

# Business Tax Revenue in the Toledo Area



July 18, 2005

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# Acknowledgements

NorthWest Ohio Tax Commissioners Association

## Study Advisory Group

The following tax commissioners provided advice, data, interpretations of state laws, and suggestions about the situation facing municipalities in Northwest Ohio. They contributed important information to this study, including impacts that changes at the state level have had on communities using income taxes to raise revenue.

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- Patricia Wast, City of Oregon

Patricia Wast, Tax Commissioner for the City of Oregon, Ohio also served as my partner for the presentation of ***Business Taxes: Case Study Toledo*** at the Ohio's Future Forums program ***Ohio's Future Economy*** sponsored by the Center for Urban & Public Affairs, Wright State University, January 28, 2005.

While municipal tax commissioners contributed significant insights throughout this study, all statements, analyses, errors, and conclusions expressed in this study are mine; they should not be associated with NWOTCA or individual tax commissioners.

Paul Kozlowski  
June 15, 2005



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## Executive Summary

State law authorizes municipalities to tax wages, salaries, and other compensation earned by residents and nonresidents who work in a municipality. The tax applies also to business net profits that are attributable to activities within a municipality. Because the municipal income tax – personal and business – is the cornerstone of funding for Toledo's operations, this study focused on trends in the region's central city compared to key suburban municipalities and the geographic, economic, demographic, and public policy factors associated with changes in business tax collections.

Toledo's revenue from its tax on business income dropped 26% from 1996 to 2001. Revenue in 2004 was actually \$3.6 below the amount collected in 1996. While municipalities surrounding Toledo experienced differing degrees of swings in business income tax revenue, the City of Toledo had the deepest and longest-lasting contraction. Differences among municipalities in Northwest Ohio since 1996 can be highlighted by the range of growth in current-dollar revenue from the tax on business income: a high of 13.4% per year in Perrysburg to a low of -3.7% per year in Toledo.

The findings indicate the falloff in business income tax collections was attributable to multiple factors that converged after 1996 with significant negative impacts on the City's business income tax base. The business cycle affected total income tax revenue negatively in 2001. Collections from businesses had a disproportionately large impact during that recession and also during the weak recovery that followed. In addition, long-term structural adjustments contributed to the drop in revenue as the City lost business establishments and the number of businesses filing tax returns fell. State policies also contributed to the downward trend. House Bill 95, for example, broadened the exclusion of certain types of intangible income from municipal taxes. The result was horizontal inequity within the business sector that adversely affected municipalities in Northwest Ohio with heavy reliance on manufacturing. Some of these negative impacts on the tax base were beyond the control of municipal officials. Nevertheless, adverse long-term structural adjustments are associated with local economic development efforts that were confronted with unfavorable and rapidly changing market conditions since the mid-1990s. The downward trend in business income tax revenue provided a signal that long-term problems require re-assessment of local goals for development.

State policies influence the municipal tax base. Municipalities should find it in their best interest to organize politically. The state legislature responds to actions by interest groups and it is not clear that municipalities in Northwest Ohio, or throughout the state, have sufficient, organized strength to make their case politically. The City of Toledo would benefit from such organization and political action to prevent further erosion of its business income tax base.

A strong rebound in revenue from business net profits seems unlikely in the near future. In this sense, the City is faced with a daunting task in terms of its future budgets.

## A. Introduction

Income tax collections from businesses have declined in the City of Toledo since 1996. In 2004, revenue from the municipal tax on business income of 2.25 percent was \$3.6 million below the amount collected in 1996. In current-dollar terms, therefore, the City found itself with about 20 percent less in revenue from businesses located within the City than was collected eight years earlier. The downtrend in business income tax revenue has had a considerable impact on the City's budget, particularly on the City's ability to provide municipal services sufficient to meet current needs.

Municipal income taxes are authorized by state law in Ohio. They are imposed on wages, salaries, and other compensation earned by residents and nonresidents who work in a municipality such as an incorporated city or village. This tax is also applied to business net profits that are attributable to activities in a municipality. Because the municipal income tax – personal and business – is the cornerstone of funding for Toledo's operations, it is necessary for decision makers in municipal administration and City Council to understand the forces contributing to the significant reduction in this major source of revenue.

This study addressed four key questions:

1. What has actually happened to business income tax revenue within the Toledo area?
2. Is the observed trend in the central city pervasive throughout the area?
3. Are observed trends in municipal business income tax revenue long-term and expected to continue?
4. Are systematic factors at play: national, state and local conditions and policies?

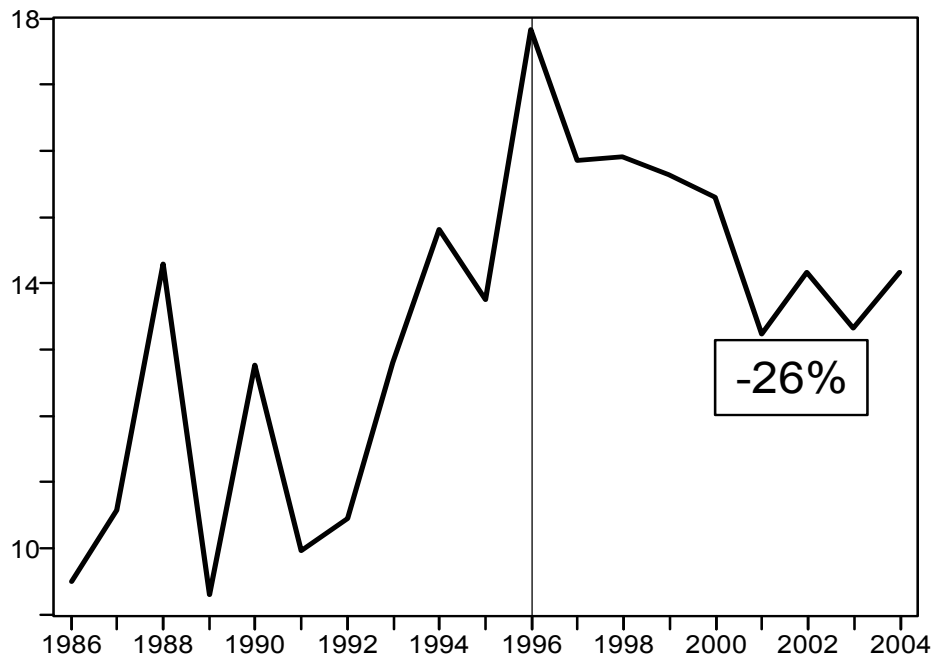
This analysis of business income tax revenue focused on measuring trends in the region's central city compared to key suburban municipalities during the last fifteen years. Geographic, economic, demographic, and public policy factors associated with changes in tax collections were examined.

The results suggest that the downward trend in Toledo's business income tax collections is attributable to multiple factors of a short-term cyclical nature and of a longer-term structural type. Although some of these factors are outside the control of municipal decision makers, the decline in business income tax revenue requires a response; otherwise this source of tax revenue is unlikely to rebound sufficiently to ease the city's weak budget prospects in future years.

## B. Economic Setting: Growth and Cycles

The overriding economic conditions in the last five years are associated with the 2001 recession and the weak recovery that followed. These short-run cyclical conditions cannot be overlooked in explaining the decline in business tax revenue. They represent the environment in which the decline occurred to a great extent, and some of the negative growth since 1996 is attributable directly to those short-run conditions.

