Business Tax Revamp:

A Deficit in the Making

Executive Summary

The Ohio General Assembly in 2005 approved an overhaul of the state's tax system. In addition to cutting the personal income tax and making other changes, the legislature phased out two of the state's 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, based on gross receipts in Ohio.

This business tax overhaul has resulted in big savings for business – more than $500 million last fiscal year alone, with further cuts still to come. 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 had been weakened over the years or remained stagnant in real terms.

Though the business-tax changes cost Ohio substantial revenue, 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 CAT indeed is a broader tax than the franchise tax, covering roughly three times as many corporate entities. Among the 272,029 entities registered to pay the CAT as of October 2008, more than two in five were limited liability companies or S Corporations that have proliferated in recent years and do not pay the franchise tax. However, the CAT still has numerous exemptions.

A previous study had estimated that when the tax changes were fully implemented, manufacturers would save about $600 million a year. However, the record so far suggests that manufacturers may save somewhat more than expected. Manufacturers remain far and away the largest payers of the CAT, as they do with the franchise tax. In FY2008, manufacturing accounted for 30.8 percent of the $929.7 million in CAT tax due. The next biggest payers of the CAT are the retail industry, at 17.9 percent of the total, and wholesalers, 14.6 percent. These two industries will pay a great deal more in CAT than they did in franchise tax, though they also benefit from the tangible property tax they no longer pay.

The limited data that exist on the location of companies paying the CAT tally the number of taxpayers by address, which does not necessarily provide an accurate picture of the amount paid by companies located in and out of Ohio. However, it shows that 85.8 percent of the 180,667 CAT taxpayers by street address are located in Ohio. Most of the rest are either in a neighboring state, or in one of the largest states in the U.S.

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Economists and tax policy experts often criticize gross receipts taxes like the CAT because of what they call "pyramiding": The tax may be paid multiple times as a product or service is resold, such as steel going into auto parts and then finished cars. A comparison of taxable gross receipts with Ohio gross state product provides a rough measure of pyramiding. Under this admittedly crude comparison, the CAT is being paid roughly 1.4 times on each dollar of economic output in Ohio, and more 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. Some other tax exemptions that were tied to the franchise tax will disappear. However, other franchise-tax incentives remain in place, or have been changed so they are applicable against the CAT. The amount claimed of job creation tax credits, a key state incentive, has remained flat or increased. Local tax abatement on real property has been growing at a double-digit pace, while the state continues to offer substantial incentives to businesses not only to locate in Ohio, but to stay here. The business-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.

Revenues from the CAT could be sizably reduced in the next few years for two separate, unrelated reasons. A suit by the grocery industry claiming the CAT is an unconstitutional tax on food could cost hundreds of millions of dollars. Meanwhile, a trigger built into the tax could automatically reduce the CAT rate if collections exceed projections by more than 10 percent.

While the national recession clearly is a major cause of the state's looming budget shortfall, the reduction in business taxes has been an important contributor. As another Policy Matters Ohio report indicates, there is little evidence the overall tax cuts have achieved the objective of improving the state's economy. In addition to previous recommendations 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 these two business taxes bring in as much inflation-adjusted revenue as the franchise tax and the tangible property tax produced in 2005. 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 the industry's favor. This would ensure that grocers and other sellers of food for off-premise consumption pay a general business tax, as other businesses do.