Boosting revenue: Tapping top earners to meet Ohio's needs

A Report From

Policy Matters Ohio

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Executive Summary

In order to balance the Ohio state budget, Gov. Ted Strickland has proposed temporarily restoring the last year of a five-year, 21 percent income-tax cut approved in 2005. The governor has called for suspending one year of the cut to generate $844 million over two years for the state's General Revenue Fund.

After the major slashes in state spending that were required to balance the budget, calling off one part of the tax cut is a realistic first step. However, the General Assembly should go farther and also reinstitute the tax rate of 7.5 percent on income over $200,000 that existed prior to the tax cuts enacted in 2005. In addition, the legislature should consider creating a new, 8.5 percent bracket for income over $500,000. This analysis relies on the Institute on Taxation and Economic Policy, a Washington D.C.-based research institute with a sophisticated model of state and federal taxation systems, to examine the effects of all three steps: Gov. Strickland's proposal, reinstating the previous rate on income over $200,000 and creating such a new $500,000 bracket.

According to the ITEP analysis, combining the governor's proposal with the increases for the highest-income Ohioans would generate more than $950 million a year. Almost $600 million, or more than three-fifths of that amount, would be paid by Ohio taxpayers in the top 1 percent of the income spectrum, those expected to make $319,000 or more this year. On average, this group makes $841,000 a year. The tax increase would cost such taxpayers on average 1.3 percent as a share of their annual income. Their overall Ohio income tax on average would climb from $36,673 to $47,616, or 5.7 percent of their income.

By contrast, the four-fifths of Ohio taxpayers making $76,000 or less a year together would pay just 14 percent of the total tax increase. On average, taxpayers in the middle fifth of the income scale – those making between $32,000 and $49,000 a year – would have to pay an additional $37 a year, or less than one tenth of one percent of their annual income. Lower-income taxpayers on average would pay even less than that. Under this proposal, all taxpayers would continue to see four-fifths of the tax reductions that they experienced on any income earned below $200,000.

Across the country, affluent Americans have benefited far more from economic growth in recent decades than those lower down on the income ladder. Between 1993 and 2007, for instance, half of all income growth went to families in the top 1 percent of the income spectrum. While income inequality in Ohio is not as extreme as in the nation as a whole, in 2006, the richest 1 percent of Ohio families took in more than 15 percent of all income in the state, while the entire bottom half of the population shared less than 15 percent of the state's income before taxes.

Raising the income tax on high-earning Ohioans makes sense because it will allow the state to make crucial investments in education, help mend the safety net when it is most needed and adequately finance the current budget while preparing for the loss of one-time revenues that help support it. High-income Ohioans are most able to pay additional taxes – and the revenue is badly needed.

As necessary as the governor's proposal is, it will still leave Ohio's budget precariously balanced, with a real chance that it will fall out of whack again. As approved, the budget slashed spending for important human needs, including mental health services and programs that allow seniors to stay in their homes and for children's early care and education. At the same time, it insufficiently funded Gov. Strickland's school plan, mass transit, libraries and food pantries, among other items. It relies on stretching out debt payments and using up reserves. This leaves a gigantic hole when the one-time sources used in this budget are not available.

Roughly half of the money raised from adopting this tax proposal would be needed to close the existing gap in the biennial budget for fiscal years 2010 and 2011. The other half would allow the General Assembly to restore some of the cuts made in the FY10-11 budget and to better position the state for the long-term, as annual revenues are billions of dollars below the necessary level to sustain even existing state services.

The 2005 income-tax cuts have not resulted in a relative improvement in Ohio's economy to the rest of the nation, either before or after the beginning of current recession. Increases in income taxes for the affluent are less likely to hurt the state's economy than the spending cuts that have taken place – and will take place – if the tax cuts are all maintained.

Other states have been taking steps to boost income-tax rates on the wealthiest households: Seven states have done so this year alone, according to the Center on Budget and Policy Priorities. Ohio will need to take other steps, such as bolstering business taxes and tightening up on tax loopholes, to put its budget on a sound foundation. However, strengthening the income tax with higher rates for the most affluent is a crucial first step.

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In order to balance the Ohio state budget, Gov. Ted Strickland has proposed temporarily restoring the last year of a five-year, 21 percent income-tax cut approved in 2005. The governor has called for suspending one year of the cut to generate $844 million over two years for the state's General Revenue Fund.