**Figure 1: Business Income Tax Revenue (millions): City of Toledo**



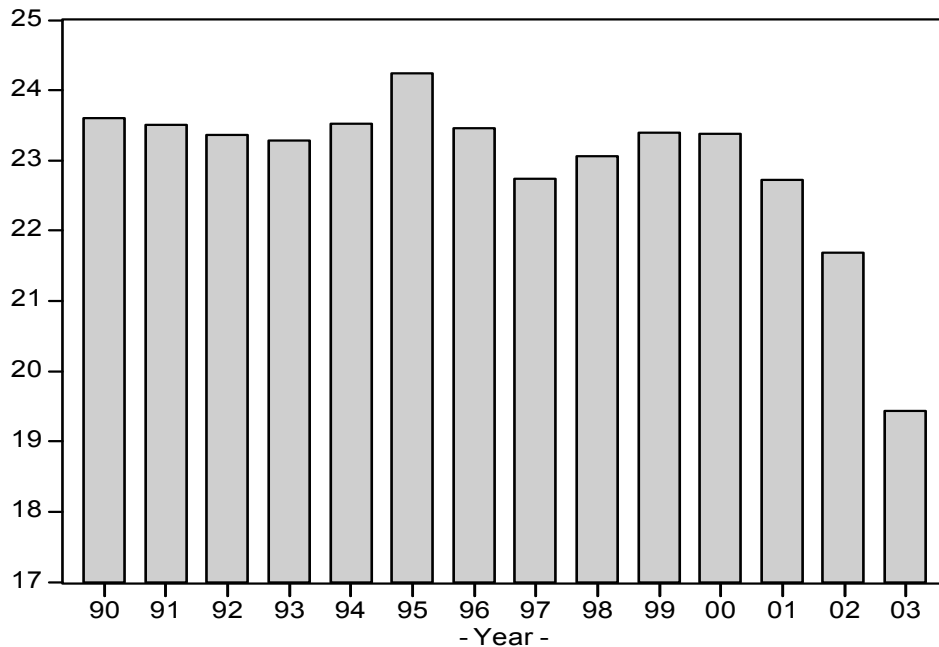
Source: City of Toledo, Finance Department.

Figure 1 shows the behavior of the City's business income tax revenue since 1986. Although the recession did not begin until 2001, the City's revenue from businesses had already fallen for four years when that recession started. The total decline was 26 percent spread over five years. By historical standards, a five-year specific slump in tax revenue is very long. During the late-1980s/early-1990s the slump in revenue was only one year despite the fact that the recession of 1990-91 was a little more severe.

In contrast, the City's total income tax revenue dropped only during 2001. The falloff in business tax revenue accounted for 50 percent of the total decline even though that category had only a 10 percent average share of total income tax revenue during the 1986-2004 period. The current-dollar loss in business tax revenue was \$2.1 million in 2001 which equaled the loss from withholding that accounts for about 88 percent of total income tax revenue. The City's loss of total revenue in 2001 was, therefore, associated disproportionately with the decline in the amount collected from local businesses.

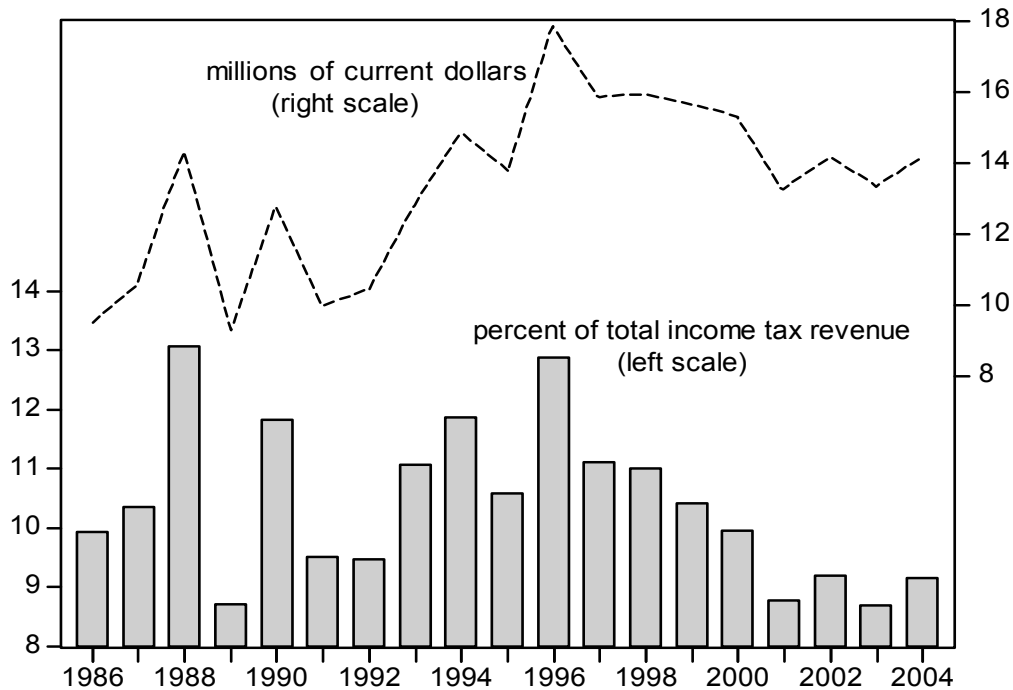
Moreover, Figure 2 shows a considerable drop in the number of business filings. From 1990 to 2000, total business filings of municipal income taxes remained close to the average of 24,400. By 2003, two years after the recession ended, the number had fallen below 20,000. The City has not only experienced a downtrend in the amount collected since 1996, but also a significant falloff in the number of businesses actually filing municipal tax returns. In fact, from 1996 to 2003 the correlation between the number of filings and the amount collected is .66. This positive link should certainly raise concerns about the evolution of business within the city.

**Figure 2: Business Filings for Municipal Income Tax (thousands):  
City of Toledo**



Source: City of Toledo, Finance Department.

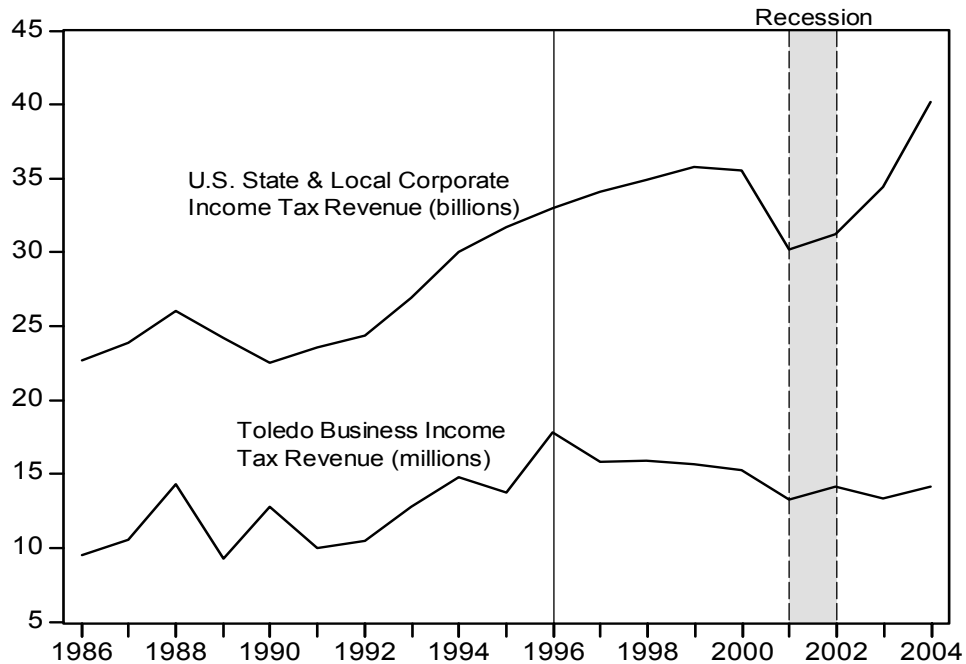
The drop in the share business contributed to total income tax revenue is illustrated in Figure 3. Businesses accounted for a larger share of Toledo’s revenue during the 1990s. From 1993 to 2000, for example, the business share averaged 11.1 percent. It dropped to 8.9 percent for the 2001-2004 period. Moreover, in 1996 the business category accounted for 13 percent of City’s total revenue; and, as the chart shows, the business share of municipal income tax revenue dropped for five consecutive years from 1997 to 2001. There has been little recovery in the business share since then.

**Figure 3: Business Share of Income Tax Revenue: City of Toledo**

Toledo's experience with business tax revenue differs from a nationwide aggregate for state and local governments in terms of both long-run growth and short-run cyclical swings. The national and local income tax revenue is exhibited in Figure 4. For the entire country, state and local tax revenue peaked in 1999; Toledo's peak was three years earlier. The drop in the national aggregate, associated with the 2001 recession, was about 16 percent compared to 26 percent for Toledo.

