

# Tax Reform for Ohio's New Millennium

## Executive Summary

- This report considers the implications of relying on income taxation as a major source of revenue for financing state government. The report argues income tax cuts are needed to ensure the long term prosperity of the state.
- Some basic tax facts about Ohio:
  - Ohio's state and local tax burden grew faster than 48 other states between 1980 and 1996, and it is now the ninth highest in the U.S.
  - From 1985 to 1999, Ohio suffered a net out-migration of over 300,000 residents. Meanwhile low tax states like Florida gained millions of new residents.
  - Ohio recently received a letter grade of "D" from the Cato Institute for Ohio's inability to control spending and taxation.
  - The American Legislative Exchange Council recently gave Ohio a letter grade "F" for greatly increasing state expenditures over the past decade.
  - Ohio's steeply progressive income tax system has more tax brackets than all but two other states.
  - In 1998, the top ten percent of taxpayers paid 56 percent of all individual income taxes, and the top 50 percent of taxpayers paid 94 percent of all Ohio individual income taxes.
  - Between 1996 and 2000, half of Ohio's budget surpluses were spent rather than returned to taxpayers.

## Tax Reform Proposals

- This report presents the Buckeye Institute Tax Plan which includes six distinct proposals. These proposals can be looked at as a menu of options for policy makers to consider as they think about what kind of tax system Ohio should have in the coming century. *All six tax cut proposals reduce total taxes for the state and for every individual income taxpayer.*
- The report examines the theoretical underpinnings of taxation in general and the income tax in particular. The six income tax reform proposals are examined from the standpoint of equity, efficiency, paternalism and liberty.
- Boston's Beacon Hill Institute provides us with statistical estimates of the impact of the six tax cut proposals on jobs, payrolls, sales tax receipts, etc. The Beacon Hill estimates are *dynamic* estimates that take into account the positive effects of tax cuts on economic activity.
- The six tax cut proposals vary in the degree to which they cut taxes, the jobs created, and the distribution of the tax cuts. The report does not suggest that one tax cut is *better* than another, but rather offers these six choices as a range of options to at least get the policy debate moving in the proper direction.

- Proposals 1, 2, and 3 are across-the-board cuts in marginal income tax rates of 5%, 10%, and 15% respectively. These proposals cut taxes between \$319 million (proposal 1) and \$954 million (proposal 3) and create between 23,000 (proposal 1) and 70,000 new jobs (proposal 3).
- Proposal 4 increases the personal exemption to \$3,000, and is estimated to create nearly 21,000 jobs and reduce tax receipts by \$798 million.
- Proposals 5 and 6 attempt to simplify the income tax by reducing the number of tax brackets from the present 9 to 4 and 5 brackets respectively in addition to cutting overall taxes. The estimated job gains are about 56,000 and 22,000, and the estimated tax cut is \$644 million and \$401 million for proposals 5 and 6 respectively.
- Proposals 3, 4, and 6 also significantly reduce the numbers of taxpayers who will be liable for any taxes.

	<b>Proposal Description</b>	<b>Increase in Jobs</b>	<b>Total Tax Cut (\$mil.)</b>	<b>% of Filers Removed from Tax Rolls</b>
Proposal 1	cut marginal tax rates 5%	23,261	-319	0
Proposal 2	cut marginal tax rates 10%	46,613	-637	0
Proposal 3	cut marginal tax rates 15%	70,036	-954	0
Proposal 4	increase personal exemption to \$3,000	20,945	-798	17
Proposal 5	decrease number of tax brackets to 4	55,790	-644	25
Proposal 6	decrease number of tax brackets to 5	21,965	-406	25



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## Introduction and Overview of the Report

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*Tax cuts are needed in Ohio to help continue the prosperity of the last two decades.*

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Taxes are a fact of life. Government provides various goods and services such as national defense and mail delivery at the national level and roads, prisons and schools at the state and local levels. Governments finance these activities through taxes.<sup>1</sup> Activities undertaken by the private sector are different because they must be financed through voluntary payments or gifts.

In a world of limited resources, taxes also transfer resources to the government from private citizens. Ohio University economics professors Richard K. Vedder and Lowell E. Gallaway define a tax as “a device to enable governments to take command over or redistribute resources.”<sup>2</sup> Because of the involuntary nature of taxes and their use in redistributing real resources, it is important to gauge the impact they have on the economy. This report will analyze the impact of one tax — the state individual income tax — in Ohio.

During FY2001, 49 percent of Ohio's projected tax revenue will

come from income taxes, and income taxes will account for 35 percent of all revenues (including federal grants, non-tax revenues, and transfers).<sup>3</sup>

Ohio's total state and local tax burden is relatively high. According to the Tax Foundation, Ohio is in the middle of all states when total tax burden, which includes federal taxes, is considered (ranking 20<sup>th</sup>), but it is much higher when state and local taxes only are considered (ranking 9<sup>th</sup>).<sup>4</sup> Moreover, according to Vedder (citing data from the Bureau of Economic Analysis), the rate of increase of the tax burden has been very high: taxes increased more in Ohio between 1980 and 1996 than any other state except one — North Dakota.<sup>5</sup>

Ohio recently received a letter grade of “D” from the Cato Institute for Ohio's inability to control spending and taxation. The American Legislative Exchange Council recently gave Ohio a letter grade “F” for greatly increasing state expenditures over the past decade.