After the major slashes in state spending that were required to balance the budget, calling off one part of the tax cut is a realistic first step. However, the General Assembly should go farther and also reinstitute the tax rate of 7.5 percent on income over $200,000 that existed prior to the tax cuts enacted in 2005. According to an analysis by the Institute on Taxation and Economic Policy (ITEP), a national research institute with a sophisticated model of state and federal taxation systems, fewer than 2 percent of Ohio's taxpayers would be affected by such a step. By itself, reinstating the 7.5 percent rate would raise about the same amount of revenue as the across-the-board measure proposed by the governor.[1] But both are needed for adequate revenue.

In addition, the legislature should consider creating a new, 8.5 percent bracket for income over $500,000. This analysis uses ITEP's model to examine the effects of all three steps: Gov. Strickland's proposal, reinstating the previous rate on income over $200,000 and creating such a new $500,000 bracket. We begin by examining the last two elements of the package, a return to the 7.5 percent rate on income over $200,000 and the creation of the new bracket, sometimes referred to as a "half-millionaire's tax." State Reps. Mike Foley and Bob Hagan have introduced House Bill 308 that includes both of these measures.

Raising the income tax on high-earning Ohioans makes sense because it will allow the state to make crucial investments in education, help mend the safety net when it is most needed and adequately finance the current budget while preparing for the loss of one-time revenues that help support it. High-income Ohioans are most able to pay additional taxes, yet recent state tax policies raising sales and excise taxes have been weighted against lower- and middle-income Ohioans.

As Table 1 below shows, the combination of two changes – restoring the 7.5 percent rate on income over $200,000 and creating the new bracket – would generate about $600 million annually. The analysis breaks Ohio residents into five income groups, or quintiles, and then subdivides the top quintile into three groups. The vast bulk of the increase would be paid by taxpayers in the top 1 percent of the income spectrum, who are expected to make more than $319,000 this year.[2] On average, they would pay an additional $10,469 a year before taking into

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[1] The two measures overlap, however, so one cannot add the revenue generated by each and arrive at the sum of doing both together. Part of the increase in taxes for upper-income Ohioans would take place both under Gov. Strickland's proposal and a return to a 7.5 percent rate for income over $200,000.

[2] ITEP's projections for 2009 data are based on a combination of sources including government agencies such as the Internal Revenue Service and the Congressional Budget Office, as well as an August 2009 forecast from Moody's Economy.com, a nationally known economics firm. For more on the ITEP microsimulation model and the income

account any reduction in federal taxes (almost one dollar in five of the added state taxes would come back in the form of lower federal taxes). This amounts to 1.2 percent of the group's average income of $841,000.

Table 1

Impact of Restoring 7.5% Rate Over $200,000 and Adding a New 8.5% Rate Over $500,000							
2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $18,000	$18,000 - $32,000	$32,000 - $49,000	$49,000 - $76,000	$76,000 - $138,000	$138,000 - $319,000	$319,000 Or More
Average Income in Group	$10,000	$24,000	$41,000	$61,000	$97,000	$196,000	$841,000
State Tax Change as a % of Income	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	1.2%
$ Average State Tax Change	$ 0	$ 0	$ 0	$ 0	$ 0	+$145	+$10,469
Group Share of State Tax Change	$ 0	$ 0	$ 0	$ 0	$ 0	$32 million	$572 million
	0.0%	0.0%	0.0%	0.0%	0.0%	5%	95%

Source: Institute on Taxation and Economic Policy. All Ohio residents, estimated 2009 income levels. All numbers are rounded.

Under Gov. Strickland's proposal, taxpayers in the top fifth of Ohio earners would pay 70 percent of the additional taxes. Middle-income Ohioans would contribute a share – $37 on average for taxpayers in the middle of the income spectrum, those with incomes between $32,000 and $49,000 a year. Because Ohio has a graduated income tax, in which rates increase with income, an across-the-board, flat-percentage boost in rates results in those with higher incomes paying a larger amount. Thus, those in the top 1 percent would pay on average $1,980 a year more, while those with income between $138,000 and $319,000 would average a $363 yearly increase.[3] In each case for these upper-income taxpayers, this still represents only about 0.2 percent of annual income. ITEP estimated the temporary rollback would raise about $442 million, comparable to administration estimates.[4]

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projections used see: http://itepnet.org/itepmodel.htm ITEP estimates in this report are for total income-tax collections, not only those going to the General Revenue Fund

[3] Recent estimates by the Ohio Department of Taxation on the effect of the Strickland proposal on different income groups were similar to those shown below in Table 2. See Niquette, Mark and Jim Siegel, "Delaying income-tax cuts would dock high incomes the most," The Columbus Dispatch, Oct. 5, 2009. http://www.dispatch.com/live/content/local_news/stories/2009/10/04/atax.html?sid=101

[4] The Strickland plan is projected to raise $895 million in total over two years, $51 million of which would go to local governments and public libraries, leaving $844 million for the General Revenue Fund.