By 2004, total state and local corporate income tax revenue had not only recovered from the recession but it was also 12.3 percent above its pre-recession peak. In contrast, the City of Toledo found itself with business income tax revenue 20.2 percent below the amount collected in 1996. In terms of cyclical recovery, therefore, the City's business tax revenue has improved little. If Toledo's business tax revenue had expanded at the national rate and had moved 12.3 percent above its 1996 level, then that would have generated an additional \$5.8 million in revenue for the City in 2004. That would have eliminated the budget problem the City faced in 2004. The failure of business income tax revenue to recover from the 2001 recession represents a major problem for City officials struggling with growth in expenditures for City services.

When the entire period from 1986 to 2004 is examined, the growth of Toledo's business tax revenue is not too much below that of the U.S. state and local government total shown in Figure 4. The average annual growth rates were 2.1 percent and 2.9 percent, respectively. Toledo lost in real terms because over the same period, the rate of inflation, measured with the Department of Commerce GDP price index was 2.2 percent per year.

**Figure 4. Business Income Tax Revenue: U.S. and Toledo**

Sources: U.S. Department of Commerce, Bureau of Economic Analysis,  
<http://research.stlouisfed.org/fred2/data/ASLCTAX.txt>  
 City of Toledo, Finance Department.

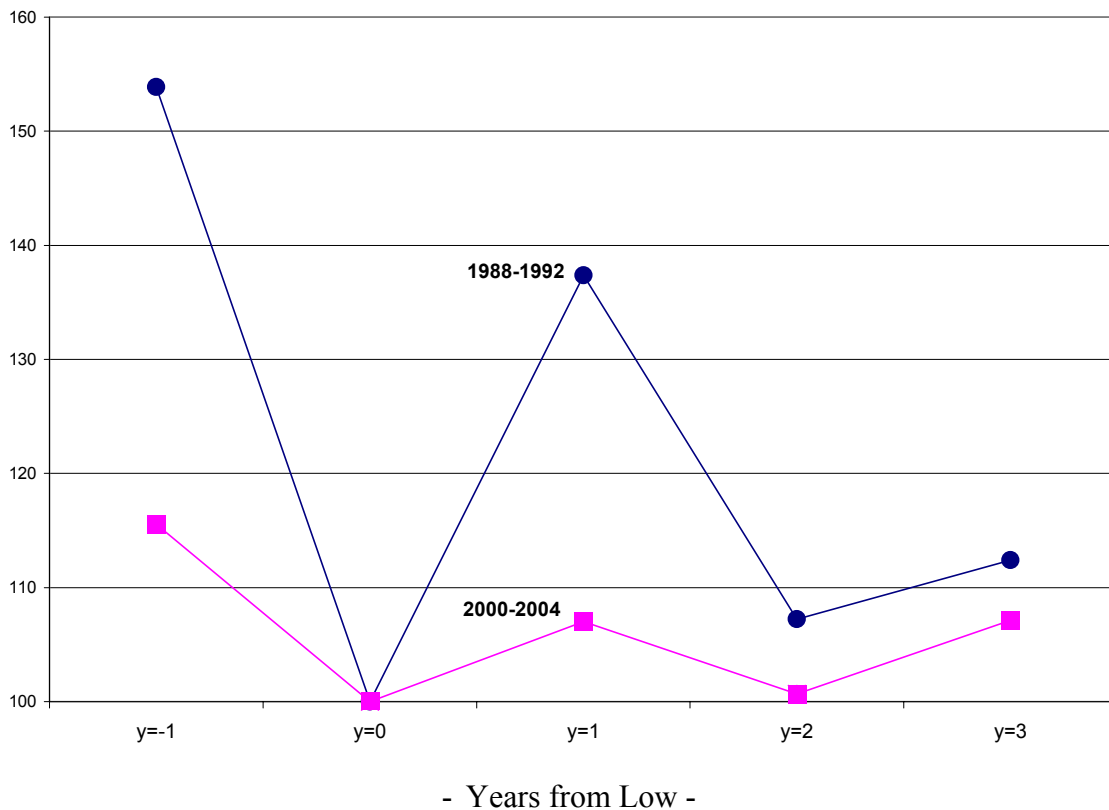
There is a sharp contrast between the U.S. and Toledo business tax revenue for the 1996-2004 period. However, U.S. state and local corporate income tax revenue grew 0.7 percent/year even with the slump recorded during the recession. Toledo's growth was -3.7 percent/year. Given that the inflation rate averaged 1.8 percent/year, the negative growth in current-dollar revenue translates into a much bigger loss in inflation-adjusted terms. In short, Toledo's business income tax revenue has shrunk in both nominal and real terms over the last nine years.

While historically Toledo has been more cyclically sensitive than the nation as a whole, the experience in the most recent episode was different. That is not surprising because all cyclical episodes include unique characteristics. An index of revenue from the Toledo business sector is shown in Figure 5 for two five-year periods: 1988-1992 and 2000-2004. By 2004, for example, which is three years after the recession ended, the index of Toledo's business income tax revenue was 107.1 compared to 112.4 of recovery following the recession of 1990-91. This time it's been an extremely weak recovery locally with its impact on tax revenue that distinguishes the recent cyclical episode from past experiences.

In summary, there has been no growth in Toledo's business income tax revenue during the last nine years. The recession of 2001 explains some but not all of the loss of

revenue from local businesses. By historical standards, the national recession of 2001 was short and mild. Toledo's decline in business tax revenue has been long and deep. Moreover, there was little gain during the three years of recovery. Even the most optimistic forecast would not predict growth fast enough to bring full recovery in the next few years. In fact, a recent examination of prospects for the Toledo MSA resulted in a ranking of 321 (worst = 325) for employment growth for 2002-2007 (Economy.com, 2004). And based on a broader range of indicators Toledo ranked 195 out of 200 metropolitan areas in the United States (Milken Institute, 2003).

**Figure 5. Index of Business Income Tax Revenue: City of Toledo (recession low = 100)**



Given its recent growth and cyclical behavior, the economic prospects for the Toledo area are summarized well by Fischer (Economy.com, 2004).

Toledo will be a below average performer over the forecast horizon due to its structural weaknesses and unfavorable demographics. Indeed, job growth in TOL will be among the weakest nationwide. While TOL has been benefiting from an experienced and highly productive manufacturing work force that enjoy wages well above the state and national averages the recent recession in manufacturing has only hastened the manufacturing industry's secular decline. In the longer term, TOL faces the daunting task of replacing these high-paying manufacturing jobs.

## C. Revenue Changes: Central City and Suburbs

Urban sprawl is a fact; central cities in Ohio have lost population to rapidly growing suburban communities including cities and townships. This phenomenon also affects tax revenue from withholding on wages and salaries and from businesses profits generated within municipalities. The loss of tax revenue from business may be due to some degree to movement of business to suburban areas. The complex phenomenon of business location decisions is not the focus of this study. Nevertheless, movement of establishments out of central cities has a direct impact on revenue generated from municipal income taxes.

There is considerable variation in revenue trends from businesses in municipalities surrounding the City of Toledo. The growth in real (inflation-adjusted) revenue is shown in Table 1. From 1990 to 2003 the average annual real growth rates ranged from a high of 20.6 percent in Perrysburg to a low of -2.9 percent in Sylvania. There was no growth in real tax revenue in the City of Toledo. Adjusted for inflation, therefore, only three of the six municipalities in Table 1 experienced positive growth in tax revenue from the business sector. Two major suburbs adjacent to Toledo--Maumee and Perrysburg--stand out in this respect.

**Table 1. Annual Growth Rates of Real Business Income Tax Revenue<sup>a</sup>**

Municipality	1990-2003	1996-2003
Holland	10.1%	4.5%
Maumee	5.1%	-2.6%
Oregon <sup>b</sup>	-1.1%	-0.6%
Perrysburg	<sup>c</sup> 20.6%	11.4%
Sylvania	-2.9%	-2.8%
Toledo	0.0%	-5.4%

<sup>a</sup> Current-dollar values deflated with the GDP chain-type price index.

<sup>b</sup> Revenue adjusted for reporting anomaly in 2001.

<sup>c</sup> 1992-2003.