Tax cuts are needed in Ohio to help continue the prosperity of the last two decades. Recessions and budget crises come and go and state lawmakers are correct in dealing with these issues, but tax cuts are necessary for the *long run health of the Ohio economy*. Short term necessities, important though they may be to politicians, should not completely outweigh considerations of long term economic prosperity. The global competition for human, financial, and physical capital dictates the leanest possible tax code if Ohio wants to be considered an investment mecca for the 21<sup>st</sup> Century.

The Buckeye Institute Tax Plan consists of six distinct proposals, each with the guideline that it could not increase any *individual's* tax burden, nor could it increase *total* income tax revenue. The first three proposals reduce each individual's income tax by reducing each of Ohio's tax rates. The second three proposals change the structure of the income tax by either increasing the personal exemption

or by decreasing the number of rates. The former serves to exempt more personal income from taxation, while the second could be a first step in future rate simplification. The ultimate tax simplification, short of eliminating the tax altogether, would be a flat tax. But

*Proposal 1: 5% tax cut in marginal rates*

*Proposal 2: 10% tax cut in marginal rates*

*Proposal 3: 15% tax cut in marginal rates*

*Proposal 4: increase personal exemption from \$1,050 to \$3,000*

*Proposal 5: decrease in the number of rates from 9 to 4*

*Proposal 6: decrease in the number of rates from 9 to 5*

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*The Buckeye Institute Tax Plan consists of six distinct proposals, each with the guideline that it could not increase any individual's tax burden, nor could it increase total income tax revenue.*

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a flat tax is not one of the options suggested at this time. Perhaps in the future, the state may be willing to consider a flat tax proposal. The report's 6 possible tax changes — 3 rate changes, and 3 structural changes — are given in the accompanying box.

Section 1 of this report employs public finance principles to describe the economic effects of income taxes on the state. It considers the impact of the Buckeye Institute Tax Plan in terms of equity and fairness, economic efficiency, paternalism, and freedom. In addition, the report considers and rebuts arguments that the state needs to increase funding for education or for other government projects.

Section 2 presents economic analysis by the Beacon Hill Institute of Boston, Massachusetts of various tax proposals. This section provides detailed estimates of the effects of the six tax proposals on employment, payrolls, income, tax revenues, etc. The Appendix presents the statistical and econometric details employed in Section 2.

## Section I: Economic Effects of the Individual Income Tax

### 1.1 Principles of Taxation and the Buckeye Institute Tax Plan

What factors should be used to evaluate taxes? Economists, legal scholars, political philosophers and others have traditionally evaluated taxes using a number of factors. Edgar K. Browning and Jacqueline M. Browning, economists at Texas A&M University and authors of the well-regarded textbook, *Public Finance and the Price System*, identify four principles of tax analysis:<sup>6</sup>

- equity and fairness
- economic efficiency
- paternalism
- individual freedom

As Browning and Browning point out, “to decide whether a policy is good or bad involves two steps: positive analysis and a value judgement.”<sup>7</sup> Positive analysis deals with “the measurable or observable outcomes of policy,” such as how income taxes affect employment and wages.<sup>8</sup> It therefore identifies the economic consequences of a

policy and provides a useful framework for determining what is desirable. Value judgments, on the other hand, seek to find whether the consequences themselves are desirable. As Browning and Browning are quick to point out, “*economic analysis cannot demonstrate that any policy is desirable.*”<sup>9</sup> Only value judgments can do that, but fact-based analysis can show the consequences of various policy changes.

#### Equity and Fairness

The first principle of tax analysis identified by Browning and Browning, *equity and fairness*, tries to determine the justice and evenhandedness of a particular tax. No one, of course, believes that a tax should be unfair, but the question immediately arises: what does fairness mean?<sup>10</sup> Economists typically base discussions of equity and fairness on two approaches: the benefit principle and the ability to pay principle.<sup>11</sup>

Benefit Principle. The benefit principle suggests that taxes are the price we pay for government

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*Unfortunately, the benefits provided by government are not equitably distributed and do not “increase as income increases.”*

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goods and services, so an individual's taxes should be in line with the benefits they receive from government. If you receive a lot of government services, then according to the benefit principle, you should pay more in taxes. As Browning and Browning note, “the great advantage of the benefit principle is that it emphasizes the essential two-sidedness of government tax-expenditure decisions,” namely both taxes and spending.<sup>12</sup> The benefit principle may help illustrate whether the beneficiaries of an expenditure “pay their own way” (such as with highway construction financed by gasoline taxes).

Regarding progressive income tax rates, Walter J. Blum and Harry Kalven, law professors at the University of Chicago, argue that “if it can be shown that the benefits increase as income increases, and that at some levels of income benefits increase more rapidly than income, a compelling justification for progression will have been established.”<sup>13</sup> Unfortu-

nately, the benefits provided by government are not equitably distributed and do not “increase as income increases.” Much government spending at the state and federal levels consists of various forms of redistribution, meaning transfers (usually) from high-income taxpayers to low- and middle-income taxpayers. About 65 percent of Ohio's General Revenue Fund consists of such redistribution.<sup>14</sup> Unless one is prepared to reject redistribution out-of-hand (by asserting, for example, that welfare beneficiaries pay for their own welfare — a self-defeating goal for redistribution), the benefit principle would find vastly more areas of inconsistency than consistency in the state budget.

Ability-to-pay Principle.

Analysis of the ability-to-pay principle means that taxes are imposed based upon one's capacity to pay the tax, with those who have a greater ability to pay bearing a heavier burden of taxation. In contrast to the benefit principle, it altogether ignores the benefits

received from government spending. There are two variations of the ability-to-pay principle that scholars have commonly applied to equity and fairness: *horizontal equity* and *vertical equity*.

