A Step Toward Fiscal Balance: Options for Ohio's Income Tax

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Policy Matters Ohio, the publisher of this study, is a non-profit, nonpartisan statewide research institute dedicated to bridging the gap between research and policy in Ohio. Policy Matters seeks to broaden the debate about economic policy in Ohio, by providing quantitative and qualitative analysis of important issues facing working people in the state. Other areas of inquiry for Policy Matters have included unemployment compensation, workforce policy, wages, education, housing, energy, tax and budget policy, and economic development. All reports are available at www.policymattersohio.org.

Introduction

In the spring of 2008, Ohio's state government finds itself in familiar territory – facing a budget shortfall because of an inadequate revenue system and a slowing economy. Governor Ted Strickland has initiated $733 million in budget corrections to head off a threatened deficit. However, both the administration and the legislature consider revenue-raising alternatives off limits.

Now is the time to begin examining the state's options for raising revenue, both to avert a deficit and to invest in needed priorities. Policy Matters Ohio worked with the Institute on Taxation and Economic Policy (ITEP), a Washington, D.C., based research institute with a sophisticated model of state and federal taxation systems, to review some possibilities. The ITEP model is based on a variety of sources including federal Internal Revenue Service (IRS) data and shows the effects of tax changes on average Ohio families using 2007 income levels. The ITEP model separates Ohio families into five groups, or quintiles, based on their level of income. Each quintile contains an equal number of families. The results shown below have a more detailed breakout for the highest income quintile, including the top one percent.

One of the state's key fiscal challenges is to reform the income tax, which is the single largest contributor to state revenue and is our most progressive tax because of its tiered rates.[1] It is the tax that is most capable of growing long term with the economy, particularly in an era in which income gains are concentrated among the wealthiest households.

Current policies cut income tax rates by 21 percent across the board over a five-year period. A 4.2 percent rate cut takes place each year with the last cut scheduled to take place in 2009. Table 1 shows the original 2004 rates and the 2008 rates. Each rate is a marginal rate that corresponds to a slice of a family's taxable income.[2] In other words, this year a family with a taxable income level of $24,000 would pay 0.743 percent on its first $5,000 in taxable income, then 1.486 percent on the next increment between $5,001 and $10,000, and so on through the 4.457 rate on the final increment over $20,000. Families with taxable income below $10,000 receive a credit that removes all liability.

[1] Income tax revenues of $8.885 billion comprised 45.6 percent of total General Revenue Fund tax revenues in FY 2007. Office of Budget and Management. Council of Economic Advisors Economic Forecast Update, January 2008.
[2] Taxable income is not the same as total income. Deductions and exemptions reduce the amount of income subject to taxation.

Table 1.
Original (2004) and Current Year (2008) Ohio Income Tax Brackets and Marginal Rates

Taxable Income ($)	Marginal Rates (%)	
	2004	2008
0 - 5,000	0.743	0.618
5,001 - 10,000	1.486	1.236
10,001 -15,000	2.972	2.473
15,001 – 20,000	3.715	3.091
20,001 – 40,000	4.457	3.708
40,001 – 80,000	5.201	4.327
80,001 – 100,000	5.943	4.945
100,001 – 200,000	6.900	5.741
Over 200,000	7.500	6.240

Source: O.R.C. § 5747.02

We estimate that the cuts will reduce income tax revenues by approximately $2.22 billion in calendar year (CY) 2009 when compared to previous rates. Actual revenue losses may be higher because the estimates are based on 2007 income levels. This amount is greater than the basic annual operating subsidy provided to Ohio's public colleges through the Board of Regents.[3]

The slowing economy reduces income tax receipts even further. Income tax revenues have been below original budget estimates for five months in a row, including a 6.3 percent shortfall in March.[4] Through the first nine months of FY 2008, personal income tax receipts are 2.4 percent, or $149.5 million, below annual estimates.[5]

Continuing planned rate cuts in the current environment is irresponsible. We asked ITEP to model three possibilities: (1) freezing rates at 2008 levels, (2) restoring the original 7.5 percent top rate for the highest income families, and (3) and rolling back rates to 2007 levels. We recommend moving forward with the first two options immediately. The third option may be necessary if the state's fiscal health continues to deteriorate. Raising the top rate back to 7.5 percent alone would raise approximately $376 million in annual revenue compared to today's tax structure. The top rate applies to the highest income bracket, i.e., the share of a family's taxable income above $200,000. If this action is taken, less than two percent of all Ohio families would experience an actual change in tax liability.