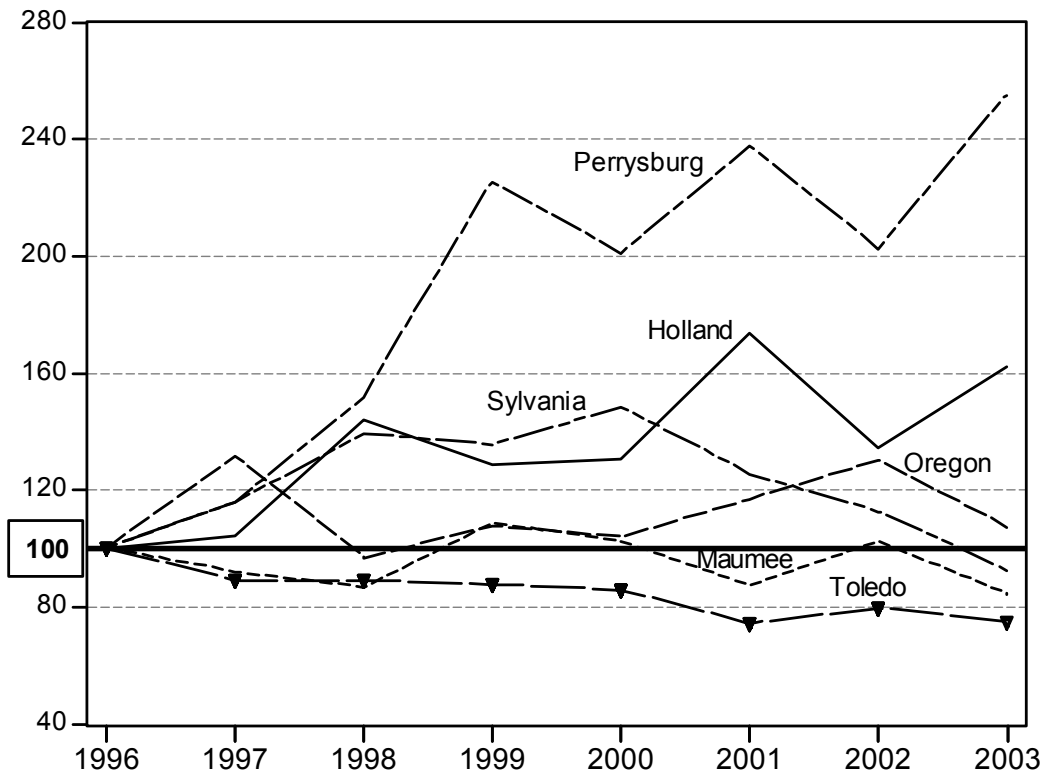
Four of the six municipalities listed in Table 1 experienced negative growth in real business income tax revenue after 1996. Although Oregon, Maumee and Sylvania also showed negative growth from 1996 to 2003, the -5.4 percent annual decline in Toledo was considerably greater. Perrysburg is certainly the high-end city among the six listed in Table 1.

Figure 6 summarizes the dynamics of change in revenue in the six municipalities from 1996 to 2003. The City of Perrysburg is certainly the high-end performer as current-dollar business income tax revenue increased 155 percent. Over those years, that city's total income tax revenue rose 85 percent. In current-dollar terms revenue collected from



businesses accounted for 6 percent of the gain in Perrysburg. In contrast, the City of Toledo was the low-end performer; its slow growth in total income tax revenue is disproportionately attributable to the falloff in revenue from the local business sector.

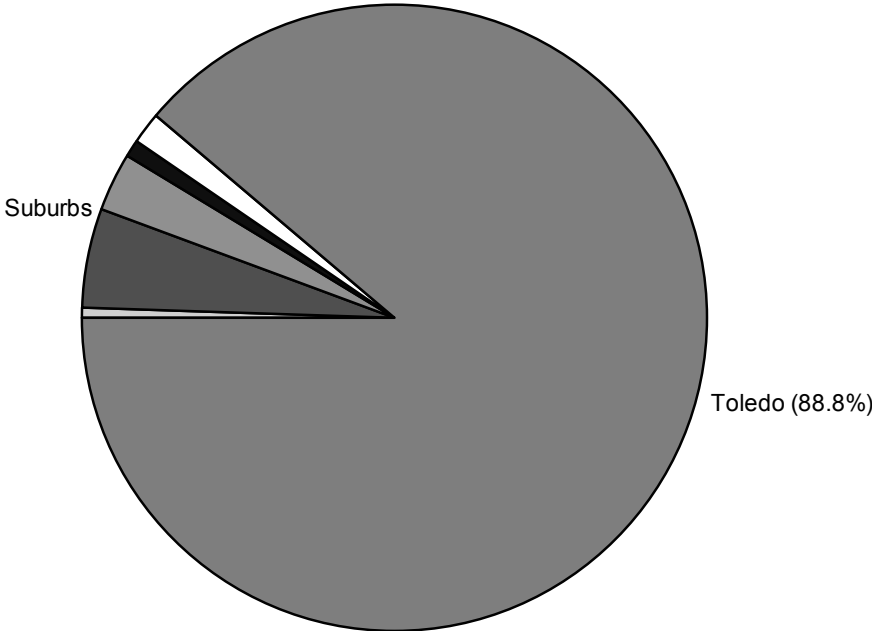
**Figure 6. Index of Current-dollar Business Income Tax Revenue: Selected Municipalities (1996 =100)**



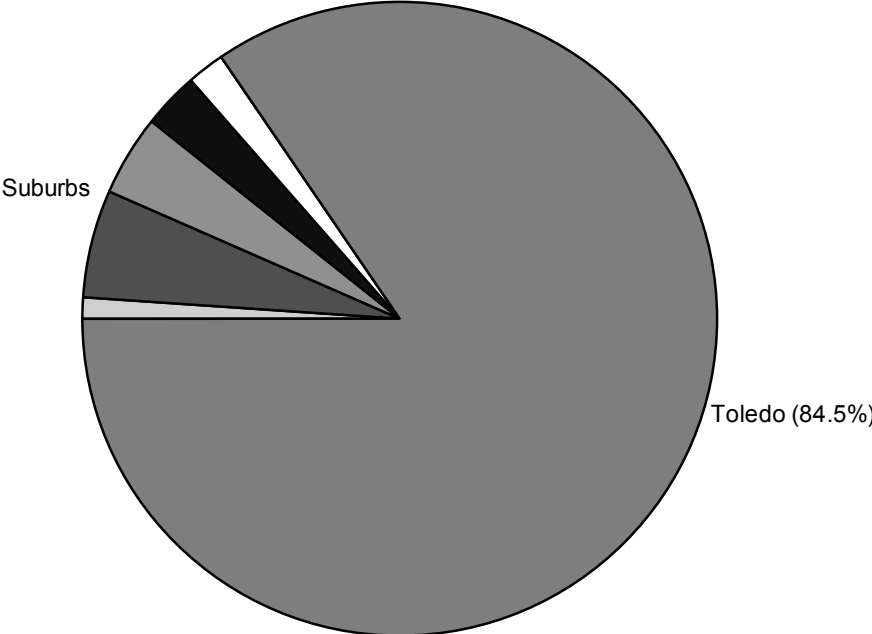
Sources: Municipal Tax Commissioners.

The distribution of business income tax revenue for the six municipalities is shown in Figure 7. As the largest area in Northwest Ohio, the City of Toledo has the biggest share of tax revenue collected from businesses. Nevertheless, the central city lost about 5 percent of its share from 1996 to 2003. The largest gain in share occurred in Perrysburg, shown by the darkest sections of Figure 7. The pickup in share collected from business in Perrysburg resulted from its rapid growth compared to the other municipalities. Toledo's smaller share of business income tax revenue was the result of its negative growth during this period. In summary, the central city of Toledo not only experienced a decline in business income tax collections but also a shrinking share of the total collected among key municipalities within the metropolitan area.

Figure 7. Share of Municipal Business Income Tax Revenue



1996



2003

## D. Municipal Income Tax Revenue

Ohio law allows municipalities to levy taxes on earned income and business profits. Tax rates vary among the 548 municipalities that levy such taxes in Ohio. These areas include 234 cities and 314 villages; townships in the state do not levy income taxes. Ohio law also specifies that administration of municipal income tax is strictly local, either by cities or villages themselves, or by central agencies representing several municipalities.