Horizontal equity refers to the equal treatment of taxpayers in equal circumstances. The problem, however, lies in defining equality. As Harvard University law professor Louis Kaplow notes, “one major source of potential unequal treatment involves the tax treatment of different family configurations.”<sup>15</sup> These would include whether the tax filer is married and has children or other dependents. Because tax filers in Ohio can file individually or jointly (if married), and because a certain amount of income per dependent can be exempted from taxation, “the same” family income can be viewed differently. These ways include:

- income per person
- income per exemption claimed
- income per dependent child

- income per employed person

These are simple examples of defining “the same” income differently. As Oxford University economist Anthony de Jasay points out, “this is a rather innocuous case of different distributional results being obtained by strictly adhering to ‘equal treatment,’ but shifting the reference class. One can trust the ingenuity of lobbyists and politicians worried about the next election to think up others whose distributional bite is sharper and deeper, while still conforming to some plausible construction of equal treatment and generality.”<sup>16</sup> Horizontal equity must be considered carefully.

Conversely, vertical equity refers to distributing the incidence of tax fairly by income classes. Economists have contentiously debated the merits of the notion of vertical equity much more than horizontal equity. Most people suggest that vertical equity justifies progressive income taxes as the “rich will pay their fair share.” But

*All the tax plans under consideration in this report, like the existing income tax, are progressive taxes that require higher income people to pay larger shares of their incomes in taxes.*

vertical equity, upon closer examination appears to be vertical inequity: people are systematically treated differently when one moves up or down the income ladder.

In any case, vertical equity suggests that those with higher incomes should pay more, but the problem is the notion does not clearly indicate *how much more* you should pay as your income rises. All the tax plans under consideration in this report, like the existing income tax, are progressive taxes that require higher income people to

pay larger shares of their incomes in taxes.

Table 1 shows the average tax burdens borne by different income categories. It shows that the top 1 percent of Ohioans pay 20 percent of the state's income tax, and that the top half of taxpayers pay 94 percent of the income tax, while the rest pay just 6 percent. Some, using the benefit principle, would find this highly inequitable: the tax burden of government falls largely on a few people, while the benefits are largely distributed to

others. Additionally, those income earners pay different tax rates: they pay marginal income tax rates of 7.5 percent on their income, while those who make less may pay lower marginal income tax rates. State government in fact discriminates against Ohio taxpayers by levying nine different tax rates, more than all but two states.<sup>17</sup> Similar distinctions are typically not seen in

**Table 1. Distribution of Income Tax Burden (1998)**

Percent of All Returns	Number of Returns	Ohio Tax Liability (After All Credits)	Percent of All Ohio Income Tax	Average Income Tax Liability
Top 1%	53,729	\$1,332,249,094	20	\$24,795
Top 2%	106,923	\$2,181,802,502	32	\$20,405
Top 5%	267,719	\$2,965,988,805	44	\$11,078
Top 10%	535,095	\$3,764,691,872	56	\$7,035
Top 20%	1,070,600	\$4,790,633,755	71	\$4,474
Top 50%	2,674,524	\$6,324,563,606	94	\$2,364
Bottom 50%	2,675,149	\$390,961,897	6	\$146
Total	5,349,673	\$6,715,525,503	100	\$1,255

Source: Table Y-1, No. 39 (2000), Ohio Department of Taxation (reported through April 15, 1999), June 20, 2000.

market transactions, where, for instance, a sweater costs \$30 (or a loaf of bread \$1) whether a person makes \$10,000 a year or \$100,000. Using another example, Ohio applies a constant 5 percent sales tax rate in Ohio regardless of how high the purchaser's income is.

Whether or not one considers these examples to be "fair" depends upon whether one accepts the principle of the ability-to-pay. Here, as earlier, one must use judgements of taste.

"[T]he ability-to-pay principle," observe Browning and Browning, "is simply an attempt to make an explicit value judgment about the distributional effects of taxes."<sup>18</sup> This judgment, they recognize, argues that high-income earners should pay a disproportion-

ate percentage of taxes.<sup>19</sup> As they point out, "economics is well designed to explore how policies affect the distribution of income, but that is probably only one dimension of the equity issue."<sup>20</sup>

Both the ability-to-pay principle and the benefit principle invoke value judgements: wealthier taxpayers "should" pay more (*ability-to-pay principle*), and benefits "should" follow taxes paid (*benefit principle*).

Equity and Fairness in the Buckeye Institute Tax Plan. Under Proposal 1, 2, and 3, all income groups receive equal tax cuts in percentage terms, though not in dollar terms. For instance, under proposal 2, the 10 percent tax cut, all taxpayers will see their tax liability fall by 10 percent. If

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*Whether or not one considers these examples to be "fair" depends upon whether one accepts the principle of ability-to-pay. Here, as earlier, one must use judgements of taste.*

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**Table 2. Distribution of Tax Benefits from Proposals (%)**

Tax Returns	Current Tax Liability	Proposal 1	Proposal 2	Proposal 3	Proposal 4	Proposal 5	Proposal 6
Lowest 20%	0.2	0.2	0.2	0.2	1.8	2.1	3.7
Second 20%	2.4	2.5	2.5	2.5	11.2	7.9	13.8
Middle 20%	8.3	8.5	8.5	8.5	19.3	4.5	8.0
Fourth 20%	17.8	18.0	18.0	18.0	27.2	13.3	16.3
Top 20%	71.3	70.8	70.8	70.8	40.5	72.2	58.2

Taxpayer A currently pays \$100, he will now pay \$90—a savings of \$10. But if Taxpayer B currently pays \$1,000, he will now pay \$900—a savings of \$100. The *dollar* amounts are different under each, but the *percentage* tax cut is the same.

