



Policy Brief

(614) 224-4422

88 East Broad Street, Suite 1120, Columbus, Ohio 43215

April 15, 2007
No. 13

Ohio's Dumb Taxes

Marc Kilmer

Research Associate, Buckeye Institute for Public Policy Solutions

Executive Summary

This paper examines four different “dumb” taxes in Ohio. They are: the estate tax, the dealers in intangibles, tobacco taxes tax and horse racing taxes.

A dumb tax is: 1) One levied in a way that singles out a group to pay for benefits enjoyed by all, 2) one that attempts to influence social behavior, and/or 3) one that produces an unnecessary distortion in the economy.

On the other hand, the tenets of a sound tax policy are: 1) a low rate, 2) a broad base, and 3) few loopholes.

The four dumb taxes reviewed in this paper violate one or more of the principles of sound tax policy.

In light of the numerous dumb taxes littering Ohio's tax code, state policy makers would be wise to overhaul the current system with the principles of sound taxation in mind.

Mission Statement

The Buckeye Institute for Public Policy Solutions is a nonpartisan research and educational institute devoted to individual liberty, economic freedom, personal responsibility, and limited government.

About the Buckeye Institute for Public Policy Solutions

The Buckeye Institute assists policymakers, scholars, entrepreneurs, the media and the public by providing objective analysis and sound solutions to state and local policy questions, particularly in the areas of taxation, government spending, regulation, and education.

Our work challenges government intervention as the default solution to Ohio's needs. We offer a compelling vision of how policies that maximize the freedom and independence for our citizens also bring more prosperity to our state.

The Buckeye Institute for Public Policy Solutions neither seeks nor accepts government funding. It enjoys the support of foundations, individuals and businesses sharing a concern for Ohio's future.

The Buckeye Institute
88 East Broad Street
Suite 1120
Columbus, Ohio 43215
Voice (614) 224-4422
Fax (614) 224-4644
E-mail buckeye@buckeyeinstitute.org
Website www.buckeyeinstitute.org

Introduction

With tax season once again upon the nation, thoughts of how much the government takes from taxpayers are on many peoples' minds. When most people think of taxes, they tend to consider the income tax, the sales tax, and the property tax. However, government also imposes a variety of taxes that are invisible to many Ohioans. But these taxes – excise taxes and business taxes – impact Ohioans much the same way as income taxes.

Some of these taxes, such as the gasoline tax, can be justified on the grounds that those who are paying it (drivers) use the products (roads) that this tax provides. Other taxes, however, are just plain dumb. Their rationale for existing is weak and they distort the economy in ways that hurt Ohio. This paper reviews four of these taxes: the estate tax, the dealers in intangibles, tobacco taxes tax and horse racing taxes.

What Makes a Dumb Tax?

Since we are examining dumb taxes, it makes sense to define what makes a tax “dumb.”

In general, tax policy should be set by the government to raise revenue for necessary services. The way to do this is to have a low tax rate with few loopholes. The tax base should be broad, since in general all citizens in a state benefit from the services paid for by tax revenue. Special taxes should only be levied to pay for externalities caused by the group being taxed. The gas tax, for instance, makes sense because those who use the roads are paying the tax.

Dumb taxes, on the other hand, are taxes

levied in a way that singles out a group to pay for benefits enjoyed by all. A tax is also “dumb” when it seeks to influence social behavior. Another way a tax can be dumb is if it produces an unnecessary distortion in the economy.

As John R. McGowan of the Tax Founda-

When excises are levied simply as revenue sources, or to offset perceived societal costs without an accurate assessment of those costs, then the tax can have highly distortionary effects on economic activity, thereby lowering the value of national output and society's welfare. Whether an excise has been well-targeted or not, however, by conventional measures of income most excise taxes fall disproportionately on lower-income taxpayers. To the extent a goal of tax policy is to levy a tax on a proportional basis, or even disproportionately on upper-income taxpayers, most excise taxes fail to achieve this objective.¹

tion puts it:

All the taxes described below fail the test of sound tax policy. For various reasons, legislators have not yet repealed them (although some have tried). Ohioans may not be aware of their existence, but these taxes affect them nonetheless.

Estate Tax

Ohio's first tax on death was levied in 1893. Although it has changed since then, the state has followed behind the Grim Reaper for 114 years, taking what it sees as its share. This tax has come under increasing scrutiny from both state and federal lawmakers over the past decade. There have been moves on both levels to phase it out, but as of now the Ohio estate tax has sur-

vived all challenges and the federal estate tax will only disappear for one year due to federal budget rules.

