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An Analysis of the Proposed Ohio Capital Gains Tax Cut
July 2006

Introduction & Summary:

The Ohio legislature is considering a proposal to scrap the current Ohio rule that taxes capital gains (profits from selling stock, investment real estate, etc.) at the same rates as other income. The plan would reduce the maximum Ohio tax rate on capital gains as follows:

- In 2007, from the currently scheduled 6.555 percent to 5 percent.
- In 2008, from the currently scheduled 6.24 percent to 4 percent.
- In 2009 and thereafter, from the currently scheduled 5.925 percent to 3 percent.

Taxpayers whose top marginal income tax rate is less than these proposed maximum capital gains rates would be unaffected by the proposal.

An analysis of the proposed Ohio capital gains tax cut by the Institute on Taxation and Economic Policy finds that:

- Three quarters of the proposed tax cuts in the first three years would go to the wealthiest one percent of Ohioans.
- The plan would likely cost the state thousands of jobs, because a large share of the tax cuts would be diverted out of state, including almost a fifth that would be sent directly to the federal government in higher federal income taxes.

1. Who would get the tax cuts?

Using the ITEP Microsimulation Tax Model, the analysis looked at the distributional effects of the first three years of the proposed capital gains tax cut. It found:

- The average 3-year tax cut for the lowest-income 40 percent of Ohioans, those with average 2007 income of $17,900, would be zero.
- The average 3-year tax cut for the middle 20 percent (average income of $40,600) would be $1.
- The average for the next 20 percent (average income of $61,800) would be $6.
- The average for the next 15 percent (average income of $98,200) would be $40.
- The average for the next 4 percent (average income of $194,000) would be $422.
- But the top one percent of Ohioans, with average 2007 income of $812,000, would get an average of $7,164.
- Three-quarters of the total tax cuts over three years would go to the top one percent, and 92 percent would go to the top five percent.

Effects of the Proposed Ohio Capital Gains Tax Cut In its First Three Years

Ohio Income Group	Average 2007 Income	2007		2008		2009		Three-year total	
		Average tax cut	% of total tax cut	Average tax cut	% of total tax cut	Average tax cut	% of total tax cut	Average tax cut	% of total tax cut
Lowest 20%	$ 10,900	$ —	—	$ —	—	$ —	—	$ —	—
Second 20%	25,000	—	—	—	—	—	—	—	—
Middle 20%	40,600	—	—	—	—	–1	0.5%	–1	0.3%
Fourth 20%	61,800	—	—	–1	0.7%	–5	2.3%	–6	1.3%
Next 15%	98,200	–2	1.8%	–11	5.4%	–27	8.8%	–40	6.3%
Next 4%	194,000	–73	14.9%	–137	17.6%	–212	18.7%	–422	17.6%
Top 1%	812,000	–1,621	83.3%	–2,385	76.3%	–3,158	69.6%	–7,164	74.5%
ALL	$ 57,700	$ –19	100.0%	$ –31	100.0%	$ –45	100.0%	$ –95	100.0%

Source: Institute on Taxation and Economic Policy Tax Model, July 2006

2. How would the plan affect Ohio jobs?

In its first three calendar years, the analysis estimates that the proposed capital gains tax cuts would take $537 million out of the Ohio state budget (with annual costs in excess of a quarter of a billion dollars a year thereafter). Without the tax cut, that money could otherwise be used in other ways. For example, it could be devoted to public services that generally hire Ohio workers and buy from Ohio suppliers. Or it could be used to put money in the pockets of middle- and low-income Ohioans to be mostly spent in Ohio. Or it could be saved in the state rainy-day fund to spend on these kinds of things during an economic (and revenue) downturn.

In contrast, the analysis then looked at where the money would be likely to go if it is used to cut state income taxes on wealthy investors.

One effect is very clear. A significant portion of the Ohio tax cut would be sent out of Ohio to the federal government. That's because state income taxes are deductible in computing federal taxable income for those who itemize deductions. Thus, if state income taxes are cut on better-off people, then federal income taxes will increase.

The study estimates that over the first three years, $97 million, or almost a fifth of the Ohio tax cut, will be sent directly to Washington, D.C. in higher federal income taxes.

As Box 1 on the next page explains, this estimate is sensitive to future Congressional action regarding the Alternative Minimum Tax, which denies deductions for state and local taxes for those who pay it. The $97 million estimate is based on the likelihood that Congress will maintain the AMT at its current level, by extending the temporary 2006 AMT relief into 2007 through 2009. Should Congress instead repeal the AMT, as some congressional leaders have proposed, then $159 million (30 percent) of the proposed Ohio capital gains tax cut would go directly to the federal government.

Box 1: Why is the federal itemized deduction offset so small?

The fact that less than a fifth of the proposed Ohio capital gains tax cut would be offset by increased federal income taxes may seem odd, given that almost all of the tax cuts will go to Ohioans in high federal tax brackets (33 or 35 percent). But the reason why the offset is not about a third of the tax cut is straightforward: the federal Alternative Minimum Tax.

Originally intended as a tax on well-off people who otherwise aren't paying taxes, the AMT has evolved into a tax on those who *do* pay taxes, specifically state and local income and property taxes. Federal deductions for state and local taxes are allowed under the regular federal income tax, but are not allowed against the AMT.

The ITEP analysis found that without the AMT, $159 million or 30 percent of the proposed Ohio capital gains tax cut would go directly to Washington, D.C. in the form of higher federal income taxes due to reduced itemized deductions. But because of the AMT, only 18 percent will be offset by higher federal taxes.