For municipalities that use income taxes, revenue is directly related to two factors: the tax rate and the tax base. Income tax revenue is the product of both and can be summarized as

$$\text{Income Tax Revenue} = \text{Tax Rate} \times \text{Tax Base}$$

There has been no significant change in municipal tax rates statewide since 1983. The average rate for more than 200 cities in Ohio was 1.57 percent in 2002, only slightly above the 1.27 percent average in 1983. Furthermore, the most frequently occurring municipal income tax rate was 1.5 percent in 1983 and in 2002. Across the state's municipal landscape, income tax rates are relatively low and, by themselves, they are not likely to be a major factor influencing the trends in municipal income tax revenue.

The tax base is more complex. It is a function of numerous factors, including short-run business conditions, long-run structural changes, and national, state and local policies. Extensive interviews with municipal tax commissioners in Northwest Ohio support the conclusion that changes in the tax base are the most important issue surrounding revenue generated from the tax levied on business net profits. In this respect a range of factors seems to have affected the municipal tax base and revenue from that base.

Ohio's HB 95 defines the income subject to municipal tax in two ways.

- Municipal income taxes are generally imposed on wages, salaries, and other compensation earned by residents and nonresidents who work in the municipality.
- The income tax is also applied to business net profits that are attributable to activities in the municipality.

The earned compensation from the first definition generates the most revenue through withholding. Most municipalities permit either a partial or full credit to residents for municipal taxes paid to another municipality where they are employed. With respect to business net profits, it is important to note that only profit attributable to a municipality is taxed, and that it is the responsibility of businesses to specify the geographic location of profits within the state. Because of this businesses have been required to report profits attributable to multiple locations if they operate in more than one area levying an income tax. Municipal tax forms include formulas for specifying the allocation of profits, but

businesses have raised the issue of the cost of compliance when reporting to multiple cities and villages.

While cities and villages collect most of their income tax revenue from withholding on wages, salaries and other compensation of residents, income from incorporated and unincorporated businesses contribute to revenue. Business income tax revenue accounted for an average 10.4 percent of income tax revenue in Toledo from 1986 to 2004, varying from 13.1 percent in 1988 to 8.7 percent in 2003. Factors that affect the tax base for business income are the keys to understanding the decline in the City's revenue from local businesses since 1996.

**Table 2. Income Tax Rates**

Municipality	1983	2002
Bowling Green	1.50	1.92
Maumee	1.50	1.50
Northwood	1.50	1.50
Oregon	2.25	2.25
Perrysburg	1.50	1.50
Rossford	1.50	2.25
Sylvania	1.50	1.50
Toledo	2.25	2.25

Table 2 gives the income tax rates for eight municipalities in Northwest Ohio. The average tax rate was 1.7 percent in 1983 and 1.8 percent in 2002. There were only two increases after 1983 and none after 1990. Therefore, like the rest of the state, there were no significant changes in municipal income tax rates in Northwest Ohio. While the average rates for municipalities listed in Table 2 were above the state average in 1983 and 2002, in the latter year four of the eight areas had income tax rates slightly below the average of 1.6 percent for 234 cities that levied income taxes. Nevertheless, Toledo, the largest city in Northwest Ohio, had an income tax rate above the statewide average for the entire period.

Although tax rates varied by just 0.75 percent from high to low in the eight municipalities, the dollars paid by businesses may be considerably different depending upon the profits reported. For example, \$1,000,000 in net business profits in 2002 would have required payment of \$22,500 in income tax to the City of Toledo but only \$15,000 in tax payment to Maumee, Northwood, Perrysburg, and Sylvania. The difference of \$7,500 per \$1,000,000 in net business profits is not large in absolute terms, but it may influence business decisions to some extent especially in businesses with low profit margins.

The trends in business income tax revenues, shown in Figure 6, indicated that Perrysburg experienced the most rapid growth since 1996. Its 1.5 percent income tax rate is the same as the rate in Maumee and Sylvania where growth was considerably slower. Therefore, differences in municipal income tax rates may have contributed somewhat to the decline in business income tax revenue in Toledo, but they cannot fully explain the City's negative growth since 1996. Maumee and Sylvania both experienced negative growth with tax rates 0.75 percent lower than the rate for Toledo, and the same as the most rapidly growing community--Perrysburg. As noted above, changes in the municipal business income tax base—the number and size of firms, and the amount of their revenues-- are considerably more likely to be the reason for the drop-off.

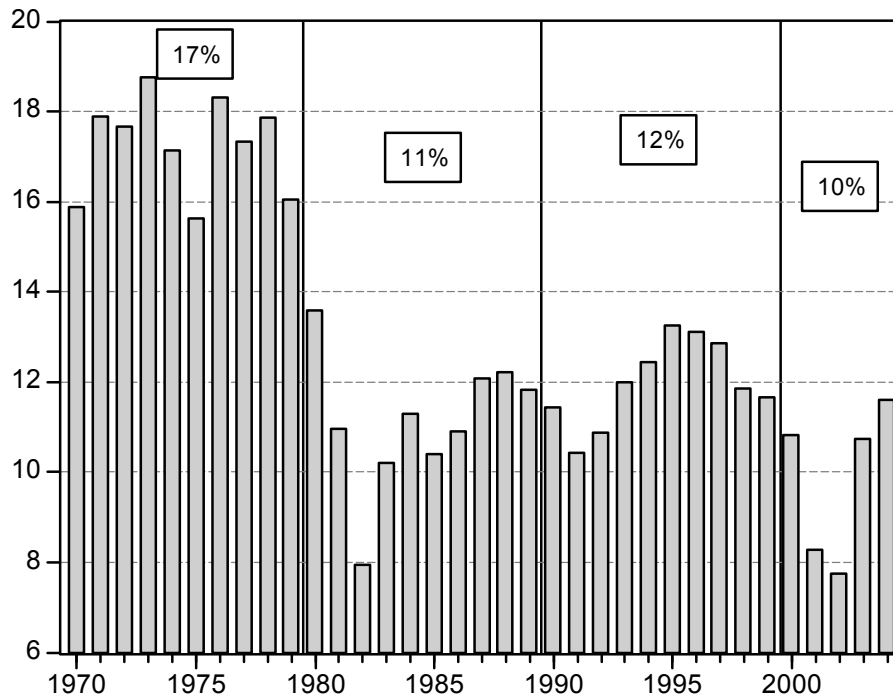
## **E. Business Income Tax Base**

The municipal business tax base is a complex function influenced by many factors. It has shifted over time because of economic conditions, state policies, and local adjustments. The result is a change in revenue generated from the business sector; the change has not been positive for the City of Toledo.

It is important to recognize that the drop in the business share of Toledo's total income tax revenue, shown in Figure 3, is not just a local phenomenon; the business share has fallen nationwide. Figure 8 shows the corporate income tax accounted for 17 percent federal tax receipts during the 1970s. Since 2000 the share is only 10 percent. For Toledo the business share of income tax revenue averaged 9.1 percent since 2000, just slightly below the national share. Moreover, during the boom years of the 1990s, the business shares were also close, 12 percent for the federal government and 11 percent for the City. The business sector in Toledo, therefore, accounted for almost the same share of tax revenue as corporations did nationwide since 1990. The major difference between the local and federal tax systems was the recovery in 2003 and 2004. Toledo did not experience the strong rebound in business tax receipts that occurred at the federal level. The weak recovery in the local economy did restrict tax revenue coming from local businesses.

It is also important to note that business income subject to municipal income tax depends directly on the amount of revenues that businesses report to the IRS. For municipalities, net profit is the same as the amount reported to the IRS for federal income tax. Changes in federal tax laws affect business income reported to municipalities in the state. Profits reported to the IRS under federal laws provide the base for adjusted net income reported to municipalities in the state. Therefore, when federal laws change the rate at which corporate incomes are taxed, reductions also occur in the amount that local jurisdictions can tax. Consequently, municipalities have no control over net profits reported by incorporated and unincorporated business located there. Stated succinctly, categorical reductions in federal taxes, reduce state and local taxes by changing the "income" defined as subject to taxation.

