

Testimony on H.B. 49 Impact of Cigarette and Tobacco Tax increases

Ohio House of Representatives – Ways and Means Committee

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Chairman Schaffer

Vice Chairman Scherer

Ranking Member Rogers

Members: Barnes, Becker, Blessing III, Boyd, Cera, Fedor, Goodman, Green, Hambley, Henne, Householder, Merrin, Ramos, Reineke, Retherford, Riedel, Ryan, Sykes.

Chairman Schaffer, Vice Chairman Scherer and members of the committee, thank you for allowing me the opportunity to present testimony surrounding the impact of the proposed Cigarette and Tobacco tax increases in H.B. 49 on my company. I own the Keilson Dayton Company, a stamping wholesale distributor of cigarettes and wholesaler of other tobacco products with locations in Dayton and Columbus, Ohio. My company is a full service wholesaler, meaning we offer delivery and handle a variety of different categories within a convenience store including: candy and snack, grocery, and beverage. The cigarette and other tobacco products category represented 95% of my company’s revenue in 2016. Of my company’s total revenue 90% of my revenue is derived from tobacco products. Keilson Dayton Co employs 55 Ohioans.

Part1 – Why increasing Ohio’s excise tax on cigarettes again is a bad idea.

I have provided two tables below illustrating where Ohio falls in relation to its border states with regards to the cigarette excise tax rate. As the charts indicate, Ohio today falls roughly on the high middle side of cigarette excise tax rates when compared with its border states. Ohio is less than Michigan and Pennsylvania, yet more than West Virginia, Indiana and Kentucky. More of Ohio borders state with lower current cigarette excise tax rates than it borders with higher cigarette excise tax rate states. Raising the cigarette excise tax over its current levels would only increase the gap between Ohio and the majority of its border.

Cigarette Tax Rate – Current 3/9/2017	
Pennsylvania	\$2.60
Michigan	\$2.00
Ohio	\$1.60
West Virginia	\$1.20
Indiana	\$.995
Kentucky	\$.60

Cigarette Tax Rate – Proposed 7/1/2017	
Pennsylvania	\$2.60
Ohio	\$2.25
Michigan	\$2.00
West Virginia	\$1.20
Indiana	\$.995
Kentucky	\$.60

A February 2008 Harvard University Faculty working paper titled “Crossing the Line: The Effect of Cross Border Cigarette Sales on State Excise Tax Revenues” by Lesley Chiou and Erich Muehlegger looked at the cross border issue. In the paper, the authors determined by looking at data that consumer behavior is changed by differences in pricing across

borders. The authors looked at the various distances that consumers will travel to save money on cigarettes up to 40 miles. A consumer is willing to travel 2.7 miles to save \$1.00. For each additional mile within the first ten miles a consumer wants to save an additional \$.65. Between 10 and 20 miles a consumer wants to save an additional \$.34 per mile. Between 20-30, \$.21 per mile. Between 30-40, \$.20 per mile. What do these numbers mean?

They mean that a smoker will drive 2.7 miles to save \$1.00 on cigarettes. A smoker will drive 10 miles to save \$5.75 on cigarettes. A smoker will drive 20 miles to save \$9.15 on cigarettes. A smoker will drive 30 miles to save \$11.25 on cigarettes and 40 miles to save \$13.25 on cigarettes. Based on that data under Ohio's current tax rate this means that Ohio citizens who purchase cartons of cigarettes (10 packs) and live within approximately 7 miles of West Virginia are more likely to buy their cigarettes in West Virginia. Ohio citizens who are cigarette carton purchasers who live within 11 miles of Indiana are more likely to purchase their cigarettes in Indiana. Ohio citizens who are cigarette carton purchasers who live within 24 miles of the Kentucky are more likely to purchase their cigarettes in Kentucky. As someone who used to own a smoke shop in Milford, OH (approximately 15 miles from Kentucky) I can personally attest to this. I closed my store in 2014 after my lease was up due to low sales, primarily due to proximity to Kentucky. During my three years in Milford smokers who I spoke with told me over and over "I get my cigarettes in Kentucky". There is a silver lining today! Pennsylvania smokers who live within 24 miles of Ohio are more likely to travel to Ohio to make their cigarette carton purchases. Michigan smokers who live within approximately 7 miles of Ohio are more likely to buy their cigarettes in Ohio. Have you ever wondered why there is a disproportionate number of cigarette and liquor stores on the Kentucky side of the Ohio River compared to the Ohio side? Thus today under current rates, Ohio is already a net exporter of tax revenue to Kentucky, Indiana and West Virginia.

The other factor that we must look at is what other purchases do consumers make when they travel outside of Ohio to buy their cigarettes? Beer? Liquor? Perhaps lunch after the trip. Why only buy one carton of cigarettes if I had to travel to purchase them cheaper, why not stock up? In fact, stockpiling is a common practice for smokers who travel across state borders to make their cigarette purchases. They may buy three or four cartons for their own use and, may also pick up a few for their neighbor or relative.

Under HB49, Ohio becomes a higher cigarette tax state than Michigan and the mileages I illustrated in the prior paragraph only go up. Ohioans within 40 miles of Kentucky now become more likely to travel to Kentucky to buy their cigarettes. 40 miles means smokers in Dayton (my backyard) become now traveling outside of Ohio to make their cigarette purchases. Ohioans within 30 miles of Indiana become more likely to travel to Indiana to buy their cigarettes outside of Ohio. Ohioans within 24 miles of West Virginia become more likely to travel outside of Ohio to buy their cigarettes. Ohioans within 4 miles of Michigan become likely to travel to Michigan to buy their cigarettes, whereas today Michigan's citizens are traveling into Ohio to buy theirs. Ohio should still see some cross border traffic coming in from Pennsylvania to buy cigarettes in Ohio, but whereas before Pennsylvanians were more likely to come from 24 miles into the state, now it is likely that only smokers within 6.5 miles of Ohio will travel into Ohio to buy their cigarettes.