Most other states have their estate tax linked to the federal tax. Therefore, when

That leads to the exact opposite situation envisioned when the estate tax was enacted—the wealthy escape but those of moderate means do not.

the federal tax disappears for a year in 2010 (and if it ever goes away permanently), their tax will follow suit. This also ensures that those who are doing estate planning do not deal with two sets of conflicting estate tax rules. While no estate tax would be ideal, if one exists, linking it to the federal tax is sensible.

Ohio's estate tax is not linked to the federal tax. Here, if your estate is under \$388,333 you pay no tax. If it is between \$388,333 and \$500,000 you pay \$13,900 plus six percent of the amount between \$388,333 and \$500,000. If the estate is over \$500,000 you pay \$23,600 plus seven percent of any amount over \$500,000.

The main problem with this tax is that because of its complexity there is an incentive for people with large estates to find ways to avoid it. They can afford to hire lawyers to shelter assets and determine the best way to get around the tax. People with moderate estates, however, may not have either the resources to do this. That leads to the exact opposite situation envisioned when the estate tax was enacted – the wealthy escape but those of moderate means do not.

There is also evidence that the estate tax

leads wealthy older residents to leave high tax states for states that have lower estate taxes or no estate tax. A study by Jon Mekija and Joel Slemrod contends that there is a statistically significant migration by the wealthy elderly out of states with high estate taxes into states with low estate taxes.² For a state like Ohio, with a colder climate and an even colder tax policy, it makes sense for elderly people with significant estates to move to a state like Florida, which is both warm and lacks an estate tax. After all, with satellite television broadcasting Buckeye games all over the nation, who wouldn't want to enjoy their golden years in the warmth of Florida rather than the cold of Cleveland?

This movement is likely to be significantly increased if the federal estate tax is eliminated. Right now, an elderly person moving to avoid a state estate tax will not necessarily save a significant amount of money since the federal government will get its share. However, if the federal government does not levy a tax, the only estate tax to be paid will be those in states like Ohio. That means a wealthy elderly person could save a significant amount of money by moving out of the state.

For those who do not move out of state, there is a thriving industry of estate planners who will help them find ways to avoid the estate tax. While these planners may succeed in their goal of finding ways around the law, they are, in essence, a huge waste of resources. Money that would otherwise be spent on productive purposes is instead spent trying to get around the estate tax. It would be a better idea to simply get rid of the estate tax and eliminate the inefficient use of money that comes from trying to avoid it.

There have been attempts in Ohio to eliminate this tax. In 2001, there was a push for elimination. However, the weak economy and opposition from municipalities killed repeal efforts. The issue has recently been revived, though, and in the 2007 legislative session there are efforts underway to repeal the tax.

One of the obstacles to eliminating the estate tax in Ohio is that 80 percent of the revenue collected is remitted to counties. Thus, any elimination of the tax would deprive counties of a significant revenue stream. However, it is not proper tax policy to leave a tax in place in order to preserve easy money for one level of government. The services counties offer are used by all citizens. Therefore, they should raise their revenue from the broadest possible tax base. Singling out the estates of dead county residents for tax revenue is not sound tax policy.

The Ohio estate tax should be eliminated completely. Or, if policymakers do not want to go that far, it should be linked to the federal estate tax. Most other states do this. Ohio's citizens should not be forced to move their wealth outside of the state to avoid having a significant portion of it confiscated upon their death.

Dealers in Intangibles Tax

Ohio is the only state in the nation to have a tax on dealers in intangibles. The state tax commission defines these dealers as engaging in the following businesses: "lending money; discounting, buying or selling bills of exchange, drafts, acceptances, notes, mortgages, or other evidences of indebtedness; buying or selling bonds, stocks, or

other investment securities; or as agent or broker for others with a view to profit or personal earnings." However, there are some important exceptions. Both insurance companies and financial institutions are exempt from the tax.

The dealers who do pay the tax pay eight-tenths percent of the value of the following: "Shares of stock of incorporated dealers in intangibles and unincorporated dealers in intangibles with capital stock divided into shares" and "Capital employed in Ohio by an unincorporated dealer in intangibles with capital stock not divided into shares." In return, these dealers do not pay the corporate activities tax or the tangible personal property tax.