Figure 8. Corporate Income Tax Share of Federal Receipts (fiscal year)\*



\*Number in box is the average for the designated period.  
 Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Table 3 lists important definitions as well as the main lines from Toledo’s income tax form. Changes in federal laws affect local net profits from unincorporated (Line 4) and incorporated (Line 5) businesses. The amounts reported provide the base for adjusted net income (Line 9) and the allocation of the amount to the city (Line 10). Thus, part of the reason for reduced revenues to local jurisdictions; arise from changes in the criteria of the available tax base by other government entities beyond the control of local jurisdictions.

Municipalities do control losses carried forward, however. The City of Toledo allows a 5-year carry-forward (Line 11). The loss carry-forward provision varies among municipalities. In Toledo’s case, the 5-year period permits businesses to offset positive net profits for an extended period of time. That obviously has an affect on tax revenue generated from businesses; lowering the tax obligation of many firms over the duration of the 5-year period.

Three items have an impact on net business profits reported on lines 4 and 5: the number of businesses filing, the types of income excluded from net business profits in Ohio, and fluctuations in profits associated with the business cycle. The latter represents short-run sensitivity of local business income examined in section B. The others appear to be linked to long-term structural changes in the local economy as well as to adjustments in federal and state tax policies.

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**Table 3. Net Profits Definitions, City of Toledo Income Tax Returns**

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**GENERAL INSTRUCTIONS**

**1. WHO IS REQUIRED TO FILE**

This return is to be used by individuals, partnerships, corporations, or any other entity.

**5. INCOME SUBJECT TO THE TAX**

B. Net profits of unincorporated businesses either located in Toledo or located anywhere if owned by a Toledo resident.

C. Net profits of incorporated businesses for business activity conducted inside Toledo whether or not an office or place of business is maintained in Toledo.

**6. WHAT CONSTITUTES NET PROFITS**

Net profit of any business entity is the same as reported to IRS with adjustments for Toledo for the requirements of the Ordinance and Regulations and rulings of the Commissioner.

**7. THE FOLLOWING ARE NOT DEDUCTIBLE IN DETERMINING NET PROFITS FOR TOLEDO INCOME TAX PURPOSES**

(A) Municipal, Federal or State Income Taxes.

(B) Gift, Estate or Inheritance Tax.

(C) Taxes for local benefits or improvements to property which tend to increase its value.

(D) Taxes on property producing income not taxable by the Municipal Income Tax Ordinance.

(E) The Federal Investment Tax Credit.

(F) Loss on the sale, exchange or other disposition of depreciable property used in the taxpayer's business.

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**LINES THAT APPLY TO BUSINESS INCOME**

4. PARTNERSHIP INCOME (Attach Federal Form 1065)

5. CORPORATION INCOME (Attach Federal 1120, 1120S, 1120A)

9. ADJUSTED NET INCOME

10. PERCENT OF LINE 9 ALLOCABLE TO TOLEDO IF ALLOCATION

FORMULA IS USED FROM SECTION Y, LINE 35 ON PAGE 2

\_\_\_\_\_ . \_\_\_% x LINE 9

11. LOSS CARRIED FORWARD (Limited to five most recent prior years.)

12. TOLEDO TAXABLE INCOME

13. TAX ON LINE 12 @ 2.25%

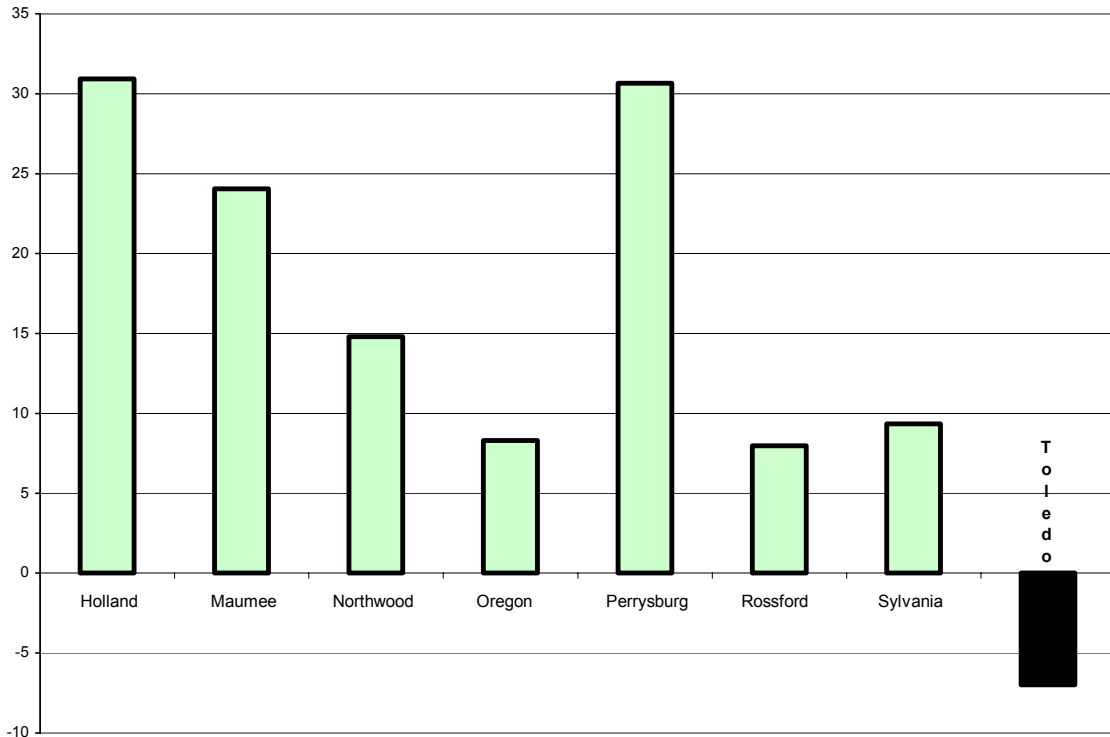
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## I. Long-term Structural Adjustments

The trend in the number of businesses filing income tax returns in Toledo has been significantly negative since 1990. In 2003 the number dropped below 20,000. The City's ordinance requires partnerships, corporations, or any entity to file a municipal income tax return. The drop in the number filed is linked to the falloff in tax revenue, and this is related directly to the shrinking business sector in the city.

Figure 9 shows the loss in establishments<sup>1</sup> in Toledo from 1994 to 2002. The City is the outlier among surrounding municipalities. It is the only one with a negative change in establishments. Fewer establishments are associated with fewer income tax filings.

**Figure 9. Change in Establishments, 1994 - 2002 (percent)**



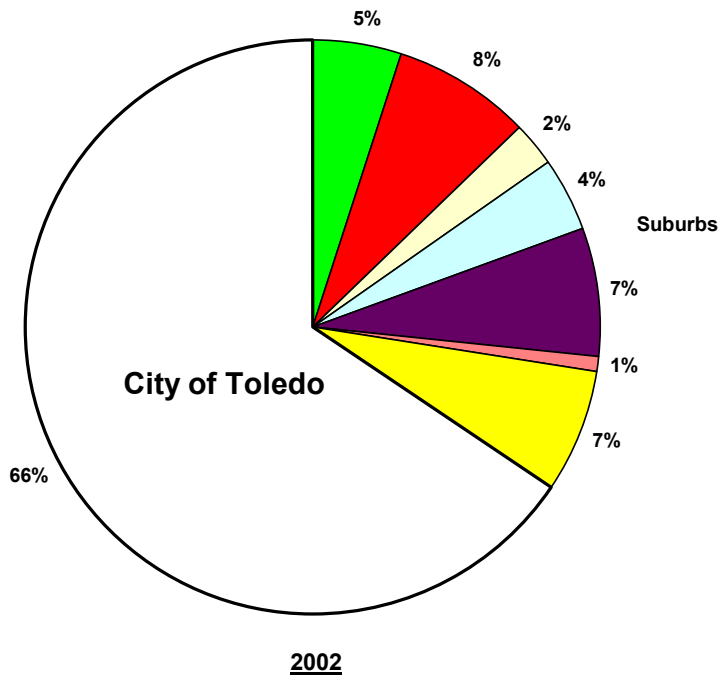
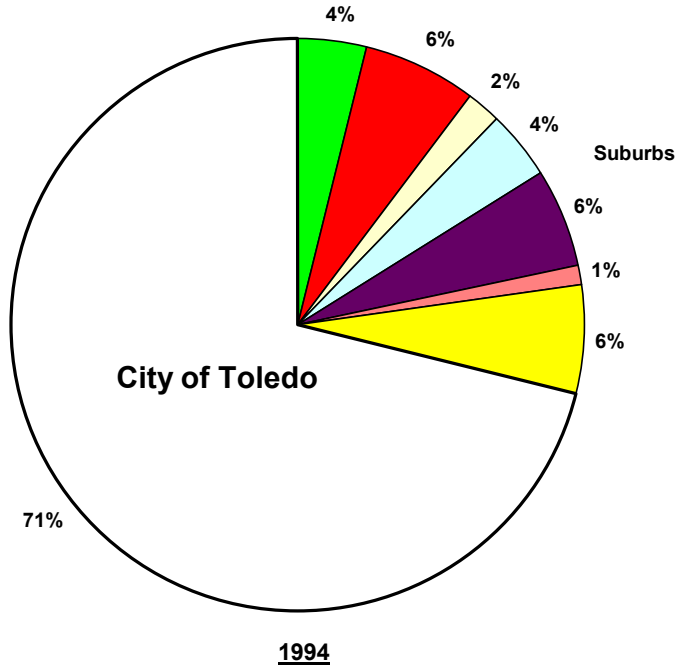
Source: U.S. Department of Commerce, Bureau of the Census.<sup>2</sup>

