest Ohioans, and investing in services we need.

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[6] 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

[7] Kimberly Murnieks, OBM director, Testimony to the Senate Finance Committee, April 24, 2019, p. 8. Schiller, Zach and Wendy Patton, "The Good and the Bad in the House Tax Plan," Policy Matters Ohio, May 29, 2019, at https://bit.ly/2wFDwLA

[8] Schiller, Zach, "Closing the LLC Loophole," Policy Matters Ohio, May 29, 2019, at https://bit.ly/2KQClvF

[9] Patton, Wendy, "Testimony to Senate Finance Committee on House Bill 166," June 14, 2019, at https://bit.ly/2Zpnfqo

[10] Patton, Wendy, Investing in Ohio and Ohioans, Policy Matters Ohio, February 22, 2019 at https://bit.ly/2Tfr42N

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