Proposal 4 increases the personal exemption by \$1,950 (to \$3,000 from \$1,050). In this proposal lower income taxpayers receive a disproportionately large tax cut compared to higher income taxpayers in percentage terms, but larger dollar savings will still accrue to higher income tax payers. For instance, if Taxpayer A is in the 3.0 percent marginal tax bracket, an increase in the personal exemption of \$1,950 would cut his taxes by \$58.50. But Taxpayer B, who is in the 7.5 percent marginal tax bracket would see his taxes fall by \$146.25. In terms of percentage tax cuts, Taxpayer A would actually be getting the larger tax cut, even though his dollar tax cut would be less.

The distributional impact of

Proposals 5 and 6 are more complicated to analyze. Proposal 5 reduces the number of tax brackets to 4. In these proposals, the greatest tax cuts accrue disproportionately, in percentage terms at least, to the lowest 40 percent of taxpayers — many of whom will see their tax liability fall to zero. The top 60 percent receive a smaller tax cut in percentage terms. Again, the tax cuts in terms of dollars will still be highest for the higher income tax payers even if their percentage tax cuts are lower.

Fairness, as we have discussed, is a slippery concept meaning different things in different contexts. The current income tax code meets some definitions of fairness while failing others. The same is true of the six proposed plans under consideration in this report. We should remember that all six tax proposals will cut income taxes for everyone, and all six tax proposals are progressive taxes, the rich pay disproportionately more than lower income taxpayers. But no tax reform is possible that *equally* cuts taxes for everyone in

**Table 3. Equity and Fairness  
Comparing Ohio's Current Tax System with Proposals for Reform**

Ohio's Current Tax System	Proposals for Reform
<p>The Ohio income tax violates the principle of equity and fairness by placing the overwhelming burden of the income tax on a small percentage of taxpayers, irrespective of the benefits to which those taxpayers consent or even receive.</p>	<p>Each of the tax reform proposals included in this report improves equity and fairness.</p> <ul style="list-style-type: none"> <li>• Proposal 1, 2 and 3 reduces tax rates on all taxpayers, thereby reducing the degree of redistribution (although it maintains the relative burden of taxation among the various income groups).</li> <li>• Proposal 4 increases the personal exemption to \$3,000, thereby exempting a larger share of individual and family income from taxation, which increases fairness.</li> <li>• Proposal 5 reduces the number of tax rates from 9 to 4, thereby reducing some of the inequity of taxing different people at different rates.</li> <li>• Proposal 6 reduces inequity of taxing different people at different rates.</li> </ul>

terms of both percentages and dollars.

**Economic Efficiency**

The second principle of tax analysis identified by Browning and Browning, *economic efficiency*, concerns

how (and to what degree) a particular fiscal policy alters human behavior and impacts the well-being of individuals. In a formal sense, economists define efficiency as an allocation of resources in which "it is impossible, through any change in resource allocation, to make some person or persons better off without making someone else worse off."<sup>21</sup> Less formally, economic efficiency occurs when the allocation of resources maximizes the well-being of people in the community. Unfortunately, all taxes alter this ideal allocation of resources. But not all

taxes are created equal—some are more harmful toward economic efficiency than others.<sup>22</sup>

Income taxes cause work to become more expensive. The income tax makes work more expensive relative to leisure, tending to induce less work. Taxes lower effective wage rates, causing workers to substitute more leisure for less work.<sup>23</sup> Tax cuts, therefore, help to reduce the cost of work relative to leisure, by increasing the amount of work. Working becomes more attractive to employees, which results in jobs being created by the

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productive economy.<sup>24</sup>

Married women and older men near retirement are most likely deterred from being in the labor force as a result of income taxes. Tax cuts, therefore, are likely to result in more married women entering the labor force and more older men working longer (i.e., retiring later).<sup>25</sup>

Section 2 of this report will explain in detail the job creation effects of various tax cut proposals.

Income taxes discourage people from specializing. An income tax penalizes people who work in the marketplace but not those who work for themselves. That is, if you work to make money to pay a plumber to fix your pipes, you have to pay taxes on that income, but if you fix your pipes yourself, you can avoid taxation. This realization leads people to specialize less and, according to basic economic theory, will lower living standards.

The effect has been analyzed by economists at the Federal Reserve Bank of Dallas. By reduc-

ing the degree to which individuals specialize in market activity, income taxes, they found, discourage people from engaging in those activities that reflect their comparative advantage. "Instead, they encourage everyone to become a jack-of-all-trades. In so doing, income taxes may have their most distorting effects not by encouraging individuals to work less but by causing them to spend more time working at endeavors in which their talents do not lie."<sup>26</sup>

High taxes cause people to move to lower tax jurisdictions. Public policy decisions may affect the attractiveness of a particular state. People move from one state to another to improve their well-being, including finding better jobs and earning higher after-tax income.<sup>27</sup> Therefore, a net inflow of migrants into a state would suggest better opportunities in that state. A net *outflow* of migrants, on the other hand, would indicate that better choices exist elsewhere. Between 1985 and 1999, 307,000 more people left Ohio than moved into

it.<sup>28</sup> This number equals the entire population of Toledo.<sup>29</sup> Meanwhile states like Florida, which has no income tax, have been attracting residents in the millions.

