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Testimony to the Ohio House Committee on Ways & Means

October 2021

Chairman Merrin, Vice Chair Riedel, Ranking Member Sobecki, Members of the Committee,

Thank you for the opportunity to speak with you today. My name is Ulrik Boesen, and I'm a senior policy analyst with the state policy team at the Tax Foundation. For those unfamiliar with the Tax Foundation, we are a nonpartisan, nonprofit organization that has monitored fiscal policy at all levels of government since 1937. We have produced the *Facts & Figures* handbook since 1941, we publish the *State Business Tax Climate Index* each year, and we have a wealth of data, rankings, and other information at our website, www.TaxFoundation.org.

I'm pleased to have the opportunity to speak with you today with regard to House Bill 234 and Ohio's commercial activities tax. While we take no position on legislation, we hope to offer our insights and provide a national perspective on tax issues.

The Commercial Activities Tax Hampers Economic Growth

As a gross receipts tax, the Ohio CAT represents a throwback to a far earlier era, bringing back a form of taxation once on the path to extinction. Such taxes were nearly done in by a consensus that levying a tax on the basis of gross revenues was inequitable, promoted otherwise inefficient economic decision-making, and impeded growth. Today, most states levy corporate income taxes. Corporate income taxes are on net income (essentially profits)—income after expenses, like employee compensation and production or acquisition costs. Corporate income taxes have an "ability to pay" component, as they're (imperfectly) levied on what's left after expenses. A gross receipts tax, like Ohio's CAT, is based on gross revenue.

Ohio's Commercial Activity Tax is imposed at a rate of 2.6 mills (0.26 percent) on business gross receipts in excess of $1 million. Additionally, a tiered minimum tax is imposed on all businesses with taxable gross receipts of $150,000 or more, at amounts ranging from $150 for filers less than $1 million in receipts to $2,600 for filers with more than $4 million in receipts. As a gross receipts tax, the CAT is levied on the entirety of a company's Ohio business receipts, without deductions for compensation, costs of goods sold, or other expenses. During fiscal year 2020, CAT collections were approximately $2.0 billion.

The tax casts a broad net, applying to any person or business which "owns or uses any capital in Ohio, is authorized to do business in Ohio, has bright line presence, or can otherwise be reached by Ohio for taxation under the U.S. Constitution." Because profit margins vary widely across industries and even across individual businesses, and because intermediate transactions are taxed under the CAT, businesses can face wildly disparate effective tax rates. Indeed, there is a broad consensus that gross receipts taxes are non-neutral and economically destructive, and such taxes had largely fallen out of favor in the modern era.

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Effective Tax Rate by Industry in Ohio

Industry Sector	Profit/Receipts Ratio	Effective Tax Rate
Agriculture, Forestry, Hunting, and Fishing	5%	4.7%
Mining	4%	6.7%
Construction	3%	8.6%
Manufacturing	6%	4.0%
Wholesale	3%	8.3%
Retail	3%	7.9%
Transportation and Warehousing	4%	7.0%
Information	8%	3.4%
Real Estate and Rental & Leasing	18%	1.4%
Professional, Scientific, and Technical Services	5%	5.0%
Management of Companies (Holding Companies)	70%	0.4%
Administrative/Support, Waste Management	4%	6.3%
Educational Services	6%	4.5%
Health Care and Social Assistance	6%	4.4%
Arts, Entertainment, and Recreation	4%	6.2%
Accommodation, Food Services, Drinking Places	6%	4.4%
Other Services	4%	6.0%
Weighted Average	5%	4.7%

Source: Jared Walczak, "Ohio's Commercial Activity Tax: A Reappraisal," Tax Foundation, Sept. 26, 2017, https://www.taxfoundation.org/ohio-commercial-activity-tax-2017/.

The numbers above represent the rates on profitable businesses. They indicate that gross receipt taxes provide an advantage to businesses with high profit margins or considerable vertical integration, while they penalize companies with narrow margins or multiple transacted stages of production. Moreover, unprofitable businesses, technically, experience an infinite tax rate under the CAT. This is one of the major issues with gross receipts taxes—they are completely divorced from whether a business has the ability to pay. As such, they can be extra burdensome in times of economic distress, or to startups which often experience losses in the first years of operation.

The tax's superficial appeal is obvious enough: a stable source of revenue at a time when traditional corporate income tax revenues are eroding, with a seemingly low rate and a base which captures businesses which lack corporate income tax liability in the state.