[3] The legislative appropriation for the "state share of instruction" for Ohio's colleges and universities is $1.68 billion in FY 2008 and $1.84 billion in FY 2009. *Ohio Legislative Service Commission.* FY 2008 – 2009 Final Fiscal Analysis, Board of Regents. Available at http://www.lbo.state.oh.us/fiscal/budget/FiscalAnalysis/127GA/BOR.pdf
[4] Office of Budget and Management. *Monthly Financial Report.* April 2008, p. 13 and Table 1: General Revenue Fund Receipts. Preliminary Actual FY 2008 vs. Estimate 2008. Available at www.obm.ohio.gov.
[5] *Id.*

Freezing income tax rates at 2008 levels by itself would preserve approximately $441 million in revenue. Combining this action with raising the top rate back to its previous level of 7.5 percent would boost revenue by approximately $817 million in CY 2009.

If policymakers went a step further and rolled rates back to their 2007 levels while increasing the top rate to its original 7.5 percent level, they would raise approximately $1.16 billion more than is currently expected in 2009 (See Table 4 on page 8). Families in the middle quintile income group (annual incomes between $29,000 and $47,000) would see an average increase of $75 per year over 2009 rates, or two-tenths of one percent of their total income. They would see an average increase of $37 over what they are paying now, and they still would have an average net reduction of $112 or three-tenths of one percent of their income when compared to 2004 income tax rates. The vast majority of the $1.16 billion in additional revenue, 78 percent, would be paid by the top quintile of income earners.

Tax Reform and the Budget Shortfall

Ohio's economy has been weak in this decade. The number of seasonally adjusted nonfarm payroll jobs in the state remains over 200,000 below its previous peak in June 2000. Recent budgets have been patched together with one-time revenue and transfers from various non-tax sources, particularly Ohio's share of the national legal settlement with tobacco companies. The current budget, for example, relies on securitizing the state's tobacco settlement payments to pay for expanded property tax relief and an accelerated school building program. Separately, the Strickland administration expanded important social service programs by drawing down a surplus in federal TANF funds. These social programs will need additional ongoing revenues in order to continue providing the same level of services.[6]

In legislative testimony in February, Office of Budget and Management (OBM) Director J. Pari Sabety outlined three budget options based on projected economic activity – low growth, zero growth, and recession. The administration is acting on the low growth scenario, which creates the need for a budget correction of $733 million.[7] These cuts will result in the reduction of thousands of state employment positions and cuts to programs, including the closure of two psychiatric hospitals.

Seventy-one percent of the budget shortfall is caused by a downward revision of revenue estimates by $557.7 million through the balance of this budget cycle, which ends in June 2009.[8] This marks the second downward revision to official revenue estimates in the last