The structure of income taxes matters. Jonathan Gruber of the Massachusetts Institute of Technology and Emmanuel Saez of Harvard University find that taxpayers who have incomes above \$100,000 a year are particularly sensitive to income taxes.<sup>30</sup> High marginal tax rates encourage people to shift income to tax deductible activities or to reduce income altogether. Gruber and Saez find that income taxes with lower rates but fewer deductions and loopholes “could raise revenues more than twice as efficiently as our current system, since individuals would not be able to avail themselves of these loopholes to avoid taxation.”<sup>31</sup>

In summary, the income tax directly affects labor market decisions. It causes the cost of labor to increase and the productivity of labor to decrease. It also leads to less specialization, thereby decreasing productivity and restraining wage growth. Certain adjustments in the structure of the income tax, however, can reduce the inefficiency of the tax.

Economic Impact of the Buckeye Institute Tax Plan. The Buckeye Institute Tax Plan proposals in this report improve economic efficiency by lowering the tax burden. In part, we can measure the

**Table 4. Efficiency and Economic Growth Comparing Ohio's Current Tax System with Proposals for Reform**

Ohio's Current Tax System	Proposals for Reform
Ohio's current income tax dramatically changes individuals' behavior, thereby reducing economic growth and efficiency.	Each of the reform proposals reduces the degree to which individuals change their behavior for tax purposes. The proposals therefore increase economic growth. <ul style="list-style-type: none"> <li>• Proposal 1: 23,000 new jobs.</li> <li>• Proposal 2: 46,000 new jobs.</li> <li>• Proposal 3: 70,000 new jobs.</li> <li>• Proposal 4: 46,000 new jobs.</li> <li>• Proposal 5: 55,000 new jobs.</li> <li>• Proposal 6: 21,000 new jobs.</li> </ul>

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*Government substitutes its own decisions for those of individual citizens. It does this in part by taxing individuals and then spending the proceeds on programs.*

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improvement in economic efficiency of these six proposals by the increase in jobs created. See Table 4.

### **Paternalism**

The third principle of tax analysis identified by Browning and Browning is *paternalism*, meaning government policies “intentionally designed to provide services that would not be selected by people if they had a choice.”<sup>32</sup> In other words, government substitutes its own decisions for those of individual citizens. It does this in part by taxing individuals and then spending the proceeds on programs. Paternalism would not exist if individuals’ preferences could be perfectly transmitted through their representatives. However, as Browning and Browning observe, “if individuals are not thought competent to make decisions that mainly affect themselves . . . then, taking this a step further, they must be even less competent to make decisions that affect everyone in society through the voting process.”<sup>33</sup>

For example, had individu-

als not been taxed, they might have used their income to purchase more or better housing, enroll for prescription drug coverage, transfer their children to private schools, invest in local companies, or contribute to charity. By supplanting those decisions, governments paternalistically decide how individuals make decisions and live their lives. This approach is inconsistent with our nation’s founding principles of individual liberty and civil society.

The scope of these paternalistic actions on the part of government should not be underestimated. In 1998, the Tax Foundation noted that Ohioans spent more of their income on taxation than they did for food, clothing, shelter, and transportation *combined*.<sup>34</sup>

All six proposals in the Buckeye Institute Tax Plan reduce the degree of paternalism exercised by Ohio government by reducing the tax burden per taxpayer. All six of our proposals reduce paternalism by letting individuals decide for themselves how to spend a larger

portion of their earnings.

### **Individual Freedom**

The fourth principle identified by Browning and Browning, *individual freedom*, addresses the fact that taxes necessarily reduce individual liberty by coercing individuals to submit part of their income in the form of taxation. In the economic sphere, individual freedom is generally taken to mean that economic arrangements are voluntary. University of Chicago law professor Richard Epstein defines taxation explicitly: “taxation is the power to coerce other individuals to surrender their property *without* their consent.”<sup>35</sup> Tax cuts help restore taxpayer’s income and therefore their liberty.

Some would argue that taxation is the price we pay for freedom and that “liberty depends on taxes.”<sup>36</sup> By this, they mean liberty cannot be ensured without state intervention to protect life, liberty and property through courts, police, fire protection, etc. Without examining the merits of this argument, we note that the overwhelming majority of state

spending from the General Revenue Fund (GRF) does not consist of such spending. Approximately 65 to 70 percent of GRF spending is redistributive spending on health, education, welfare, and other programs. Only about 10 percent of the GRF is spent on courts, law enforcement, and so forth.<sup>37</sup> Resisting modest tax cuts on the grounds that “liberty depends on taxes” clearly misstates the important facts about state spending and makes claims that are largely irrelevant to the debate.

The proposals outlined in this report increase every taxpayer’s freedom by lowering taxes for everyone. Our tax plan allows individuals and families to retain control of more of their income. The Buckeye Institute Tax Plan expands personal income between \$319 million and \$954 million.

## **1.2 Taxation and Government Spending**

Some would argue against tax cuts because increased tax

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*Tax cuts help restore taxpayer’s income and therefore their liberty.*

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revenues are necessary to provide higher spending for education, especially K-12 education, or other government priorities. Therefore tax cuts should not be considered since they reduce potential funding for education and other programs.

Government spending has exploded since the income tax was enacted. State spending in all categories has increased dramatically since 1973 when the state's income tax was enacted. Table 5 shows the increased spending over that period. The increased tax revenues from 1990-1999 provided significantly greater funds for all areas of spending, including education, which increased 63 percent.

