Not a fat CAT:

Commercial Activity Tax adds to Ohio's budget problems

A Report From

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Ohio's broad state tax on business – the Commercial Activity Tax – has now gone into full effect. Unfortunately, like Ohio's other major state taxes, the CAT is producing less revenue than was anticipated earlier. This is a source of problems for the state budget, even if the Supreme Court upholds the constitutionality of the tax in a case to be heard Sept. 1.[1] The CAT:

- Fell $94.9 million or 7.4 percent in Fiscal Year 2009 below projections from earlier this year. This was one of the reasons that the state had to use the rainy day fund to balance the FY09 budget.[2]
- Is now expected to generate $1.4 billion in revenue in the current fiscal year, $200 million below what was anticipated as recently as February.
- Is now expected to fall $476 million short over the FY2010-2011 biennium of generating enough to reimburse schools and localities. Revenue from the tax is currently used to reimburse school districts and local governments for the taxes they no longer receive because of the phase-out of a local business property tax.

In short, the CAT is not holding up in the poor economy. In addition to the shortfalls in other major state taxes and tax cuts mandated by the General Assembly in 2005, this was a significant contributor to the reductions required in the state budget approved in July. The General Assembly should take action to bolster business taxes and the CAT in particular.

The Commercial Activity Tax replaced two other long-standing Ohio taxes as part of a major overhaul of the tax system in 2005: the corporate franchise tax on non-financial businesses, which had been the state's corporate income tax, and the tangible personal property tax (TPPT), a local tax on machinery, equipment, inventories, furniture and fixtures used in business in Ohio.

CAT collections due earlier this month for the first time reflect the full rate of the tax. The CAT is levied at a 0.26 percent rate after the first $1 million in gross receipts. Companies pay a flat $150 on the first $1 million in receipts, and those with less than $150,000 in annual gross receipts are exempt.

Much of the state's budget problems owe to major shortfalls in the personal-income and sales taxes, the two largest state taxes.[3] However, the CAT also is making a significant contribution. Table 1 below shows how CAT revenues fell below expectations last fiscal year and how expectations for the next two years have declined as well since the governor made his budget proposal in February. The simplest explanation is that the economy has reduced Ohio gross receipts, which are the base of the CAT.

The estimates are based on an economic projection by Moody's Economy.com.[4] Assuming the full CAT rate had been in effect in FY2009, the Ohio Department of Taxation estimates that CAT revenue would fall about 5 percent in FY2010. Some of this reduction reflects an increase in tax credits taken against the

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[1] The Supreme Court is due to hear arguments in Ohio Grocers Association, et. al., v. William W. Wilkins (Richard A. Levin), in which the grocers argue that the CAT is an unconstitutional tax on food.

[2] See Ohio Office of Budget & Management, Monthly Financial Report, July 10, 2009, pp. 13-14, available at http://obm.ohio.gov/MiscPages/MonthlyFinancialReports/, and Statement of J. Pari Sabety, Director, Office of Management & Budget, to the Conference Committee, Thursday , June 11, 2009, at http://obm.ohio.gov/SectionPages/Budget/FY1011/Default.aspx