Table 2

Impact of Restoring Rates to 2008 Levels							
2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $18,000	$18,000 - $32,000	$32,000 - $49,000	$49,000 - $76,000	$76,000 - $138,000	$138,000 - $319,000	$319,000 Or More
Average Income in Group	$10,000	$24,000	$41,000	$61,000	$97,000	$196,000	$841,000
State Tax Change as a % of Income	0.0%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%
$ Average State Tax Change	+$2	+$15	+$37	+$69	+$146	+$363	+$1,980
Group Share of State Tax Change	$2 million	$16 million	$41 million	$76 million	$120 million	$79 million	$108 million
	0%	4%	9%	17%	27%	18%	24%

Source: Institute on Taxation and Economic Policy. All Ohio residents, estimated 2009 income levels. All numbers are rounded.

Combining the governor's proposal with the increases for the highest-income Ohioans would generate more than $950 million a year (there is some overlap in the proposals, so the amount raised is not just the sum of the two). According to the ITEP model, almost $600 million, or more than three-fifths of that amount, would be paid by Ohio taxpayers in the top 1 percent of the income spectrum, those making $319,000 a year or more. On average, this group makes $841,000 a year. The tax increase would cost such taxpayers on average 1.3 percent as a share of their annual income. Their overall Ohio income tax on average would climb from $36,673 to $47,616, or 5.7 percent of their income.[5]

By contrast, the four-fifths of Ohio taxpayers making $76,000 or less a year together would pay just 14 percent of the total tax increase. On average, taxpayers in the middle fifth of the income scale – those making between $32,000 and $49,000 a year – would have to pay an additional $37 a year, or less than one tenth of one percent of their annual income. Lower-income taxpayers on average would pay less than that, as Table 3 below shows:

[5] Taking into account the higher deduction that they could take on their federal tax returns, the net state and federal taxes would increase from $28,362 to $37,199.

Table 3

Impact of Rate Rollback to 2008 Levels, Reinstating 7.5% Rate over $200,000 and 8.5% Rate Over $500,000							
2009 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $18,000	$18,000 - $32,000	$32,000 - $49,000	$49,000 - $76,000	$76,000 - $138,000	$138,000 - $319,000	$319,000 Or More
Average Income in Group	$10,000	$24,000	$41,000	$61,000	$97,000	$196,000	$841,000
State Tax Change as a % of Income	0.0%	0.1%	0.1%	0.1%	0.2%	0.2%	1.3%
$ Average State Tax Change	+$2	+$15	+$37	+$69	+$146	+$479	+$10,943
Group Share of Total State Tax Change	$2 million	$16 million	$41 million	$76 million	$120 million	$105 million	$598 million
	0%	2%	4%	8%	13%	11%	62%

Source: Institute on Taxation and Economic Policy. All Ohio residents, estimated 2009 income levels. All numbers are rounded.

Under this proposal, all taxpayers would continue to see four-fifths of the tax reductions that they experienced on any income earned below $200,000.[6] For taxpayers in the middle fifth of the income distribution, that amounts to about $153 a year. Taxpayers with income over $200,000 would continue to see those tax cuts, but would pay the rate they had been paying before 2005 – 7.5 percent – on income over $200,000.[7] This rate was established by the General Assembly when George Voinovich was governor in 1992. Those taxpayers with income over $500,000 would see a new, higher rate on that income. As with Gov. Strickland's proposal, this assumes an increase in the personal exemption for each taxpayer and dependent to $1,550 from last year's $1,500.

Roughly half of the money raised from adopting this tax proposal would be needed to close the existing gap in the biennial budget for fiscal years 2010 and 2011.[8] The other half would allow the General Assembly to restore some of the cuts made in the FY10-11 budget and to better position the state for the long-term, as annual revenues are billions of dollars below the necessary level to sustain even existing state services.[9]