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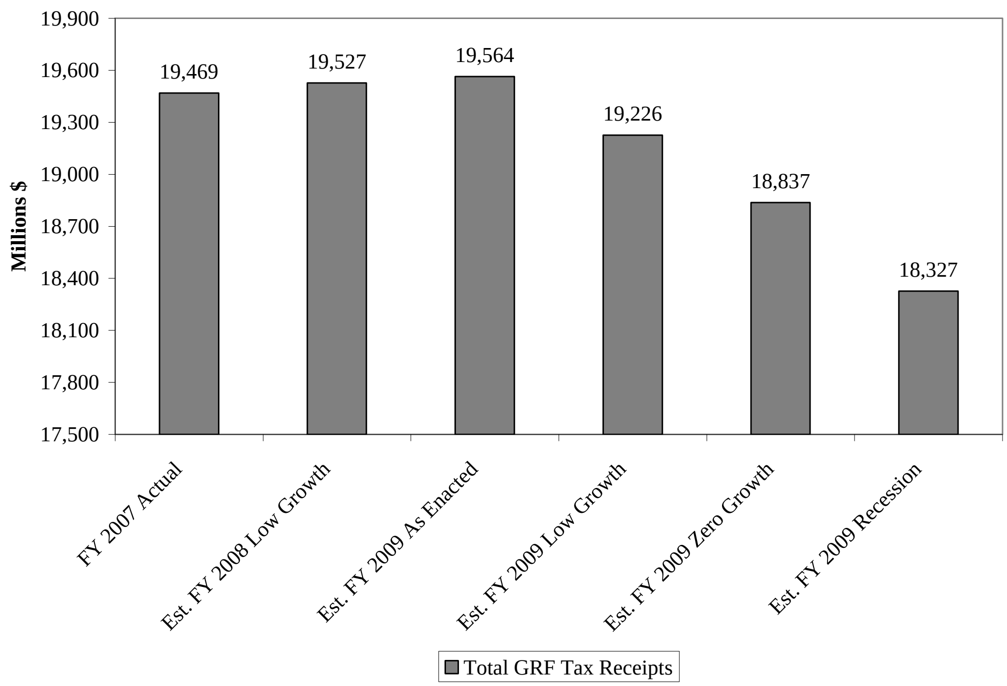
[6] Richard Sheridan, "Health and Human Services Issues for FY 2008-2009. Part 2: Job and Family Services (Family and Children's Services). *State Budgeting Matters*. Vol. 3, Issue 27. Aug. 15, 2007, Center for Community Solutions, p. 4.
[7] OBM subsequently revised the amount of the adjustment to $741million, of which $402 million are agency cuts. Gongwer News Service. "OBM signals more tight times ahead with FY 2010-2011 Budget Guidance to Agencies; Department Cuts Adjusted." Vol. 77, Rept. 72, Art. 2. April 14, 2008.
[8] Testimony of J. Pari Sabety, Director, Ohio Office of Budget and Management, before the Ohio House of Representatives Finance and Appropriations Committee, February 26, 2008, p. 5.

year. Since we are in the final quarter of FY 2008, most of the reductions will be felt in FY 2009.

Figure 1 below contrasts actual FY 2007 total General Revenue Fund (GRF) tax receipts with OBM's projected impact of various economic scenarios. Even in the most optimistic, low growth scenario, GRF tax receipts will be $243 million lower in FY 2009 than two years earlier. In a recession scenario, tax receipts will be over one billion dollars lower than FY 2007.

Figure 1. Total Estimated General Revenue Fund Tax Receipt Scenarios under HB 119 (FY 2008-2009) versus Actual FY 2007 Receipts



Source: OBM.

The expected fall in revenues will have a severe impact on state agencies' budgets for the next budget cycle as well. OBM guidance for state agencies directs them to plan for FY 2010 GRF spending that is ten percent below the adjusted FY 2009 levels.[9] To put this in perspective, the $733 million adjustment amounts to about 3.5 percent of the originally planned state-only GRF spending in FY 2009.[10] Even in FY 2011, OBM expects agencies' GRF spending levels to be five percent below their FY 2009 levels.