<sup>1</sup> The Census Bureau defines establishments as: An establishment is a single physical location at which business is conducted or services or industrial operations are performed. It is not necessarily identical with a company or enterprise, which may consist of one or more establishments. When two or more activities are carried on at a single location under a single ownership, all activities generally are grouped together as a single establishment. The entire establishment is classified on the basis of its major activity and all data are included in that classification.

<sup>2</sup> Establishment counts represent the number of locations with paid employees any time during the year. (U.S. Bureau of the Census, *County Business Patterns*, 2002.)



Figure 10. Distribution of Establishments



The losses since 1994 put Toledo in a position different from the surrounding municipalities in Northwest Ohio. Large gains occurred in Holland, Maumee, and Perrysburg. The City of Perrysburg also experienced the most rapid growth in business income tax revenue since 1996. Suburban sprawl has certainly taken its toll on Toledo. As the central city in the metropolitan area, Toledo has lost population, employment, and business establishments. The result has been a slump in municipal income tax revenue. The City is faced not only with more intense competition nationwide but also within the metropolitan area itself. The city's manufacturing base is simply not growing and the prospects for future growth are not bright.

The result of intra-metropolitan competition for business is summarized in Figure 10. The City of Toledo's share of business establishments has fallen since 1994. Maumee, Perrysburg, and Sylvania increased their shares of businesses in the region. The largest absolute gain occurred in Perrysburg (2002). While Toledo remains the largest municipality in Northwest Ohio, its relative position with respect to business activity has slipped; that contribution contributed to the City's loss of business income tax revenue.

The loss of businesses in the central city represents a long-term market adjustment which is ongoing. The evolution observed in the city's business structure will continue. This points to a more aggressive economic development response required from the city. Otherwise, market conditions will continue to move unfavorably for the city. Business income tax revenue is unlikely to rebound significantly under those conditions.

## II. State Policies

According to state law, administration of the municipal income tax is strictly local, either by the cities and villages themselves or by central collection agencies representing several municipalities. Although administration is left to municipalities, which includes collecting and auditing returns, the state specifies types of income that are subject to municipal income taxes.

House Bill 95 represents a good example of the legislature's impact on municipalities. HB95 specified that, beginning in 2004, a municipality may not tax a business' net profit using any base other than the taxpayer's federal taxable income. That provides the base for municipalities' business income taxes, which itself is subject to change by the Ohio legislature.

HB95 contains several provisions that have impacts on municipalities' ability to raise revenue from the business sector. The first is the state's specification of net profit (net income) excluded from municipal taxes, specifically "intangible income."

- Continuing law prohibits municipal corporations from taxing **intangible** income,

In HB95, state legislators decided to add to distinctions between tangible and intangible income for business by excluding more intangible items from municipal taxes. Impacts vary among municipalities throughout the state: income from manufacturing operations is taxed; certain types of income from the financial sector are not. The latter are classified as “intangible” even though, in a business sense, they represent profits derived from business activity within the state.

HB95 defined intangible income as income of the following types:

- Income yield, interest, dividends, or
- Other income arising from the ownership, sale, exchange, or
- Other dispositions of intangible property including:
  - Investments,
  - Deposits,
  - Money, or credits.

The act adds more to the intangible income category:

- Capital gains,
- Patents,
- Copyrights,
- Trademarks,
- Trade names,
- Investments in real estate trusts,
- Investments in regulated investment companies,
- Appreciation on deferred compensation.

Finally, HB95 expressly excludes from intangible income prizes, awards, and other income associated with lottery winnings or other similar games of chance.

The exclusion of so-called intangible income from municipal income tax means that the legislature requires municipalities to treat profits differently depending on the source. This adds horizontal inequity to the municipal income tax system throughout the state. Businesses with similar financial conditions are treated differently depending on the type of income from which profits flow: tangible or intangible. For example, \$1,000,000 in net profits from tangible income is taxed at the municipal rate whereas the same amount from an intangible income source like money and credit activities is excluded. This has added more horizontal inequity to the state’s system of taxation.

Hill and Geyer (2002) analyzed the state system of taxes on tangible personal property and through the corporate franchise tax. Table 4 shows the amount of tax along with the rank order (1 to 9) for the state’s major industrial sectors. Manufacturing businesses, which have provided the economic base for Toledo, paid five times the amount paid by businesses in the financial sector per \$1,000 of contribution to Ohio’s gross state product. When the provisions of HB95 excluding various types of intangible income are considered, the state’s system of business taxation – tangible property, corporate franchise, and municipal net profits – is even more horizontally inequitable.

**Table 4. Horizontal Inequity in Selected Sectors, Ohio\***

	Tax per \$1,000 of Gross State Product
Manufacturing:	\$10.35 (2)
Services:	\$2.73 (7)
<u>Finance, insurance and real estate</u>	<u>\$2.08 (8)</u>
<u>State average</u>	<u>\$6.57</u>

\*Numbers in parentheses are ranking from 1 = highest to 9 = lowest.  
 Source: Hill and Geyer, <http://urban.csuohio.edu/research/pubs/hill.html>, 2002, p.9.

Another way to examine this issue is in terms of economic conditions. Table 5 shows annual growth rates from 1990 to 2002 for Lucas County where the City of Toledo is located. Note that the slowest growth in earnings occurred in the region’s manufacturing industries. Nevertheless, manufacturers are subject to municipal income tax because their net income is classified as tangible. Financial institutions, whose net profits come from items defined as intangible, do not report those profits to municipalities.

**Table 5. Rates of Growth by Sector, Lucas County: 1990-2002**

<u>Earnings</u>	<u>per year</u>
Manufacturing	0.9%
<u>Finance, insurance and real estate</u>	<u>7%</u>
<u>Income</u>	
Dividends, interest, and rent	2.6%
<u>Proprietors’ income</u>	<u>2.9%</u>

Source: U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Information System, June 2004.

Tables 4 and 5 show that the tax system is skewed in favor of businesses whose income is “intangible” and that earnings and income have grown faster in the intangible category. Municipalities like Toledo provide services to all business entities, but under state law they are not permitted to tax income generated by those entities. Instead businesses producing tangible net profits bear a higher burden in the municipal tax system in the state.

Economic reasons for horizontal inequities with respect to business taxes simply cannot explain the size of the inequities in the state system of taxation that includes municipalities. Hill and Geyer (2002) pointed out that the amount of municipal taxes directly paid by businesses increased 16.7 percent in real terms from 1976 to 1999 while payments by non-business taxpayers rose 72 percent. The system in the state is lined with *ad hoc* adjustments by the state legislature and some have serious negative consequences for hundred of municipalities.

