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FOR IMMEDIATE RELEASE, January 26, 2009

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FIND THE REPORT AT: <http://www.policymattersohio.org/BusinessTaxRevamp2009.htm>

Ohio business-tax revamp contributes to state's fiscal woes

Ohio's revamp of its business-tax system in 2005 has contributed importantly to the state's budget deficit, according to a new report issued today by the nonprofit research institute Policy Matters Ohio. The report, *Business Tax Revamp: A Deficit in the Making*, concludes that businesses saved more than \$500 million during the state's 2008 fiscal year ended last June. Overall, when fully implemented, the business tax changes are likely to reduce total state revenue by \$1 billion or more a year.

The business share of Ohio's state and local taxes remains far lower than it was 30 years ago. This is partly because the two taxes being phased out under the 2005 overhaul had been weakened over the years or remained stagnant in real terms.

"Ohio should retain its tax on corporate profits and restore the business contribution to Ohio's tax collections," said report author Zach Schiller, research director at Policy Matters. Another recent Policy Matters Ohio report found that there is little evidence the overall tax cuts have achieved the objective of improving the state's economy (see *The 2005 Tax Overhaul and Ohio's Economy*, at <http://www.policymattersohio.org/2005TaxOverhaul.htm>).

The Ohio General Assembly in 2005 approved an overhaul of the state's tax system. Besides cutting the personal income tax and making other changes, the legislature phased out two of the most significant taxes on business: The Corporate Franchise Tax on nonfinancial companies, which is the state's corporate income tax, and the Tangible Personal Property Tax, a local tax imposed on machinery, equipment, inventories, furniture and fixtures used in business in Ohio. It replaced them with a new Commercial Activity Tax (CAT), based on gross receipts in Ohio.

The new Policy Matters Ohio study reviews the effects to date of those changes on state and local government revenues, what the overhaul has meant for different types of companies and industries and how the effects have compared with how the reform was promoted. It analyzes available data on the size and industry of taxpayers paying the new CAT, their location, and the extent to which the tax overhaul has affected economic development incentives.

Though the business-tax changes cost Ohio substantial revenue, the study found, collections from the franchise and CAT taxes were stronger than expected during the FY06-07 biennium. This kept year-to-year revenue from the affected taxes from sinking in the first two fiscal years after the tax overhaul. In FY08-09 the changes really began to sting the state budget noticeably. The full effects will be felt in FY10-11, just as the state is walloped with the national recession.



The Commercial Activity Tax was billed as a broad, low-rate tax that would aid in-state industry and manufacturers in particular.

The report found that the CAT indeed is a broad tax, though it has numerous exemptions, such as suppliers to large distribution centers. In-state companies account for more than 85 percent of those paying it, but it is not clear how much of the tax is being paid by companies operating in Ohio. Manufacturers are major beneficiaries of the tax swap. They are still the largest payers of the CAT, although retailers and wholesalers taken together pay a tad more.

Most CAT taxpayers pay the minimum \$150 a year. Under both the franchise tax and the CAT, as with many taxes, most taxpayers pay very little and a relatively small number of taxpayers accounts for a large share of collections. Rough estimates suggest that on average, the multiple payment of the CAT on the same product or service – known as “pyramiding” – does not appear to be very large, though it is more substantial for some industries.

The tax overhaul has caused certain economic-development incentives to decline; for example, fewer new Enterprise Zone tax abatements are being created. However, the tax reductions have not fundamentally altered the state’s operating model for economic development away from offering tax incentives, despite the promise that the tax changes would make such inducements less necessary.

While Ohio’s looming state budget deficit is certainly a product of the economy, it is far worse because of the tax cuts, including the business-tax overhaul. The rationale for the 2005 tax overhaul – to reverse Ohio’s poor economic performance relative to the nation – has not been validated. In addition to previous recommendations that the state take steps to restore the personal income tax and eliminate tax loopholes, Policy Matters Ohio recommends that the state:

- Retain and strengthen the franchise tax;
- Mandate that nonfinancial companies pay the franchise tax or the CAT, whichever is higher;
- Adjust the rate of the CAT, so that these two business taxes bring in as much inflation-adjusted revenue as the franchise tax and the tangible property tax produced in 2005, prior to the tax overhaul. This would provide significant revenue for the state, while leaving the business share of state and local taxes well below what it was in the past, and
- Require that grocers pay the franchise tax if the Ohio Supreme Court should rule in a pending case that the CAT violates the state constitution. This would ensure that grocers and other sellers of food for off-premise consumption pay a general business tax, as other businesses do.

Policy Matters Ohio is a nonpartisan, nonprofit research institute with offices in Cleveland and Columbus.