These trends during the past decade extend patterns that have continued since the income tax was enacted. In particular, state educational spending has increased substantially, with total primary and secondary education spending increasing over 700 percent since fiscal year 1973. As Table 6 shows, only one program area — cash assistance for the poor — has failed to keep pace with inflation. Every other major area of

**Table 5. State Spending FY 1971-1999 (\$ millions)**

Function	FY 1971	FY 1990	FY 1999	% Change FY1971-1999
Primary/Secondary Education	\$575.0	\$2,898.4	\$4,721.5	721
Higher and Other Education	\$241.8	\$1,688.0	\$2,353.2	873
Health and Human Services	\$631.9	\$5,112.8	\$7,557.8	1,096
Public Safety and Protection	\$58.8	\$578.3	\$1,449.9	2,366
General Government and Tax Relief	\$31.7	\$883.3	\$1,295.1	3,985
Environment, Development and Transportation	\$31.2	\$271.9	\$273.8	778
Executive, Legislative and Judicial	\$33.3	\$152.0	\$365.6	998
Total	\$1,603.6	\$11,584.7	\$18,016.9	1,024

The category General Government and Tax Relief includes property tax subsidies.

Sources: Office of Budget and Management, Table 2, "Expenditures for Fiscal Year 1999 and Appropriations for Fiscal Years 2000 and 2001 by Agency for the General Revenue Fund," Budget Highlights, Fiscal Years 2000 and 2001: Highlights of the Biennial Appropriations for the State of Ohio for Fiscal Years 2000-2001 enacted June 1999 (Revised July 2000), pp. 45-46; Office of Budget and Management, State of Ohio Executive Budget for the Biennium July 1, 1993 to June 30, 1995, various pages; and Department of Finance, State of Ohio Executive Budget for the Biennium July 1, 1971 to June 30, 1973, various pages.

state spending has grown by multiples of general inflation since 1973.

Personal income growth grew at half the rate of total state spending during the period.

Table 7 summarizes the growth in state expenditures on a per-capita basis from FYs 1988 to 1998. As the table shows, both K-12 education and higher education have benefited from the increased tax revenues of the 1990s. (All figures are adjusted for inflation.) Elementary and secondary education budgets have increased 20 percent after adjusting for inflation during the 1990s.

Furthermore, a significant amount of the unencumbered ending GRF cash balances has been transferred to spending programs including education. Since FY1996, an additional \$1.134 billion

**Table 6. GRF Spending Compared to Personal Income Growth, Inflation, and Population Growth, FY 1973-2001**

Ohio personal income growth, 1972-1997	369%
Consumer Price Index (FYs 1973-2001)	301%
Ohio population growth, 1972-1997	4%
Corrections - Department of Rehabilitation and Corrections	2723%
Local Government Funds	2077%
Human Services - Medicaid	2040%
Transportation	1930%
Primary / Secondary Education - Other Education	1912%
Higher Education - Other	1153%
Primary and Secondary Education - Real and Tangible Property Tax Rollback	863%
Corrections - Department of Youth Services	761%
Total GRF Spending	750%
Primary and Secondary - Total	726%
Higher Education - Total	711%
Human Services - Total	610%
Higher Education - Instructional Subsidy	574%
Other GRF Spending	543%
Primary and Secondary Education - State Basic Aid and Equity Aid	495%
Human Services - Other	452%
Primary and Secondary Education - Schools for the Blind and Deaf	439%
Human Services - Cash Assistance	55%

Source: Legislative Budget Office, Table 2 - State GRF, LGF, LPEF Expenditures FY1973 - FY2001. The Consumer Price Index is based on estimated inflation for 2000-2001 contained in The Executive Budget For the Biennium July 1, 1999 to June 30, 2001.

has been spent by the Ohio Department of Education that was not originally appropriated by the legislature.<sup>38</sup> Table 8 shows the growth of this additional spending since FY1996.

The rate of return to education expenditures is very low. We must also consider the returns to education compared with other alternatives. Advocates of public

education funding typically offer several justifications: public education generates future returns, public education makes better citizens, and public education improves children's socialization. While the latter two arguments are difficult to empirically analyze, the first one is readily amenable to cost-benefit analysis.

The conclusive evidence for

**Table 7. Real Per-Capita State Expenditures: General Revenue Fund, Local Government Funds, and Lottery Disbursements, FY 1988 through FY 1998 (1996 Dollars)**

Year	Total	Elementary & Secondary Education	Higher Education	Public Welfare	Corrections	Medicaid	Transport.	Local Govt Funds	Other General Expenditures
1988	\$1,075	\$400	\$168	\$170	\$49	\$109	\$4	\$62	\$112
1989	1,108	407	171	174	52	113	5	77	109
1990	1,140	410	177	184	56	122	4	76	111
1991	1,161	412	176	182	61	139	4	77	111
1992	1,158	400	167	184	63	167	3	76	97
1993	1,146	415	160	162	78	164	3	73	100
1994	1,177	412	168	167	90	169	3	80	103
1995	1,198	419	172	164	98	165	3	82	105
1996	1,229	435	179	147	108	177	3	86	107
1997	1,272	445	182	160	113	168	3	89	119
1998	1,337	480	190	165	118	180	3	96	113

Percentage Change, 1988-1998: Total 24%, Elementary & Secondary Education 20%, Higher Education 13%, Public Welfare -3%, Corrections 141%, Medicaid 65%, Transport. -25%, Local Govt Funds 55%, Other General Expenditures 1%

Source: Expenditure data from Table 2 - State GRF, LGF, LPEF Expenditures, FY1973 - FY2001, "Ohio Legislative Budget Office. Population data from U.S. Bureau of the Census, Current Population Estimates. Data deflated using State and Local Government Implicit Price Deflator, Bureau of Economic Analysis.