[9] Office of Budget and Management. "Operating Budget Guidance: Fiscal Years 2010 and 201," p. 3. Available at http://www.obm.ohio.gov/budget/operating/executive/guidance/1011/FY10-11%20Executive%20Budget%20Guidance.pdf

[10] The original H.B. 119 appropriation level for state-only GRF spending is $21.2 billion in FY 2009. Total GRF spending includes an additional $5.8 billion in federal funds. Office of Budget and Management. *State of Ohio Budget Highlights: Fiscal Years 2008 and 2009.* Available at www.obm.state.gov

State government has been unwilling to craft a permanent solution to its fiscal problems. Our new tax system, which was put in place in 2005 (FY 2006), adds to the state's budget challenges instead of solving them. According to OBM estimates, the 2005 tax changes, even when combined with savings from ending the state-subsidized commercial property tax rollback, create revenue losses on the order of two to three billion dollars each year depending on the baseline used for comparison.[11]

As we face the prospect of another recession, it's time for the state to develop a realistic tax system that is adequate to meet the long-term needs of our population and is progressive – that is, it taxes people according to their ability to pay.

Table 2 shows the impact of the five-year rate cuts by income strata when they are fully phased-in next year. The impact is measured against the original rate structure. The greatest savings, both in terms of dollar amounts and as a percentage of income, will go to the wealthiest taxpayers. The top twenty percent of households will receive over 70 percent of the savings from the cuts, or $1.56 billion of the total $2.22 billion in tax savings. The average annual tax savings for the top one percent of families is $10,273. This amounts to 1.2 percent of their income, on average.

For the families in the lowest quintile, with incomes less than $17,000, the average savings is twenty dollars, or 0.2 percent of income. The lowest-income families in this group receive the benefit of a low-income credit that began in 2005. The credit is designed to remove all tax liability for taxpayers with less than $10,000 in taxable income. In aggregate, the lowest income quintile will receive slightly under one percent, or $21 million, of the total $2.22 billion in tax savings.

The middle quintile comprises families with incomes between $29,000 and $47,000. The average income in this group is $38,000. These families will receive a tax cut of $187 on average, or about 0.5 percent of total income. This group will receive nine percent of the total $2.22 billion tax reduction in 2009, or about $208 million.

[11] For many years Ohio's sales tax rate was five percent. In FY 2004 and 2005, the legislature temporarily raised Ohio's sales tax rate to six percent. Starting with the FY 2006-2007 budget, the rate was changed to its current permanent level of 5.5 percent. Revenue estimates that use the six percent rate as the basis of comparison show a much higher loss than using than a five percent rate. Comparisons that use the five percent baseline show the 5.5 percent rate as a tax increase. If the five percent baseline is used, GRF losses are on the order of $2 billion over the current biennium (Fiscal Years 2008-2009) and nearly $4.4 billion in the next biennium. When compared to a six percent baseline, the revenue losses increase to over $2 billion in FY 2009 alone and nearly $6 billion in the FY 2010-2011 budget. Ohio Office of Budget and Management. *Executive Budget for FYs 2008 and 2009,* Part B. Economic Forecast: Revenue Estimates and Methodology table, p. B-8.

Table 2. Impact of Fully phased-in Taft Income Tax Changes by Income Quintile

INCOME GROUP	LOWEST 20%	SECOND 20%	MIDDLE 20%	FOURTH 20%	NEXT 15%	NEXT 4%	TOP 1%
Income Range	Less than $17,000	$17,000 - $29,000	$29,000 - $47,000	$47,000 - 74,000	$74,000 - $134,000	$134,000 – $339,000	$339,000 or More
Avg. Income	$10,000	$23,000	$38,000	$59,000	$96,000	$192,000	$890,000
Avg. Tax Change as % of Family Income	- 0.2%	- 0.3%	- 0.5%	- 0.6%	- 0.8%	- 1.0%	- 1.2%
$ Avg Tax Change per Family	- $20	- $66	- $187	- $336	- $740	- $1,844	- $10,273
Group Share of Total State Tax Change	1%	3%	9%	16%	27%	18%	26%
	$660 million				$1.560 billion		

Source: Institute on Taxation and Economic Policy. All Ohio Families, 2007 income levels. All numbers are rounded.