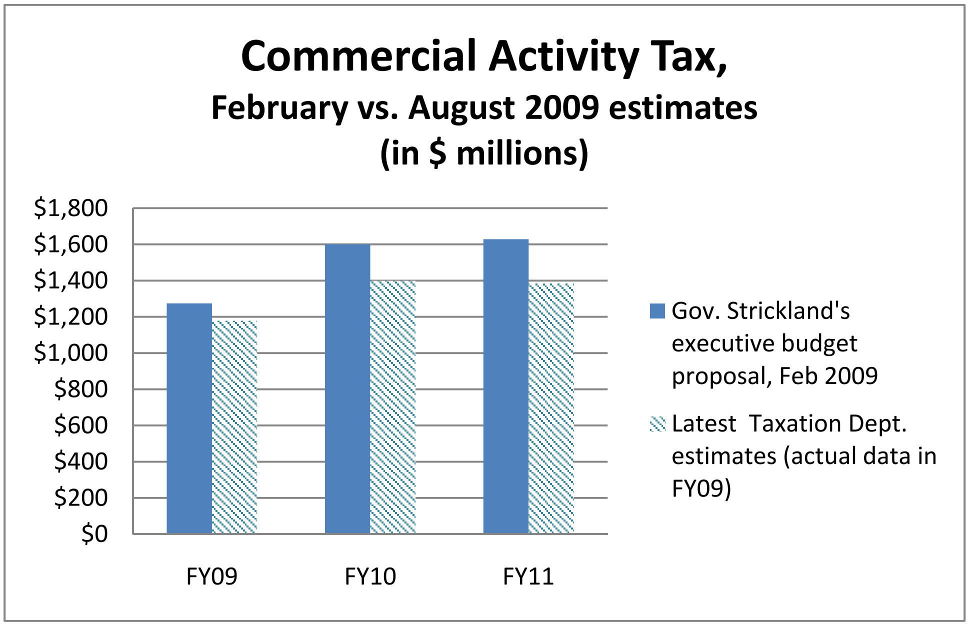
[3] Reduced revenues also can be traced to the income-tax cuts and the business tax overhaul approved in 2005.

[4] Budget Director Pari Sabety outlined this forecast in her testimony to the General Assembly's Conference Committee on June 11.

tax. In FY2011, an increase in such credits is expected to convert what would have been a tiny increase in CAT revenues into a 1 percent decline. That reflects one kind of credit in particular that will allow big companies that had accumulated at least $50 million in losses prior to the 2005 tax overhaul to start writing them off against the CAT.[5]

Data available so far on CAT revenues in July and August, the first two months of the FY10 fiscal year, do not suggest that the tax soon will bring in more revenue than expected.

Table 1



Source: Ohio Office of Budget and Management, Department of Taxation

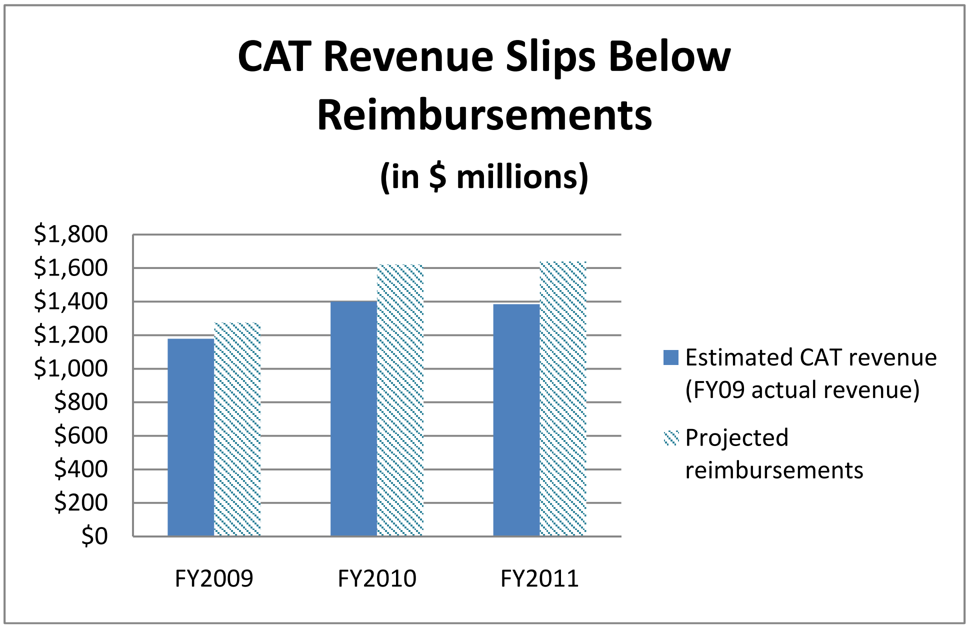
Until now, the CAT typically has gotten less attention than other significant sources of state revenue. That is in part because it has only recently become a major tax, and its revenue has been dedicated to reimbursing school districts and local governments for revenue they lost with the phase-out of the tangible personal property tax.

