Executive Summary

Ohio businesses are paying a far smaller share of the costs of state and local government than they did 25 years ago. One element in that decline has been the waning of the state's corporate franchise tax. That is Ohio's corporate income tax, which is actually paid on either on profits or net worth, depending on which produces a greater amount.

In the mid-1970s, the state's corporate franchise tax was a major source of revenue, accounting for 16 percent of the taxes supporting Ohio's General Revenue Fund, the main fund for state operations. That had declined to 4.6 percent by fiscal 2002. Though that is partly because of growth in other taxes, the amount of franchise taxes collected decreased in each of the last four fiscal years, contributing to Ohio's budget problems. In inflation-adjusted dollars, revenues from this tax have fallen below even the trough reached in the deep early 1980s recession. The drop began in fiscal 1999, well before the latest recession had started. Compared to gross state product, the measure of everything produced in Ohio, corporate franchise tax revenues are at their lowest level in decades.

Just over 100,000 non-financial businesses were liable for Ohio corporate franchise taxes for the tax year 2001. More than 44 percent of them were liable for the minimum $50, before credits. Another 36 percent were each liable for less than $2,000. Manufacturers pay a larger share of the total than any other industry.

Ohio's per capita state taxes on corporate income or net worth are below the average of all states taken together, or those of its neighbors. When Ohio municipal income taxes are factored in, Ohio's state and local corporate income taxes are closer to the national average.

A number of factors have contributed to the weakening in Ohio's corporate franchise tax, besides declining profits from the lethargic economy. One major reason is legal corporate tax avoidance. This is a national phenomenon. "We have a 'swiss cheese' state corporate income tax," said Dan R. Bucks, executive director of the Multistate Tax Commission. The current effective rate of state corporate income taxes is slightly over 5 percent, down from 9.6 percent in 1980. One common tactic involves shifting income to other states where it will not be taxed as heavily through the use of other companies there that sell goods or services to the company here. The Ohio Department of Taxation estimates that if the state required combined reporting, under which intercorporate transactions are eliminated and companies operating as a single business are treated as one taxpayer, it would take in roughly an additional $200 million a year.

Changes in U.S. tax law and aggressive tax sheltering at the federal level also have reduced the amount of Ohio taxes, since usually when federal tax liability drops, state tax liability drops with it. Changes in state law are another contributor. The state has diluted the net-worth component of the franchise tax, capping it in 1999 at $150,000. That helped lead to an especially large fall-off in collections when the economy weakened. The legislature also has cut tax rates and added tax credits. Altogether, the Legislative Budget Office estimated these changes would cost the General Revenue Fund $774 million in corporate franchise taxes between fiscal 1996 and fiscal 2003. Some credits are not well-targeted, such as job tax credits that were recently awarded for a Wal-Mart warehouse that was already being built.

The franchise tax also is declining because new businesses often are organized so that they escape the tax. Limited liability companies and others known as pass-through entities do not pay corporate franchise tax; tax on the income they generate is paid not by the business but under the personal income tax by their individual owners. The amount is substantial, and Ohio has started requiring these entities to withhold taxes on income paid to non-Ohio investors who otherwise might escape Ohio taxes. Limited liability companies offer new opportunities for multistate corporations to avoid taxes.

Ohio should take steps to curb corporate tax avoidance and fortify its franchise tax. Specifically, the state should:

- Consider requiring large corporations to disclose their corporate franchise tax returns. At the least, it should allow, as Wisconsin does, for citizens to be able to find out from the state whether a particular company is filing a return, and what its particular liability was in a given year. Ohio also should follow the lead of New Jersey and Alabama and report on overall corporate tax compliance.
- Require mandatory combined reporting. This has been used in California for decades, and 16 states in all require it.
- Repeal the $150,000 net-worth cap, which discriminates in favor of large companies. This would provide another backstop against corporate tax avoidance.
- Consider enacting what is known as a "throwback" rule, so that the Ohio corporate franchise tax would cover income from sales made by Ohio producers in other states where they are not subject to corporate income tax. Two dozen states currently have such rules.
- Adopt a moratorium on creation of new types of tax credits and create stricter standards for the award of existing ones.

Ohio also should track Alabama's new law curbing the use of contingency fees by tax preparation firms, and review whether more steps should be taken to ensure that pass-through entities are not abused by companies seeking to escape taxation.

Such steps are unlikely to harm economic growth. The franchise tax does not cover most new businesses, particularly high-technology businesses, so it is not a major barrier to business formation. Comparing overall business taxes among states is difficult, but Ohio's do not appear to be significantly out of line, and the corporate franchise tax accounts for only a fraction of total business taxes in the state. Moreover, the impact of business taxes on new investment is uncertain, at best. States that have throwback rules and combined reporting were disproportionately represented among those with strong manufacturing job growth between 1995 and 2000. Ohio needs to strengthen its corporate franchise tax, to provide the stable revenue the state needs and equity among taxpayers big and small.