In 2005, \$25.2 million was raised from this tax, 16 percent less than the previous year. The state Legislative Services Commission

Ohio is the only state in the nation to have a tax on dealers in intangibles.

estimates that the revenue will continue to decline through 2009.³

There is no rationale why businesses that deal in intangibles should pay a separate tax from other businesses. There is also no rationale why only some dealers in intangibles pay this tax. In 2003, Governor Bob Taft suggested moving businesses from the dealers in intangibles tax to the regular business tax. While there has been some tinkering around the edges of the tax since then, there has been no move to eliminate it.

Part of the answer for why this tax remains in place is that five-eighths of the money collected by the tax is remitted to counties.

The other portion of the tax is deposited in the state's general revenue fund. Thus, there is a natural constituency that benefits from the current tax structure and fights efforts to do away with it.⁴

County governments contend they will lose revenue if dealers in intangibles are moved into taxation with every other business in the state. While true, that is no rationale for retaining such a tax. If counties need revenue, they should institute a broad-based tax to raise it. They should not target certain businesses to fund government activities that ostensibly benefit all county residents.

When Governor Taft proposed eliminating the tax, consumer finance companies also fought against it. Businesses that pay this tax are exempt from other taxes and some even get a tax break. This, too, is unfair. There is no reason why the tax code should choose winners and losers. All companies in Ohio should be paying the same taxes. And while it is understandable that companies currently exempt from some Ohio business taxes would not want to begin paying them, this points to the fact that Ohio's business tax climate is among the worst in the nation.⁵ Streamlining Ohio business taxes and applying the same tax structure across the board would be much better for the state's economy.

Tobacco Tax

Tobacco users are an increasingly unpopular group. They are blamed for a variety of problems, from littering to causing cancer via second-hand smoke. It is clear from the statewide ban on smoking in bars and restaurants, enacted by popular referendum last year, that smokers have few friends in

Ohio. Instead of reviling smokers, though, the citizens of Ohio should thank them. Without the incredibly high rate of taxes they pay, the state would have far less revenue. Tobacco users pay much more than

As with other excise taxes, the only legitimate reason to tax tobacco is to make its users pay for externalities caused by the use of the product.

their fair share in taxes and some of these taxes are just plain dumb.

Most Ohioans are probably aware that the state levies a tax on cigarettes. However, it is doubtful that most could tell how much cigarettes are taxed (\$1.25 a pack). As with other excise taxes, the only legitimate reason to tax tobacco is to make its users pay for externalities caused by the use of the product. And while many claim that tobacco imposes huge costs on the government, there is really little evidence that this is true. However, there is evidence that tobacco users, in the long run, actually contribute more money to government coffers than they take in benefits.⁶

Some experts, who have studied this, such as Harvard Law School economist Kip Viscusi, estimate that cigarette smoking does impose negative externalities on society, but only at around 32 cents a pack.⁷ So although government services like Medicaid have higher expenditures due to cigarette smokers, these expenditures are much lower than most people assume. Therefore, government has a legitimate cause to impose a tax of 32 cents on a pack of cigarettes. Ohio, however, imposes a tax that is 93 cents higher. This 93 cent difference represents unsound tax policy for Ohio.

Some support raising the cigarette tax to help people stop smoking. However, that is an improper use of the tax code. The tax code should be used to raise revenue. Raising taxes on certain activities because some people do not like them is social engineering, not sound tax policy. If anti-smoking advocates want to discourage smoking, they should seek other means to do so. They are likely to receive the support of the majority of Ohioans, as the statewide smoking ban recently enacted by popular referendum suggests.

Smokers are not the only tobacco users in Ohio singled out as a revenue source. Smokeless tobacco users also pay a special tax. And unlike a pack of cigarettes, there is no easy answer about how much a can of smokeless tobacco (or a pouch of chewing tobacco) is taxed. These tobacco products are not taxed based on unit, but on value. This leads to a complicated formula that gives advantages to certain brands of tobacco over others.

Since smoking cigarettes imposes some cost on governments, there is a legitimate reason to impose a low excise tax on it. However, the use of smokeless tobacco products does not impose significant costs on the government. While unhealthy, their use is much healthier than smoking tobacco and thus imposes little burden on the Medicaid system (one of the main areas where smokers may impose costs on taxpayers).

Because of this, the optimal tax rate for smokeless tobacco products is zero. However, only one state, Pennsylvania, imposes no tax on smokeless tobacco. Ohio imposes a tax of 17 percent of the wholesale value of the product. This type of tax is called an *ad valorem* tax, since it is based on the value of the product. Enacted in 1992, it is a relatively recent tax.