CAT was only expected to make up about half of the revenue from the two taxes it replaced.[6] In February, the Strickland administration estimated that both the franchise tax and the tangible personal property tax each would have generated more than $1.6 billion in revenue in FY2010 if they were still being levied at their original rates. The CAT was expected to bring in $1.6 billion, or nearly as much as the TPPT. Now, though, the CAT is proving to be an inadequate replacement even for just the tangible personal property tax. This means that other revenue sources are being tapped to reimburse school districts and local governments.[7] Final figures for reimbursements in FY09, which just ended, are not yet

[5] For more details, see Zach Schiller, Policy Matters Ohio, *Limiting Loopholes*, September 2008, p. 8
[6] State of Ohio, Executive Budget for FYs 2010 and 2011, Economic Overview and Forecast, p. B-4, see http://obm.ohio.gov/SectionPages/Budget/FY1011/ExecutiveBudget.aspx
[7] School districts as a group are assured of 70 percent of CAT revenue into the future and each district is assured of the same amount it has received through FY2013. The FY2010-11 budget also holds local governments harmless by reimbursing them for their tangible personal property tax losses in the biennium; as originally created, those reimbursements were going to start phasing down in FY11 and ultimately disappear. Gov. Strickland vetoed

available. However, the shortfall in CAT revenue last fiscal year probably forced the state to dip into the General Revenue Fund to pay as much as $95 million of such reimbursements.[8] During the course of FY10-11, that shortfall is expected to amount to $476 million. Table 2 shows how the CAT is expected to fall short:

Table 2



Source: Ohio Office of Budget and Management, Department of Taxation

Meanwhile, the state has also eliminated its corporate income tax – a tax levied by 44 other states – with no replacement for the revenue loss. In effect, this means there is no general business tax in Ohio supporting the state budget. Of course, businesses pay other taxes, such as the sales tax. However, in the mid-1970s, the corporate franchise tax accounted for fully 16 percent of taxes supporting the General Revenue Fund.[9] Nothing of the sort exists today, beyond the franchise tax on banks and other financial institutions.[10]

The CAT Trigger

Because of the uncertainty over the revenue the CAT would generate when it was created, the General Assembly established a plan to adjust the CAT tax rate if it brought in 10 percent more or less than what was expected. At first, when it was just ramping up, the CAT brought in more than anticipated, though

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provisions in the budget bill that would have guaranteed perpetual reimbursement to local governments also for their revenue losses, as well as to individual school districts. In the longer term, the General Assembly will need to decide how to handle these issues.

[8] The calculation for this shortfall is based on the estimated reimbursements in the governor's executive budget proposal.

[9] See Zach Schiller, *Ohio's Vanishing Corporate Franchise Tax*, October 2002, p. 3, available at http://www.policymattersohio.org/franchisetaxintro.htm

[10] This tax on financial institutions' net worth is projected to generate $100 million in FY10 and $125 million FY11, or well under 1 percent of estimated GRF tax receipts. A few other businesses are still covered under the corporate income tax, but for all but a tiny number of non-financial businesses, the tax is dead.

not enough to trigger a rate cut. In 2007, the Strickland administration believed that the CAT would exceed the target in FY09, causing a reduction in the tax rate in 2010.[11]

However, now the shoe is on the other foot. In fact, the CAT brought in $10.8 million *less* than the statutory target in the fiscal year that just ended. And the Ohio Department of Taxation now estimates that the CAT will produce $1.385 billion in FY2011, some $225 million or 14 percent less than the $1.61 billion set in state law as the CAT target.

Under the CAT as originally created, this would mean that the tax rate would be adjusted starting in calendar year 2012 based on the size of the shortfall in FY11. However, in 2007, the General Assembly changed the law and eliminated the upward trigger. It retained the downward trigger, so if the CAT significantly outperformed revenue estimates, its rate would be adjusted downward. But no such protection exists now if the CAT underperforms.