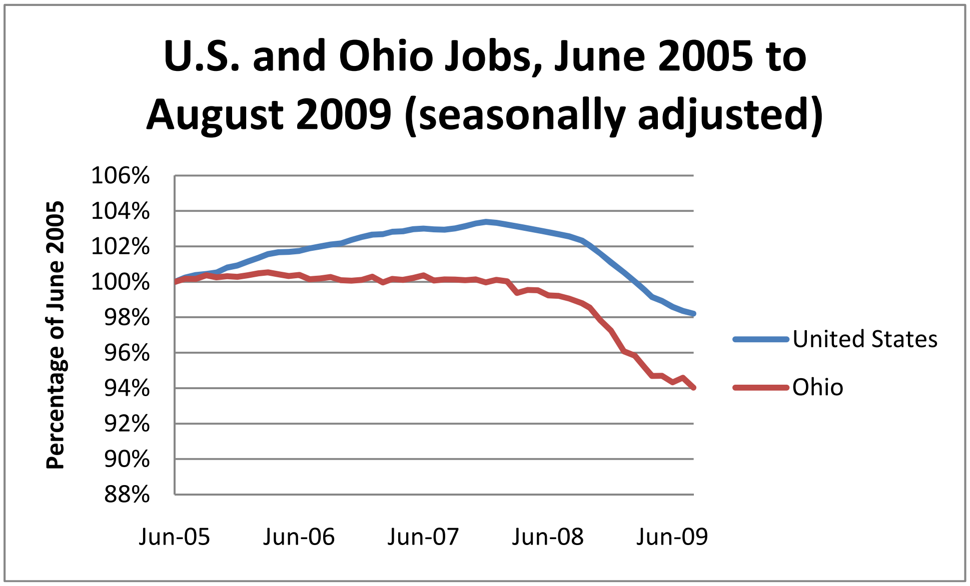
Across the country, affluent Americans have benefited far more from economic growth in recent decades than those lower down on the income ladder. Between 1993 and 2007, for instance, half of all income growth went to families in the top one percent of the income spectrum.[10] While

[6] Ohio residents with income below $10,000 receive a credit that eliminates their tax liability.
[7] Gov. Strickland's proposal covers one of the five annual cuts in the current rate on income over $200,000. It would temporarily increase the rate on such income from 5.925 percent to 6.24 percent.
[8] The exact amount of revenue that is available during the current biennium depends, of course, on when the proposal is effective.
[9] For two estimates on the amount of one-time revenue in the current budget, see "Strickland Income Tax Plan Finds Cautious Support Among Business Groups; More 'One-Time' Revenues Raise Concerns," Gongwer News Service, Volume #78, Report #92, Oct. 2, 2009.
[10] Saez, Emmanuel, "Striking it Richer: The Evolution of Top Incomes in the United States (Update with 2007 Estimates)," Aug. 5, 2009 http://elsa.berkeley.edu/~saez/ The 2007 share of income accounted for by the top 0.01 percent, Saez noted, was the highest on record of any year since 1913. See pp. 1, 9. Saez notes that much of the discussion in this note was based on previous joint work with Thomas Piketty.

income inequality in Ohio is not as extreme as in the nation as a whole, in 2006, the richest one percent of Ohio families took in more than 15 percent of all income in the state, while the entire bottom half of the population shared less than 15 percent of the state's income before taxes.[11]

Reducing spending to maintain the 2005 Ohio tax cuts is not good economic policy. Nor have the tax cuts resulted in a relative improvement in Ohio's economy compared to the rest of the nation, either before or after the beginning of current recession.[12] Figure 1 shows Ohio's relative job performance since the tax cuts were enacted in June 2005:

Figure 1



Source: Current Employment Statistics, Bureau of Labor Statistics, Ohio Department of Job & Family Services

Under the proposal shown in Table 3, about a sixth of the additional revenue generated actually would come from the federal government, and the cost to Ohio taxpayers would be reduced by that amount. That's because taxpayers who itemize their deductions to the federal income tax would have more state income tax to deduct, reducing their federal income tax liability.

Most states have been raising taxes in some fashion, and seven states have increased income-tax rates on the wealthiest households this year alone, according to the Center on Budget and Policy Priorities.[13] CBPP reports, for example, that:

-- Wisconsin added a new 7.75 percent tax bracket on income over $300,000 for a married couple and $225,000 for individuals and heads of households.

[11] Institute on Taxation and Economic Policy, "Latest IRS Data Reveal Fundamental Mismatches in the States," Aug. 5, 2008. http://www.itepnet.org/2006soistatemismatches.pdf
[12] Honeck, Jon, "The 2005 Tax Overhaul and Ohio's Economy," Policy Matters Ohio, January 2009, at http://www.policymattersohio.org/2005TaxOverhaul.htm
[13] McNichol, Elizabeth and Jon Shure, "Raising State Income Taxes on High-Income Taxpayers," Center on Budget and Policy Priorities, Sept. 30, 2009, see http://www.cbpp.org/cms/index.cfm?fa=view&id=2792 Information on the individual states is from this same source.