Although there is no sound tax policy rationale for imposing such a tax on smokeless tobacco products, an *ad valorem* tax is especially bad tax policy. The amount of tax

Cuyahoga County's Special Cigarette Tax

An especially dumb cigarette tax exists in Cuyahoga County. In the late 1980's, the state passed a law allowing counties to impose an additional four-and-a-half cent tax on cigarettes in order to pay for operating or paying for the construction of a sports facility. In 1990, Cuyahoga County enacted such a tax to help pay for a stadium for the Cleveland Browns.

This is the intersection of two very bad ideas. As discussed, excise taxes should not be levied to pay for benefits enjoyed by all taxpayers. In Cuyahoga County, it is reasonable to assume that citizens other than smokers attend Cleveland Browns games. Thus, it is unfair to ask cigarette smokers to bear a disproportionate burden of paying for the stadium.

Furthermore, using tax money to pay for sports stadiums is corporate welfare at its worst. There is no evidence that such an "investment" of taxpayer funds does anything to spur economic development or do anything positive except fatten the bottom line of those who own the sports team.

paid is greater if the value of the product is greater. Since the only legitimate reason to tax such a product is to compensate for the third-party externalities it imposes, a per unit tax is the sound tax to levy. After all, a cheap can of tobacco imposes just as much harm as an expensive can. However, under Ohio tax law, an expensive can is taxed at a much higher rate.

What this means is that cheap smokeless tobacco products receive a favorable tax position from the state of Ohio. Likely due to the majority of states that began taxing smokeless tobacco products with *ad valorem* taxes, a cheap brand of smokeless tobacco products has emerged over the past decade. In fact, in the smokeless tobacco industry, there are three tiers of tobacco products. There are tier one products, which are “premium” brands. There are tier two products, which are “value” brands, and there are tier three products, which are “discount” products. The popularity of discount products has been increasing, and

Ohio would be wise to eliminate all taxes on smokeless tobacco.

much of this is likely due to the distortion in the smokeless tobacco marketplace from an *ad valorem* tobacco tax.

Premium tobacco products can cost up to three times as much as discount products. The premium products include brands such as Kodiak, Skoal, or Copenhagen moist smokeless tobacco. These may cost over three dollars a can. On the bottom end, a can of Grizzly moist smokeless tobacco may cost a dollar a can or less. Because an *ad valorem* tax is levied on the price of the product, the discount product essentially is given a tax break. The tax paid on this can

of moist smokeless tobacco would be one-third of that paid on the premium brand.

It also means that the sales tax on these products is artificially inflated. Because an *ad valorem* tax raises the retail price of the product, the sales tax on that product is also higher. Essentially, the state is collecting a sales tax on the *ad valorem* tax paid by the wholesaler. That type of double taxation is especially pernicious.

Because of these market distorting effects, all other excise taxes are levied on a per unit basis. The state of Ohio, for instance, taxes gasoline at twenty-eight cents a gallon. Liquor is taxed at a per gallon rate and beer is taxed at a per ounce rate. All of these taxes treat high-end products the same as low-end products. After all, it makes little sense to charge one tax rate for regular unleaded gasoline and another for premium unleaded.

Not only is an *ad valorem* tax unfair to taxpayers, but there is some evidence that is a bad deal for tax collectors. The *ad valorem* tax on other tobacco products, by taxing premium products at a much higher rate than discount products, seems to be encouraging people to buy these discount products. For every person who chooses such a discount product instead of a premium product, the state loses money. In a state where the moist smokeless tobacco market is growing by four to six percent every year, unless the state changes the rate to compensate, it stands to lose a lot of revenue with an *ad valorem* tax if users of this product continue to substitute discount for premium brands.

Ohio would be wise to eliminate all taxes on smokeless tobacco. There is simply no reason to levy such a tax, except as a way for

the state to raise additional revenue. If this is the state's aim, then it is illegitimate to ask users of these products to pay more than other taxpayers. All Ohio taxpayers, not just those using certain unpopular products, should pay for government services.

However, if Ohio is determined to impose a tax on these products, it makes sense to switch to a per unit tax on smokeless tobacco products. This would end the market distortion caused by an *ad valorem* tax and bring it more in line with cigarette taxes, which are also taxed based on a per unit system.