Maintaining our Safety Net and Making Investments

A weakened revenue structure has negative implications for Ohio's ability to meet rising demands for state services and invest in its future. Demands on the state's safety net will increase in the near-term due to the recession, even as state revenues suffer. Medicaid, a joint federal-state health insurance program, accounts for 18 percent of state-only GRF spending.[12] From July through December 2007, caseloads were 19,000 higher than original estimates.[13] Recessions are also a time when higher education enrollments go up. In this budget cycle, higher education became a priority again, and the legislature provided additional funding to enable a tuition freeze. Maintaining the tuition freeze in the face of rising enrollment will require even greater revenue commitments, let alone bringing tuition costs down to the national average.

[12] FY 2007 levels of the state-only share of budget line item GRF 600-525, which supports Medicaid spending vs. total state-only GRF expenditures. Policy Matters Ohio analysis of Legislative Service Commission, Table 2: State GRF, LGF, and LPEF Expenditures, FY 1975 - FY 2009, Available at http://www.lbo.state.oh.us/fiscal/budget/RevenueHistory/HistoricalExpendituresRevenue/HistoricalExpenditures2007-07.pdf
[13] Testimony of J. Pari Sabety, p. 4.

Many other needs could be mentioned. The current state budget provides small foundation formula increases that do not come close to solving the K-12 educational system's unconstitutional over reliance on local property tax revenue. The state's prison system is over 130 percent of capacity, having recently surpassed a level of 50,000 inmates.[14] The recently-passed Adam Walsh Act and other legislation may lead to the incarceration of 2,000 to 3,000 more inmates aside from the effects of an economic downturn on crime.[15] The Department of Youth Services recently entered into a legal settlement that will require additional spending of up to $30 million per year for juvenile offenders.[16] The stimulus package agreed to by the governor and the legislature also will impact the GRF. The announced budget cuts and long-term squeeze on state revenues make it extremely difficult for the state to provide services effectively and make investments in our future.

Income Tax Options

An enhanced income tax is the cornerstone of a realistic budget strategy. At a minimum the Administration and the legislature should freeze income tax rates at their current (2008) levels. Otherwise, the final rate cut in 2009 will cost the state $441 million in total foregone annual revenue. The state also should restore the previous statutory rate of 7.5 percent to the top income bracket of over $200,000. This action would raise a total of $376 million in 2009. Together, these two actions would boost income tax revenue by approximately $817 million next calendar year.

Less than 2 percent of all Ohio families would be affected by raising the top rate. The top one percent of Ohio families by income, who make at least $339,000 a year, would pay 92 percent of the increase. Only one-fifth of the families in the "Next 4%" by income would experience an increase (Table 3). Families affected by the increase would continue to receive the benefit of 2008 rates for the share of their income below $200,000.

[14] Gongwer News Service. "Panel Wrestles with Prison Overcrowding, Alternatives to Incareration," *Gongwer Report.* Volume 77, Report 46, Article 05. March 7, 2008.
[15] *Id.*, link to Department of Rehabilitation and Correction Lima prison study.
[16] Gongwer News Service. "Settlement in Federal Class Action Lawsuit may require $30 million annual boost in budget for Department of Youth Services." *Gongwer Report.* Volume 77, Report 65, Article 02, April 3, 2008.

Table 3.
Impact in 2008 of Restoring the Top Rate of 7.5 percent on Incomes over $200,000

INCOME GROUP	LOWEST 20%	SECOND 20%	MIDDLE 20%	FOURTH 20%	NEXT 15%	NEXT 4%	TOP 1%
Income Range	Less than $17,000	$17,000 - $29,000	$29,000 - $47,000	$47,000 - 74,000	$74,000 - $134,000	$134,000 - 339,000	$339,000 or More
Avg. Income	$10,000	$23,000	$38,000	$59,000	$96,000	$192,000	$890,000
Avg. Tax Change as % of Family Income	—	—	—	—	—	0.1%	0.7%
$ Avg Tax Change per Family	—	—	—	—	—	+ $132	+ $6,298
Group Share of Total State Tax Change	—	—	—	—	—	$28 million	$348 million

Source: Institute on Taxation and Economic Policy. All Ohio Families, 2007 income levels. Dollar figures are rounded.