-- North Carolina added a two-year, three percent surtax to its income tax for married filers with income over $250,000 and single filers with income above $150,000 (a 2 percent surtax was adopted for married filers with income from $100,000 to $250,000, and single filers with income between $60,000 and $150,000).

-- New Jersey for one year will tax income of joint filers that is more than $1 million at 10.75 percent, income between $500,000 and $1 million at 10.25 percent, and income between $400,000 and $500,000 at 8 percent.

Fears that tax increases of this kind will harm the state economy are wildly overblown.[14] Those who argue that forgoing tax cuts will hurt Ohio's economy seem to forget that the spending cuts we inevitably experience instead also have an effect on the economy. In fact, this effect is likely to be as great, and quite likely greater, than that of the tax increases. Most economists agreed during the discussion of the national stimulus plan earlier this year that spending boosts the economy more than tax cuts. For example, a Jan. 6 article in *The New York Times* on a meeting of the American Economic Association reported that, "Nearly every economist who spoke here agreed that a dollar invested in, say, a new transit system or in bridge repair is spent and re-spent more efficiently than a dollar that comes to a household in a tax cut. A bigger percentage of the latter is saved, they said."[15] This is particularly true of high-income taxpayers, which is why raising taxes on that group is more likely to help the economy than budget cuts.

As necessary as the governor's proposal is, it will still leave Ohio's budget precariously balanced, with a real chance that it will fall out of whack again.[16] As approved, the budget slashed spending for important human needs, including essentials such as mental health services, and programs that allow seniors to stay in their homes and for children's early care and education. At the same time, it insufficiently funded Gov. Strickland's school plan, mass transit, libraries and food pantries, among other items. It relies on stretching out debt payments and using up reserves, including the one half percent reserve usually set aside at the end of the biennium. While there may be some disagreement about its size, this leaves a gigantic hole when the one-time sources used to fund the current budget are not available.

[14] Following previous research by David Ellis, then of the Center for Community Solutions, Policy Matters Ohio reviewed private-sector economic growth in all 50 states and found that higher state and local taxes are associated with higher levels of per capita gross state product and per capita personal income. This does not mean that one causes the other, but it illustrates that lower taxes are not a prescription for better economic performance. See Honeck, Jon, "Economic Growth and the Public Sector: Evidence from the States," Policy Matters Ohio, September 2006, http://www.policymattersohio.org/state_economic_growth_2006.htm

[15] Uchitelle, Louis, "Economists Warm to Government Spending but Debate its Form," *The New York Times*, Jan. 6, 2009, http://www.nytimes.com/2009/01/07/business/economy/07spend.html

[16] For instance, the lawsuit involving the state and the Tobacco Use Prevention and Control Foundation could well tear another $258.6 million hole in the budget. The state is appealing a Franklin County common pleas court ruling that the state could not liquidate the tobacco fund and use it for other purposes. "State Immediately Appeals Judge's Order Snuffing Out Raid on $258 Million Anti-Smoking Fund," Gongwer News Service, Volume #78, Report #155, Aug. 11, 2009

Restoring the necessary revenue to meet the needs of Ohioans and operate Ohio government can't be done with the income tax alone; it also will require changes in business taxes, which were cut by more than $1 billion a year in the 2005 tax overhaul.[17] Legislators also should reexamine tax loopholes that cost the state hundreds of millions of dollars a year.[18] However, a stronger income tax is a cornerstone of a sound budget strategy for Ohio.

[17] See Schiller, Zach, "Business Tax Revamp: A Deficit in the Making," Policy Matters Ohio, January 2009, http://www.policymattersohio.org/BusinessTaxRevamp2009.htm
[18] See Schiller, Zach, "Limiting Loopholes: A Dozen Tax Breaks Ohio Can Do Without," Policy Matters Ohio, September 2008, http://www.policymattersohio.org/LimitingLoopholes2008.htm

Policy Matters Ohio is a non-profit, non-partisan research institute dedicated to researching an economy that works for all in Ohio. Policy Matters seeks to broaden debate about economic policy by providing research on issues that matter to Ohio's working people and their families. Areas of inquiry for Policy Matters include work, wages, and benefits; education; economic development; energy policy; and tax policy. Generous funding comes from the Joyce, Gund, Cleveland, Public Welfare, KnowledgeWorks, New World, Annie E. Casey, Sisters of Charity and W.K. Kellogg Foundations, the Economic Policy Institute, and Greater Cleveland Community Shares. To those who want a more fair and prosperous economy... Policy Matters.

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