**Table 13. Statutory Marginal Income Tax Rate and Change in Income Tax by Income Group**

FAGI Income Class	Proposal 1.a			Proposal 1.b			Proposal 1.c			Proposal 2			Proposal 3			Proposal 4		
	Statutory Marginal Tax Rate	Change in Income Tax (\$)	Change in Tax Liability	Statutory Marginal Tax Rate	Change in Income Tax (\$)	Change in Tax Liability	Statutory Marginal Tax Rate	Change in Income Tax (\$)	Change in Tax Liability	Statutory Marginal Tax Rate	Change in Income Tax (\$)	Change in Tax Liability	Statutory Marginal Tax Rate	Change in Income Tax (\$)	Change in Tax Liability	Statutory Marginal Tax Rate	Change in Income Tax (\$)	Change in Tax Liability
0 – 1,000	0.706	0	-5%	0.669	0	-10%	0.632	0	-15%	0.743	0	-100%	0.000	0	-100%	0.000	0	-100%
1,000 – 2,000	0.706	0	-5%	0.669	0	-10%	0.632	0	-15%	0.743	0	-100%	0.000	0	-100%	0.000	0	-100%
2,000 – 3,000	0.706	0	-5%	0.669	0	-10%	0.632	0	-15%	0.743	0	-100%	0.000	0	-100%	0.000	0	-100%
3,000 – 4,000	0.706	0	-5%	0.669	0	-10%	0.632	0	-15%	0.743	0	-100%	0.000	0	-100%	0.000	0	-100%
4,000 – 5,000	0.706	0	-5%	0.669	0	-10%	0.632	0	-15%	0.743	0	-100%	0.000	0	-100%	0.000	0	-100%
5,000 – 6,000	1.412	-1	-5%	1.337	-1	-10%	1.263	-2	-15%	1.486	-6	-100%	0.000	-6	-100%	0.000	-6	-100%
6,000 – 7,000	1.412	-1	-5%	1.337	-2	-10%	1.263	-3	-15%	1.486	-12	-100%	0.000	-12	-100%	0.000	-12	-100%
7,000 – 8,000	1.412	-2	-5%	1.337	-3	-10%	1.263	-5	-15%	1.486	-21	-100%	0.000	-21	-100%	0.000	-21	-100%
8,000 – 9,000	1.412	-2	-5%	1.337	-4	-10%	1.263	-6	-15%	1.486	-39	-98%	0.000	-40	-100%	0.000	-40	-100%
9,000 – 10,000	1.412	-3	-5%	1.337	-5	-10%	1.263	-8	-15%	1.486	-43	-84%	0.000	-51	-100%	0.000	-51	-100%
10,000 – 11,000	2.823	-3	-5%	2.675	-6	-10%	2.526	-9	-15%	2.823	-44	-70%	0.000	-62	-100%	0.000	-62	-100%
11,000 – 12,000	2.823	-4	-5%	2.675	-8	-10%	2.526	-12	-15%	2.823	-53	-65%	0.000	-81	-100%	4.250	-81	-100%
12,000 – 13,000	2.823	-5	-5%	2.675	-11	-10%	2.526	-16	-15%	2.823	-67	-65%	4.250	-92	-89%	4.250	-92	-89%
13,000 – 14,000	2.823	-6	-5%	2.675	-13	-10%	2.526	-19	-15%	2.823	-83	-65%	4.250	-80	-62%	4.250	-80	-62%
14,000 – 15,000	2.823	-8	-5%	2.675	-15	-10%	2.526	-23	-15%	2.972	-94	-61%	4.250	-66	-43%	4.250	-66	-43%
15,000 – 16,000	3.529	-9	-5%	3.344	-18	-10%	3.158	-27	-15%	3.529	-95	-52%	4.250	-53	-29%	4.250	-53	-29%
16,000 – 17,000	3.529	-11	-5%	3.344	-21	-10%	3.158	-32	-15%	3.529	-101	-47%	4.250	-44	-21%	4.250	-44	-21%
17,000 – 18,000	3.529	-12	-5%	3.344	-25	-10%	3.158	-37	-15%	3.529	-109	-44%	4.250	-39	-16%	4.250	-39	-16%
18,000 – 19,000	3.529	-14	-5%	3.344	-29	-10%	3.158	-43	-15%	3.529	-119	-42%	4.250	-33	-12%	4.250	-33	-12%
19,000 – 20,000	3.529	-16	-5%	3.344	-33	-10%	3.158	-49	-15%	3.715	-124	-38%	4.250	-27	-8%	4.250	-27	-8%
20,000 – 22,500	4.234	-20	-5%	4.011	-40	-10%	3.788	-60	-15%	4.234	-131	-33%	4.250	-22	-6%	4.250	-22	-6%
22,500 – 25,000	4.234	-26	-5%	4.011	-51	-10%	3.788	-77	-15%	4.234	-154	-30%	4.250	-28	-5%	4.250	-28	-5%
25,000 – 27,500	4.234	-32	-5%	4.011	-63	-10%	3.788	-95	-15%	4.234	-156	-25%	4.250	-33	-5%	4.250	-33	-5%
27,500 – 30,000	4.234	-37	-5%	4.011	-74	-10%	3.788	-111	-15%	4.234	-163	-22%	4.250	-39	-5%	4.250	-39	-5%
30,000 – 32,500	4.234	-43	-5%	4.011	-85	-10%	3.788	-128	-15%	4.234	-171	-20%	4.250	-44	-5%	4.250	-44	-5%
32,500 – 35,000	4.234	-48	-5%	4.011	-96	-10%	3.788	-144	-15%	4.234	-179	-19%	4.250	-50	-5%	4.250	-50	-5%
35,000 – 37,500	4.234	-53	-5%	4.011	-106	-10%	3.788	-159	-15%	4.234	-185	-17%	4.250	-55	-5%	4.250	-55	-5%
37,500 – 40,000	4.234	-58	-5%	4.011	-117	-10%	3.788	-175	-15%	4.234	-192	-17%	4.250	-60	-5%	4.250	-60	-5%
40,000 – 42,500	4.941	-64	-5%	4.681	-127	-10%	4.421	-191	-15%	4.941	-210	-16%	4.250	-77	-6%	5.000	-65	-5%
42,500 – 45,000	4.941	-69	-5%	4.681	-139	-10%	4.421	-208	-15%	4.941	-235	-17%	4.250	-100	-7%	5.000	-70	-5%
45,000 – 47,500	4.941	-75	-5%	4.681	-151	-10%	4.421	-226	-15%	5.201	-248	-17%	4.250	-126	-8%	5.000	-76	-5%
47,500 – 50,000	4.941	-81	-5%	4.681	-162	-10%	4.421	-243	-15%	5.201	-255	-16%	4.250	-150	-9%	5.000	-81	-5%
50,000 – 55,000	4.941	-90	-5%	4.681	-181	-10%	4.421	-271	-15%	5.201	-265	-15%	4.250	-187	-10%	5.000	-89	-5%
55,000 – 60,000	4.941	-103	-5%	4.681	-207	-10%	4.421	-310	-15%	5.201	-277	-13%	4.250	-237	-11%	5.000	-99	-5%
60,000 – 65,000	4.941	-116	-5%	4.681	-231	-10%	4.421	-347	-15%	5.201	-286	-12%	4.250	-288	-12%	5.000	-110	-5%
65,000 – 70,000	4.941	-128	-5%	4.681	-256	-10%	4.421	-384	-15%	5.201	-292	-11%	4.250	-339	-13%	5.000	-121	-5%
70,000 – 75,000	4.941	-141	-5%	4.681	-282	-10%	4.421	-423	-15%	5.201	-297	-11%	4.250	-391	-14%	5.000	-132	-5%
75,000 – 80,000	4.941	-155	-5%	4.681	-310	-10%	4.421	-465	-15%	5.201	-299	-10%	4.250	-442	-14%	5.000	-143	-5%
80,000 – 90,000	5.646	-177	-5%	5.349	-355	-10%	5.052	-532	-15%	5.943	-344	-10%	4.250	-568	-16%	5.000	-212	-6%
90,000 – 100,000	5.646	-206	-5%	5.349	-412	-10%	5.052	-618	-15%	5.943	-346	-8%	4.250	-749	-18%	5.000	-313	-8%
100,000 – 150,000	6.555	-284	-5%	6.210	-569	-10%	5.865	-853	-15%	6.900	-402	-7%	6.500	-876	-15%	6.500	-426	-7%
150,000 – 200,000	6.555	-459	-5%	6.210	-917	-10%	5.865	-1,376	-15%	6.900	-404	-4%	6.500	-1,103	-12%	6.500	-653	-7%
200,000 – and above	7.125	-1,502	-5%	6.750	-3,003	-10%	6.375	-4,505	-15%	7.500	-433	-1%	7.500	-1,181	-4%	7.500	-731	-2%