However, the factors which led states to abandon gross receipts taxes in the first place have not changed. Because the tax is so non-neutral, burdensome, and lacks transparency, it discourages investment in the state and drives inefficient business decisions divorced from economic merit. For these reasons, the CAT negatively impacts Ohio's rank in our annual *State Business Tax Climate Index*, which measures tax structures—how a state levies taxes. Last year, Ohio ranked 39th overall but 42nd for corporate tax design. In the next edition, Ohio is likely to improve a few places overall based on the income tax reform already signed into law this year and repealing the CAT would further improve Ohio's rank.

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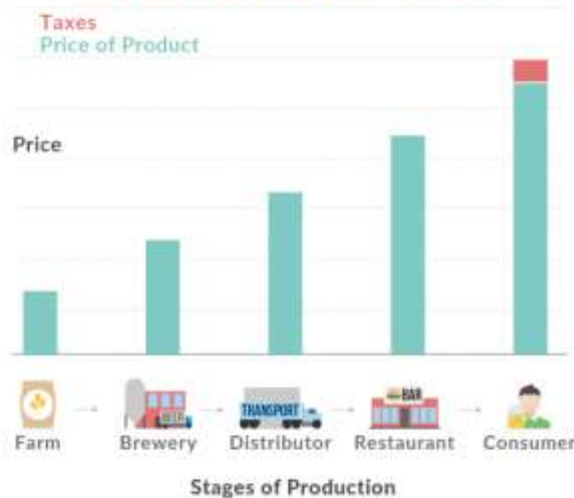
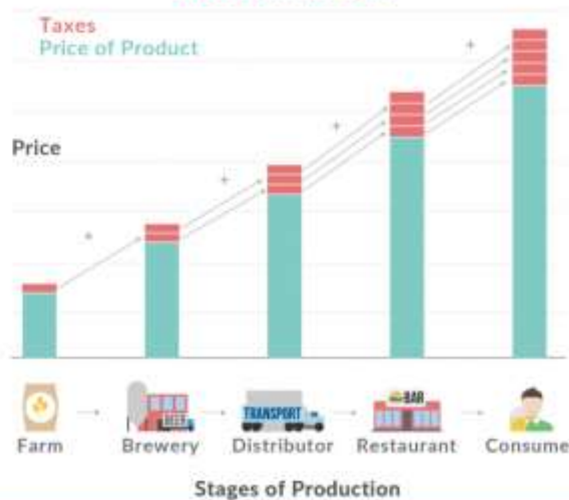
The damage caused by the CAT is recognized, but the solution so far has been the use of credits. The problem with credits and carveouts is that they act like bandages—they are not a long-term solution. In FY 2021, the state expects to forgo almost $700 million in revenue due to incentives. About $220 million is from the exclusion of the $1 million of taxable receipts, but over $300 million is from job creation and R&D incentives as well as a credit for qualified distribution centers (almost $200 million). A good example of the problem with incentives is the tax treatment of distribution centers in Ohio. According to Tax Foundation's study *Location Matters*, which analyzes effective tax rates by state and industry, Ohio ranks best in the nation for new distribution centers. In other words, Ohio has the country's lowest combined effective tax rate on new distribution centers. As the center matures and no longer qualifies for the incentives, such a business will experience a significant tax increase (ranking 28th). This kind of cliff could impact businesses' long-term investment plans, and Ohio would be more attractive for investors if the CAT was phased out.

The Effect of Tax Pyramiding Under a Gross Receipts Tax

Ideal Sales Tax on Final Consumption



Gross Receipts Tax



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Responsible Repeal

Now may be an opportune time to consider reform of Ohio's corporate tax system. The state is projecting growth through fiscal year 2023. In June 2021, the Legislative Service Commission estimated that general fund revenue would increase by 1 percent from FY 2021 to FY 2022 and by over 3 percent from FY 2022 to FY 2023. Estimates for FY 2022 and FY 2023 are around $1.2 billion higher than estimates from the beginning of this year. In other words, Ohio does have some capacity to reform taxes.

Despite projected growth, repealing a tax that generates a significant portion of the state's revenue (6.7 percent in FY 2020) is no small feat, but Ohio has done it before. The reform that introduced the CAT was a significant tax reduction as it replaced two previous levies.

One way to guarantee that growth targets or spending reductions are met in line with the reduction in tax revenue is to use triggers. For transparency, this could be combined with reductions in the tax rate by 20 percent each year instead of 20 percentage point reductions to the tax base.

Conclusion

Ohio would improve its competitiveness through reform of the CAT. Gross receipts taxes are an outdated and non-neutral tax structure, which, despite offering some revenue stability, does more harm than good to the economy. At this point in time, Ohio has some financial capacity to revisit the CAT, and phasing it out would encourage increased investment and economic growth in the Buckeye state.