Raising the top rate affects those who are most able to pay and who are best situated to reduce their federal income taxes through itemization. State and local income taxes are deductible from federal income, so a state tax increase leads to a reduction in federal income taxes on wealthy families. Almost one quarter of the increase would be passed on to the federal government.

This scenario increases the average state tax liability of the top one percent of families from $40,191 to $46,489. After the increase, total state tax liability would amount to 5.2 percent of the income of these families without taking into account federal deductions.

What if the legislature waits until next year to raise revenue to address the state's budget crisis? It is likely that the shortfall may be even deeper than it is now, and the state may need to take even stronger action. Table 4 shows the impact on the average tax liability per family of returning rates to their 2007 levels and raising the top rate to 7.5 percent measured next year. This option would increase income tax revenue by $1.164 billion over the expected level in calendar 2009. The vast majority of the additional revenue, 78 percent or just above $900 million, would be paid by the top quintile of income earners.

The option shown below retains the low-income credit for families with less than $10,000 in income tax liability. The credit removes all income tax liability for these families.

Table 4.
Net Effect on Average Tax Change per Family from Restoring 2007 Income Tax Rate Levels with 7.5 Percent Top Rate

INCOME GROUP	**LOWEST 20%**	**SECOND 20%**	**MIDDLE 20%**	**FOURTH 20%**	**NEXT 15%**	**NEXT 4%**	**TOP 1%**
Income Range	Less than $17,000	$17,000 - $29,000	$29,000 - $47,000	$47,000 - 74,000	$74,000 - $134,000	$134,000 - 339,000	$339,000 or More
Avg. Income	$10,000	$23,000	$38,000	$59,000	$96,000	$192,000	$890,000
Avg. Tax Change as % of Family Income	+ 0.0%	+ 0.1%	+ 0.2%	+ 0.2%	+ 0.3%	+ 0.4%	+ 1.0%
$ Avg. Tax Change per Family	+ $4	+ $26	+ $75	+ $134	+ $296	+ $836	+ $8,833
Group Share of Total State Tax Change	0%	2%	7%	12%	21%	15%	42%

Source: Institute on Taxation and Economic Policy. All Ohio Families, 2007 income levels.
Scenario maintains low income credit for incomes below $10,000 and uses 2009 baseline.
All numbers are rounded.

In this scenario, 98 percent of Ohio families still would receive three-fifths of the fully phased-in rate cut. Families in the middle quintile income group (annual incomes between $29,000 and $47,000) would see an average increase of $75 per year over 2009 rates, or two-tenths of one percent of their total income. The average increase from this year’s rates for this group would be only $37. These families still would have a net average reduction of $113 or three-tenths of one percent of their income when compared to 2004 income tax rates.

Conclusion

Ohio’s state government has struggled to find adequate revenues in this decade. The current policy of cutting income taxes over five years in the face of slowing economic growth, and possibly a recession, weakens our revenue base precisely at a time when the state should ensure a strong safety net. When the cuts are fully phased in next year, income tax revenues will be reduced by approximately $2.22 billion from their baseline level. Over $1.5 billion of the revenue losses from the tax cut will be captured by Ohio families in the top 20 percent of the income scale. More than a quarter will go to the top one percent of families, who make more than $339,000 a year.

Halting further cuts to the income tax and restoring the 7.5 percent rate for the top bracket is an immediate, necessary step to shoring up our revenue base. This policy brief focused on the income tax because it is the largest single contributor to the state's General Revenue Fund. Other steps need to be taken as well, such as retaining the corporate franchise tax and closing tax loopholes. State government has a responsibility to maintain a strong social safety net to help our residents through hard economic times, and to continue to invest in education and economic development to position Ohio for a better future.

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 and Sisters of Charity Foundations and the Economic Policy Institute. To those who want a more fair and prosperous economy... Policy Matters.

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