Six states currently tax smokeless tobacco at per unit rate. The American Legislative Exchange Council, the nation's largest non-partisan organization of state legislators, has endorsed a policy that calls for an end to *ad valorem* tax on these products. Americans for Tax Reform has also come out against *ad valorem* taxes on these products. Ohio lawmakers should consider revising its tax on smokeless tobacco products to bring them more into line with the principles of sound tax policy.

Horse Racing Tax

When Ohioans go to the track, they may be looking to spend a day unwinding watching the horse races or make a few dollars betting on a lucky horse. They may go there to escape their daily grind, but they cannot escape the tax man. One of the strangest taxes Ohio levies is the tax on pari-mutuel and exotic wagering at horse tracks. These taxes are not paid directly by the person making the wagers. Instead, they are paid by the racing permit holders. "Exotic wagering" is defined as any wagers

other than win, place, or show. Three percent of the total amount made in exotic wagers is paid in taxes every day, and up to four percent of the total amount of pari-mutuel wagers is paid.

Levied in 1933, these taxes are used to supply funds for a variety of state programs run by the state to benefit horse racing. In that way, this tax is a little better than some others. Taxes on horse racing are levied in a way to pay for programs that benefit the horse racing community. However, this raises the question of why should the state of Ohio be the middleman for collecting taxes on certain horse racing bets to pay for, essentially, corporate welfare for the horse racing industry? It would seem to

It would seem to make more sense for the state to simply stop taxing the industry on the one hand and on the other quit subsidizing it.

make more sense for the state to simply stop taxing the industry on the one hand and on the other quit subsidizing it. There is little rationale for the state to operate the Ohio Standardbred Development Fund, the Ohio Quarterhorse Development Fund, or the Ohio Thoroughbred Race Fund. The horse racing tax distributed \$14.6 million in 2005 to these and related funds. The horse racing industry should operate without such government assistance.

If wagering is to be taxed, there is little rationale to tax only certain kinds of wagers. Either the state should tax all wagers or none at all. Most other states that impose this kind of tax do so on all wagers, not just on certain wagers. Furthermore, it does not make much sense to impose a tax on the

total amount wagered, as the state does now. If a tax is to be imposed, it is much more logical to tax only that amount of money retained by the racing permit holders.

In short, this tax makes little sense in many different ways. Ohio should stop taxing wagering and stop subsidizing horse racing. The government's resources are better spent elsewhere.

Conclusion

Unfortunately, Ohio ranks near the bottom in terms of both personal and business tax climates. The dumb taxes described above help Ohio achieve this dubious distinction. Taxing one group to raise revenue or provide corporate welfare is not a good use of the tax code. Taxing estates simply drives wealthy elderly people to other states. Singling out "dealers in intangibles" for a special tax makes little sense. All the taxes described above should be either eliminated or drastically reformed.

Ohio would be wise to overhaul its entire tax code. The burden Ohio government places on its citizens and businesses is in large part responsible for the state's failure to fully recover from the recession earlier this decade. It is also partly responsible for the outflow of residents to other states. Ohio was once a national leader in terms of economic growth. With the elimination of some dumb taxes and an overall tax reform, it can be such a leader again.

—*Marc Kilmer is a policy analyst with the Buckeye Institute for Public Policy Solutions, a research and educational institute located in Columbus, Ohio.*

Notes

1. "Excise Taxes and Sound Economic Policy," The Tax Foundation, May 1, 1997. Available at <http://www.taxfoundation.org/research/show/584.html>
2. Mekija and Slimrod, "Do the Rich Flee from High Tax States?" Ross School of Business Working Paper Series, July 2004. Available at <http://deepblue.lib.umich.edu/bitstream/2027.42/39176/1/916.pdf>
3. Ohio Legislative Services Commission. "FY 2008 – 2009 Biennial Budget Forecast," March 20, 2007. p. 32.
4. See, for example, the fax alert put out by the Ohio Municipal League when an elimination of this tax was discussed in 2001: <http://www.omunileague.org/bulletins/2001/10-30-01.htm>
5. See, for example, the fax alert put out by the Ohio Municipal League when an elimination of this tax was discussed in 2001: <http://www.omunileague.org/bulletins/2001/10-30-01.htm>
6. See "Who Bears the Ancillary Cost of Tobacco Use" by Patrick Fleenor of the Tax Foundation. Available at <http://www.taxfoundation.org/research/show/121.html>
7. For a more detailed discussion of this, see Viscusi's article "The New Cigarette Paternalism," *Regulation*, The Cato Institute, Winter 2002-2003.