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To: Representative Sally Conway Kilbane

From: Frederick Church, Deputy Tax Commissioner

Date: March 10, 2004

RE: PROPOSAL FOR A THREE BRACKET INCOME TAX WHERE THE TAX RATES ARE NOT MARGINAL RATES

The Ohio Department of Taxation (ODT) has completed its review of your income tax proposal. We find that in order to be revenue neutral, the tax rate that you must apply to every dollar of income for taxpayers whose annual income exceeds the top threshhold ($45,000 for joint filers, $40,000 for heads of household, $35,000 for single filers and married seprate filers) is 3.9 percent.

In the material below, we provide detail on the method we used to calculate this top tax rate. We also discuss in some detail our concerns with the extremely high tax rates – well in excess of 100 percent – that occur around the income breakpoints in your proposal, where the extremely high tax rates are caused by the fact that the tax rates proposed are not the usual marginal rates used in income taxation.

Review of Proposal Elements

You have asked us to calculate the top income tax rate necessary in order to acheive revenue neutrality for your proposal. Your proposal would do the following:

(1) expand the tax base by broadening the definition of wages

The base of the income tax would be redefined. First, taxable wages would be redefined to match the withhholding tax base of the municipal income tax. Deferred compensation, public sector pension pick-up contributions, and health insurance deductions would all be added to the state income tax base (other, smaller current wage exemptions would also become taxable). These changes are estimated to increase the state income tax base by about 6 percent.

(2) expand the tax base by eliminating credits and deductions

The base of the income tax would be further expanded by eliminating most credits and deductions. Some of these changes would explicitly make taxable income that is currently partially or completely excluded from taxation. For example, Social Security income and disability and survivorsbip benefits would become subject to the state income tax. The credit for retirement income would be repealed.

The repeal of other credits and deductions would expand the tax base by disallowing current subtractions from income and/or credits for expenses such as tuition, medical expanses, child care expenses, etc.

ODT has assumed that certain credits and deductions would remain in the income tax. For example, federal law requires that the non-resident credit and the exclusion for federal interest and dividends be maintained. The full list of credits and deductions that are eliminated or retained is shown in Appendix A at the end of this memo.

(3) create a three bracket tax rate structure, where the tax rates are not marginal rates

Your proposal would create a zero rate bracket for married joint filers from $0 to $20,000 of income. The zero bracket amounts would be $15,000 for heads of household and $10,000 for single filers.

For taxpayers whose income exceeds the zero bracket amount by as little as a dollar (or a fraction of a dollar), their whole income would be subject to tax at a 2.5 percent rate. This would be true for incomes between $20,000 and $45,000 for joint filers (incomes between $15,000 and $40,000 for heads of household and between $10,000 and $35,000 for single filers).

For taxpayers whose income exceeds the 2.5 percent bracket threshhold by as little as a dollar (or a fraction of a dollar), their whole income would be subject to tax at a 3.9 percent rate. So, joint filers whose income exceeds $45,000 would pay 3.9 percent tax on every dollar of income (the same would be true for heads of household whose income exceeds $40,000 and for single filers whose income exceeds $35,000).

<u>The Impact on Taxpayers of This Non-Marginal Rate System</u>

We at ODT are not aware of any system of income taxation in use anywhere, where the tax rates are not marginal rates. The reason that governments do not use such a method of income taxation can be made clear by a couple of simple examples.

Example 1: married joint filers with income of $20,000 pay no tax, but married joint filers with income of $20,001 would pay tax of $500.03. This means that the additional tax on that additional $1 of income slightly exceeds 50,000 percent.

Example 2: married joint filers with income of $45,000 pay tax of $1,125.00, but married joint filers with income of $45,001 would pay tax of $1,755.04. This means that the additional tax on that additional $1 of income slightly exceeds 63,000 percent.

ODT cannot support a tax system that imposes such huge additional tax burdens for small increases in income. Such increases in tax burden are arbitrary and unfair. Such increases in tax burden are also incentives to either under report income, especially around the tax rate breakpoints, or to reduce hours of work so as not to exceed the income threshholds. A tax system that contains strong incentives to cheat or to reduce work effort is not a good tax system.

Calculation Method

Your proposal provided the income breakpoints and the first two tax rates, namely 0 percent and 2.5 percent. You asked ODT to estimate what the revenue neutral top tax rate would be. ODT first simulated current law for tax year 2006, and set the benchmark level of income tax that would need to be collected for neutrality at $9.46 billion. ODT found that the top tax rate necessary for neutrality is 3.9 percent, by steps discussed below.

As mentioned in the prior section, ODT estimates that the impact of expanding the definition of wage income to match the municipal income tax (MIT) definition would be to expand the income tax base by about 6 percent. A study done by ODT back in 1996, using tax year 1994 data, found that expanding the state definition of wage income to match the MIT definition would increase state collections by about 4.8 percent. ODT assumes that from 1994 through 2006 that percentage will have grown to 6.0 percent.

ODT then eliminated most of the deductions and credits that are found in current law. As mentioned above, ODT has assumed that certain credits and deductions would remain in the income tax. For example, federal law requires that the non-resident credit and the exclusion for federal interest and dividends be maintained. The full list of credits and deductions that are eliminated or retained is shown in Appendix A at the end of this memo.

Finally, ODT estimated the necessary top rate using its full-blown income tax simulation program (which must be jury-rigged to estimate a proposal such as this one that does not use marginal tax rates) and then checked the result against a different simulator that was written from scratch just for this purpose. Both simulators found that the top tax rate necessary for revenue nuetrality was 3.9 percent.

Cc: Kim Wisecup, Administrator of Legislation
Mike Sobul, Assistant Administrator of Tax Analysis
Mark Aiken, Legislative Liaision

APPENDIX A - TREATMENT OF DEDUCTIONS AND CREDITS UNDER REP. KILBANE PROPOSAL

<u>Deductions Eliminated</u>
Social Security Income
Disability and Survivorship Benefits
College Savings Plan Contributions
Tuition Expenses
Health Insurance/Medical Expenses
Medical Savings Accounts

<u>Deductions Retained</u>
Compensation in Neighboring States
Income Tax Overpayments
Federal Interest and Dividends
Losses from an ESBT
Deductions Classified as Other

<u>Credits Eliminated</u>
Retirement Income Credit
Senior Citizen Credit
Lump Sum Distribution Credit
Child Care Credit
Lump Sum Retirement Credit
Job Training Credit
Political Contributions Credit
Adoption Credit
Resident Credit
Personal Exemption Credit
Joint Filing Credit
Business Credits

<u>Credits Retained</u>
Non-Resident Credit