What will wealthy Ohioans do with the rest of their tax cut? This question cannot be answered with certainty, and will obviously differ for different people. But here are some possible ways that they might use the money:

- The most likely outcome is that most of the tax cut money will not be spent, but will simply be invested in the national stock market or in bonds of large corporations. Virtually none of that investment will redound to the benefit of Ohio's economy.
- It's also conceivable that some of those who get the tax cuts will use it to splurge on extra spending. For example, some might consider taking an extra vacation or buying a luxury product. The bulk of this kind of spending would either take place outside of Ohio or go to products not produced in Ohio.
- What about spending more on Ohio-produced goods and services? Would the rich eat more at Ohio restaurants, or play more golf on Ohio golf courses? This seems rather unlikely, since the wealthy can already afford to buy all such things that they want even without the proposed tax cut.
- Finally, what about the idea that the recipients of the capital gains tax break would use the money to start or expand an Ohio business? Or that wealthy people would flock to Ohio to take advantage of the tax break? These seem unlikely, too. Most of the recipients of the tax break are not business owners. Their capital gains are mostly profits from selling the stock of large corporations. In any event, while an average tax break of $7,164 per wealthy person is costly to Ohio's state budget, it's hardly enough to affect business investment in any significant way. (See Box 2 on the next page.)

The bottom line: It's conceivable that almost all of the capital gains tax cut money will go out of state. Assume conservatively, however, that beyond the fifth of the tax cut that goes to the federal government, only half of the remainder finds its way out of Ohio—for a total "export" percentage of 59 percent. What would that mean for Ohio jobs?

- In the first three years of the proposal, higher federal taxes alone will take $97 million out of the Ohio economy. At $40,000 per job, that alone equals 2,425 Ohio jobs lost.
- Assuming that 59 percent of the total tax cut is exported (including the part going to Washington, D.C.), then a total of $317 million will leave the Ohio economy over three years. Compared to keeping that money in Ohio, at $40,000 per job that would mean a total of 7,923 Ohio jobs lost.

Box 2: How would the proposed tax cut affect the rate of return on investments?

Besides the fact that most of the capital gains tax cuts would go to stock market investors, another reason why it is not plausible to assume any increased Ohio business investment from the proposed capital gains tax cut is that the tax break would have such a tiny effect on rates of return.

Suppose for example, that someone invests $100, and after 7 years the investment's value has grown to $150, at which point it is sold. Under current Ohio law (in 2009), a top-bracket investor would owe a 5.925 percent Ohio tax on the $50 profit, equal to $2.96. The federal capital gains tax (after accounting for the deduction for state tax), would be $6.91, for a total tax of $9.87. That would leave $40.13, which represents at annual after-tax rate of return of 4.94 percent.

With a 3 percent Ohio capital gains tax, the Ohio tax on the $50 capital gain would be $1.50, and the federal tax would be $7.20 (29 cents more because of smaller deduction for state tax). That's a total tax of $8.70, leaving $41.30 in after-tax profit, an annual after-tax rate of return of 5.06 percent.

It's hard to imagine that increasing the rate of return by 0.12 percent a year will have any significant effect on investment decisions.

Potential Cost to Ohio's economy from tax cuts exported out of state:

Cost in millions of dollars

	Federal offset only	Half of rest	Total exported	Export %
2007	$ 19.8 million	$ 44.0 million	$ 63.8 million	59.2%
2008	31.7 million	71.2 million	102.8 million	59.1%
2009	45.5 million	104.8 million	150.3 million	58.9%
3-year total	**$ 97.0 million**	**$ 219.9 million**	**$ 316.9 million**	**59.0%**

Cost in jobs at $40,000 per job

	Federal offset only	Half of rest	Total exported
2007	495	1,100	1,595
2008	791	1,779	2,570
2009	1,138	2,620	3,757
3-year total	**2,425**	**5,498**	**7,923**

Note: Figures on the cost to the Ohio economy from higher federal taxes assume extension of federal Alternative Minimum Tax Relief after 2006. In the unlikely event that AMT relief is not extended, the three-year increase in federal taxes on Ohioans from the capital gains tax cut would be $78.1 million. If the AMT is repealed, the three-year cost to Ohio's economy from increased federal taxes would be $159.4 million.

Source: ITEP Tax Model for federal offset figures.

3. Conclusion

Tax and spending policy always involves choices among alternatives. If the goal is to benefit the majority of Ohio's citizens and enhance the state's economy and jobs, then a tax cut proposal that is narrowly targeted to benefit the best-off Ohioans and that is almost guaranteed to shift money out of state would seem to be a particularly poor choice.

About ITEP

The Institute on Taxation and Economic Policy is one of the leading organizations in the country specializing in tax and budget policy issues. Since its founding in 1979, ITEP's research and analysis have played a key role in educating the public and informing federal and state tax reform debates.

ITEP's Microsimulation Tax Model allows it to measure the distributional consequences of federal and state tax laws and proposed changes thereto, both nationally and on a state-by-state basis. A description of the tax model can be found on ITEP's web site, www.itepnet.org.

ITEP's work is relied upon by officials at all levels of government and their professional staffs as a source of high quality, accurate analyses of tax issues. ITEP's studies and reports are also used by economists, professors in classrooms, and research institutions around the country, and are widely quoted in the news media.