## Section III: Report Summary and Conclusion

Ohio's tax burden grew faster than 48 other states between 1980 and 1996, and it is now the ninth highest in the U.S. This tax burden has hurt Ohio's economic growth and has likely contributed to the net migration of 307,000 Ohioans to other states. Furthermore, between 1996 and 2000, half of Ohio's budget surpluses were spent rather than returned to taxpayers.

The Ohio income tax affects the state's economy by slowing job creation and causing Ohioans to become less productive. This report examines the effects of changing Ohio's individual income tax in several ways.

This study analyzes the economic basis of taxation and presents six proposals for reform of Ohio's income tax. Each of the proposals had to meet several criteria in order to be considered: it had to meet a general definition of fairness, reduce overall revenues, reduce taxes for all Ohioans and have the possibility of being implemented quickly.

Additional fiscal reform

measures can be considered. Policy makers should consider introducing an amendment to the Ohio Constitution to include tax and expenditure limitations. The growth of taxation could be limited by requiring a supermajority vote (a vote larger than a simple majority, e.g., 2/3 or 3/5 of all members) in each house of the General Assembly in order to increase taxes. Further, the growth of expenditures could be limited to a specific formula such as the rate of inflation, population growth, or a combination thereof.

**Table 14.**

	<i>Proposal Description</i>	<i>Increase in Jobs</i>	<i>% of Filers Removed from Tax Rolls</i>
<b>Proposal 1</b>	cut marginal tax rates 5%	23,261	0
<b>Proposal 2</b>	cut marginal tax rates 10%	46,613	0
<b>Proposal 3</b>	cut marginal tax rates 15%	70,036	0
<b>Proposal 4</b>	increase personal exemption to \$3,000	20,945	17
<b>Proposal 5</b>	decrease number of tax brackets to 4	55,790	25
<b>Proposal 6</b>	decrease number of tax brackets to 5	21,965	25





































*Analysis*, (1990; 2nd ed., New York, NY: Macmillan, 1993), chapter 16; and *LIMDEP Version 7.0 User's Manual* (New York: Econometric Software Inc., 1995).

45 Refer to State of Ohio FY2000-2001 Executive Budget Proposal.

46 These estimates are based on current state law governing tax and revenue sources.