The General Assembly can – and should – remedy this by restoring the upward trigger that existed in the original CAT. As detailed in previous Policy Matters Ohio reports, other steps such as restoring the corporate franchise tax should also be taken to strengthen business taxes.[12] Tax loopholes such as the net operating loss credit cited above should be cut.

Some may argue that this is a bad time to be raising business taxes. However, the business share of Ohio's state and local tax collections is far lower now than it was 30 years ago.[13] Ohio businesses have seen large tax cuts because of the 2005 tax overhaul.[14] Last fiscal year alone, businesses saved more than $1.3 billion because of the phase-out of the franchise tax. Cuts in the state budget are closing down early childhood education programs; reducing day-care subsidies, making it harder for many parents to work; making older Ohioans ineligible for assistance that would allow them to stay in their homes; slashing support for services from mental-health to investigations of elderly and child neglect; and causing layoffs of workers who provide all of these and other services. These cuts also harm Ohio's economy directly and immediately by reducing demand for goods and services. At the same time, reductions in spending for higher education and libraries are undercutting the future productivity of Ohio's workforce. Meanwhile, the evidence that these tax cuts have closed the gap between Ohio and other states remains slight, at best.[15] Preserving the business-tax overhaul, rather than restoring cuts to state spending, is a bad deal for Ohio's economy.

[11] State of Ohio, Executive Budget for FYs 2008 and 2009, p. B-18. The trigger rates were set using an earlier version of the CAT and were not changed with the final version of the tax, when a variety of additional exemptions from the tax had been approved (changes also were made in the phase-out of the TPPT). Thus, the CAT tax rate was not reduced though revenues in the first two fiscal years after the CAT's creation exceeded budget estimates by more than 10 percent. Though revenues from the CAT were stronger than expected in FY06-07, businesses still were saving money because of the tax overhaul. By Fiscal Year 2007, these savings mounted into the hundreds of millions of dollars annually and have grown further since then.
[12] See Zach Schiller, *Business Tax Revamp: A Deficit in the Making*, Policy Matters Ohio, January 2009, available at http://www.policymattersohio.org/BusinessTaxRevamp2009.htm
[13] Ibid, pp. 10-11. See also Edward W. Hill, *Ohio's Competitive Advantage: Manufacturing Productivity*, Maxine Goodman Levin College of Urban Affairs, Cleveland State University, 2001.
[14] Ibid, p. 8-10.
[15] Honeck, Jon, *The 2005 Tax Overhaul and Ohio's Economy*, Policy Matters Ohio, January 2009, available at http://www.policymattersohio.org/2005TaxOverhaul.htm

The Ohio Department of Taxation has estimated that if the grocers win their case, the state will lose about $188 million in annual revenue, along with $355 million in refunds.[16] The state also worries that other out-of-state retailers might challenge the CAT. Regardless of the case's outcome, though, the business-tax overhaul that created the CAT is contributing significantly to Ohio's budget problems. The General Assembly should overhaul the overhaul, starting by reinstating the upward trigger on the CAT.

[16] These estimates predate the major fall-off in CAT revenues from what had been expected. Annual losses might now be somewhat less than that.

Policy Matters Ohio is a non-profit, non-partisan research institute dedicated to researching an economy that works for all in Ohio. Policy Matters seeks to broaden debate about economic policy by providing research on issues that matter to Ohio's working people and their families. Areas of inquiry for Policy Matters include work, wages, and benefits; education; economic development; energy policy; and tax policy. Generous funding comes from the Joyce, Gund, Cleveland, Public Welfare, KnowledgeWorks, New World, Annie E. Casey, Sisters of Charity and W.K. Kellogg Foundations, the Economic Policy Institute, and Greater Cleveland Community Shares. To those who want a more fair and prosperous economy... Policy Matters.

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