Over time the state's business tax system became skewed against cities like Toledo with their heavy dependence on manufacturing. Although there are economic reasons for such tax differentials across businesses, the system in Ohio--which includes taxes levied by the state and hundreds of municipalities--moved too far by increasing horizontal inequities among businesses for political rather than economic reasons. The combined horizontal inequities in the tax system provide an incentive for some businesses with tangible income to locate outside municipalities in townships where a net profits tax is not levied.

HB95 also included provisions for levying income taxes on sub-chapter S corporations. Municipalities had to adjust to the regulations specified by the state. They adjusted municipal ordinances to tax S-corporations as entities or on a pass-through basis. The adjustment can affect income tax revenue.

Under federal law, sub-chapter S corporations elect special treatment. Like partnerships, they are given pass-through tax treatment by the IRS and for tax purposes the entity's income, deductions, losses, and credits flow through the entity to the owners. In short, tax characteristics pass through the entity directly to shareholders and are reported on the shareholder's individual tax returns for federal and Ohio income tax purposes. As a result, S-corporations pay no federal income tax on operations. At the state level the income from operations flows to shareholders who report amounts as individuals.

Municipalities may levy taxes on either the entity or as a pass-through to individual shareholders. Some chose to tax the latter, but the state required that municipalities put this issue on the ballot. Failure to secure passage of taxation on S-corporation pass-through income meant that S-corporation distributive income would be tax exempt and that a municipality would lose that source of revenue. The City of Sylvania, for example, put the issue on ballot for voters to consider. It read:

*“Shall the City of Sylvania continue to tax an S-Corporation shareholder's distributive share of net profits of the S corporation to the same extent that is currently permitted by the City of Sylvania's Municipal Income Tax Ordinance?”*  
(City of Sylvania, **Issue 6**, November 2004)

The issue passed, and pass-through income from S-corporations continues to be taxed at the same municipal rate as other income. The City of Toledo had no choice but to

continue to tax S-corporations as entities instead of as pass-through income to individuals because of its past practice of doing so.

The state added a twist to the S-corporation issue by prohibiting municipalities from taxing S-corporation shareholders' distributive shares of net profits to the extent that the share is not generated by activities in Ohio. Specifically,

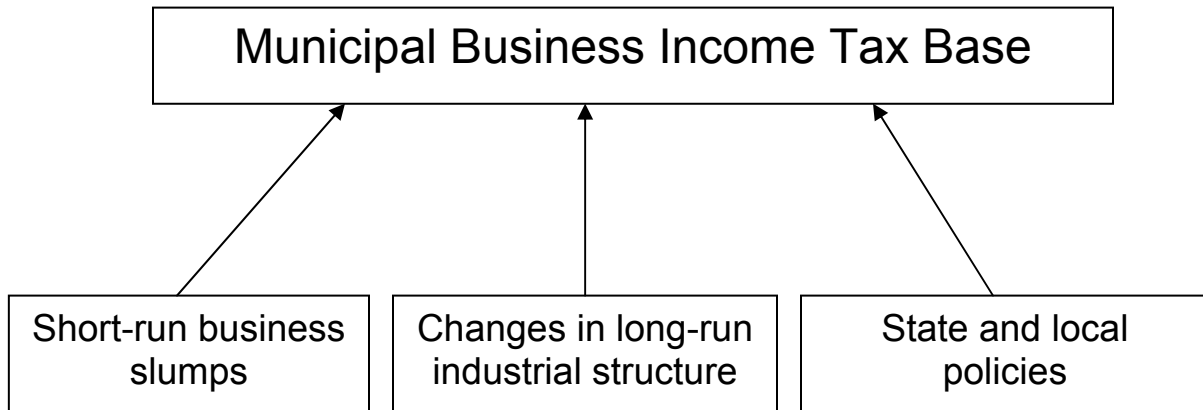
*Continuing law prohibits municipalities from taxing an S corporation shareholder's distributive share of net profits to the extent the distributive share would not be allocated or apportioned to Ohio if the S corporation were a corporation subject to the income allocation and apportionment rules of Ohio's corporate franchise tax law. (HB95)*

The result of this provision is that net profits from operations of S-corporations located out of state are not taxed as either entity or pass-through income. For municipalities close to state borders the implications are obviously unfavorable.

Finally, businesses are treated differently by the state and by municipalities. Intangible income is not taxable under the municipal income tax system but it is taxable at the state level through the corporate franchise tax. Moreover, if a business reports negative net income then the state taxes the entity's equity value; for municipalities that loss means no tax with differing carry-forward rules that have impacts in future years. In short, municipalities find themselves at a distinct disadvantage compared to the state in levying taxes on businesses. *Ad hoc* adjustments to municipal income tax on business over many years have been characterized by some groups as an "attack on home rule" by the state legislature. Overall, these adjustments have been far from revenue neutral with respect to municipal business income tax revenue.

## **F. Conclusions**

The downtrend in Toledo's business income tax revenue since 1996 is attributable to multiple factors that affected its business tax base. Linkages to the City's tax base are illustrated in Figure 11. Each factor in Figure 11 had a negative effect on the tax base; that is not necessarily the case in other municipalities surrounding Toledo. The short recession in 2001 followed by a weak recovery, evolution in the long-term industrial structure, and state policies had varying effects on municipalities. For Toledo, all three converged in a negative way after 1996, resulting in a considerable loss of business tax revenue. A strong rebound in revenue generated from business net profits is unlikely in the near future. In this sense, the City is faced with a daunting task in terms of its budget.

**Figure 11. Factors Influencing Municipal Business Income Tax Revenue**

- In municipalities throughout the state, the income tax is a relatively efficient flat tax; it is easy for businesses to pay and for municipalities to collect. Costs increase with filings in multiple municipalities which can include hundreds for large corporations with facilities spread across the state. The **Ohio Gateway System**, which allows businesses to file municipal income tax through a computerized network administrated by the state, addresses this issue. As passed in HB95, it is currently a statewide network that businesses can use on a voluntary basis. Municipalities are working with the state to make the system operational, efficient, and convenient for business. This is part of the state's goal of reducing costs of business operations within the state.
- The decline in Toledo's business income tax revenue since 1996 is related directly to its shrinking tax base. In short, for City officials, understanding the decline in revenue should be focused on the tax base, which is influenced by multiple factors. Municipalities cannot control business slumps or state policies. Since the mid-1990s those factors have contributed to the downtrend in business income tax revenue observed in Toledo. They show up through the decrease in the number of business filings and in current-dollar revenue.
- State policy has affected municipal business income tax revenue. Horizontal inequity prevails in the business sector. That is not the result of actions by municipalities. Instead, inequity resulted from *ad hoc* adjustment in state laws over many years. HB95 is a good example because it specifies business income excluded from municipal income tax. Intangible income is excluded from taxation. The result is that manufacturing businesses are taxed at a higher rate statewide than either services or financial activities. Although the distinction between tangible and intangible net profits has little economic foundation, it has adversely affected

revenue in cities like Toledo as well as in other municipalities throughout the state. Overall, the state/municipal mix of taxation distorts economic activity in Ohio; this has some effect on intra-state geographic competition among municipalities and townships.

- Municipalities also influence the business tax base. The number of business establishments in Toledo has declined; and, compared to surrounding municipalities, the City's share of businesses has declined. The evolution of the industrial structure is ongoing and the declines experienced by the City suggest a more aggressive response to market conditions. It is in this area that the City can build a more responsive long-term economic development approach. The situation with business income tax revenue has actually provided a signal of business declines that must be addressed. Otherwise, the situation is unlikely to improve. The state climate for reducing business taxes suggests that the burden of taxation is likely to move more toward non-business taxpayers in the future.
- Because state policy influences the municipal tax base, municipalities should find it in their best interest to organize politically. The state legislature responds to actions by interest groups; it is not clear that municipalities have sufficient, organized strength to make their case politically. The City of Toledo would benefit from such organization.
- Given the environment for tax reform, municipalities need to address the effects of future changes in municipal tax ordinances. The legislature's objective to lower the cost of business in Ohio suggests that municipalities and other organizations such as the Ohio Urban University Program (including the Western Ohio Research Consortium--WORC) might examine the economic effects of eliminating the municipal tax on net profits.