According to the US Census Bureau, in 2014 Ohio's population was 11,594,163. Of that population the US Census Bureau estimates that 3,239,159 Ohioans live in one of Ohio's border counties. The CDC estimates that 25.1% of Ohio's adult population smokes. Why do these statistics matter? These are the numbers of smokers who will be traveling outside of Ohio to purchase their cigarettes if HB49 increases the excise tax rate on cigarettes.

Part 2 – Increased cigarette taxes, increased incentive for criminals!

My company has seen an increase in cigarette theft following the 2015 cigarette tax increase. We used to have one-two incidents of criminal activity that affected my business each year, prior to the 2015 increase. In the subsequent 20 months I have had seven incidents of criminal acts targeting my company. As a result of the increased criminal

activity we were forced to upgrade our security. In 2016 we spent \$30,967 on security for our two facilities alone. Nobody tries to break into distribution centers for candy or groceries.

August 2015 – At our Dayton warehouse a woman misrepresented herself as one of our customers in an attempt to pick up an order for that customer. The woman was apprehended by the Dayton Police Department and prosecuted.

April 2016 – One of our delivery van's in Columbus was broken into while our driver was inside of a store. Approximately \$5,000.00 in cigarettes was stolen and \$500.00 in damage was done to our van. Columbus Police did not find or arrest anyone in the crime.

May 2016 – One of our delivery's trucks in Middletown, OH was broken into while our driver was inside of a store. Approximately \$7,000.00 in cigarettes were stolen, \$25 in damage was done to our truck. The Butler County Sherriff's office did not find or arrest anyone despite us having a license plate of the vehicle the suspect's used in the crime.

May 2016 – Our facility in Columbus was broken into after hours by 5 male Spanish speaking subjects driving a vehicle with a Pennsylvania tag. They were unable to access our cigarettes in our warehouse but did approximately \$5,000.00 in damage to our office area attempting to access our warehouse. Columbus PD was unable to find or apprehend the subjects.

November 2016 – A male subject attempted to access our Columbus warehouse after hours by tampering with our driveway intrusion sensors. He was unable to access our facility. Columbus PD did not find the subject, although they did increase patrols around our facility.

December 2016 – Our facility in Columbus was broken into after hours by a single individual. The subject was unable to access our cigarettes in our warehouse but did approximately \$1,000.00 in damage to our offices.

February 2017 – Our facility in Dayton had an intruder break into our delivery trucks after hours on our lot. The individual was able to avoid Dayton PD and fled when they arrived on site, he was not apprehended.

Part 3 – What does a wholesaler actually do for the 1.8% stamping compensation they receive?

When I hear comments from our tax commissioner about how it doesn't cost more to stamp just because the tax went up in 2015 I respectfully disagree. Please understand that wholesalers such as Keilson Dayton Co do more than just affix a stamp to a pack of cigarettes. We are the cigarette tax collection agent for the State of Ohio with regards to cigarettes. The stamp is merely a visible indicator that the tax on a pack of cigarettes has been paid.

The following are my costs associated with collecting the cigarette tax revenue for the state illustrated under the tax prior currently.

Cost for stamping cigarettes under current \$1.60 per pack.	
Initial machine cost amortized over 7 year useful life. (6 year old machine = \$60,764.71)	\$8,680.67
Annual maintenance cost of machine.	\$7,012.04
Labor cost of 1 full time employee to operate machine.	\$21,583.41
State unemployment insurance cost of stamping employee. (assuming good history)	\$54.00
Federal unemployment insurance cost of stamping employee.	\$42.00
Workers compensation insurance cost of stamping	\$419.08

labor.	
Employers Social security on stamping labor	\$1,330.12
Employers Medicare on stamping labor	\$311.08
Fringe benefits provided to stamping employee	\$777.38
Cost to transport stamps from tax department to facilities. (We pick up stamps ourselves, were this not feasible and we had to utilize a third party carrier such as UPS, this cost would be \$78,975.00.)	\$1,591.75
Insurance on tax stamps while in possession of Keilson Dayton Co.	\$4,957.00
Interest charged by bank for funds borrowed during Ohio's COD period.	\$2,446.67
Rent on 3600 sq ft space allocated for stamping @ \$3.50 / sq ft	\$12,960.00
Professional labor allocated to tax stamp reporting to Ohio each month.	\$5,741.11
Interest costs of borrowing to cover inventory carrying costs and accounts receivable associated with 2015 tax increase.	\$24,111.90
Total costs associated with stamping one machine.	\$73,647.42

My company uses a line of credit with our lending institution for operating capital throughout the year. In 2015, when we had the last cigarette tax increase, I compared our average usage of that line of credit before the tax increase and after the tax increase to determine the affect the increased inventory carrying costs and increased accounts receivable had on my cash flow. During the first half of 2015, my company's average usage on its line of credit was \$1,368,000.00. During the second half of 2015, my company's average usage on its line of credit was \$2,025,000.00. Thus my average daily borrowing increased \$657,000 after the cigarette tax increased by \$.35 per pack in 2015.

The tax commissioner is somewhat correct in his thinking that raising the tax cigarettes doesn't increase the cost to stamp. The machine cost remains the same, all of the associated labor costs remain the same. The costs that increase though are the insurance costs on an item of greater value. As our insurance company treats tax stamps like cash held on premise or transported in our vehicles, any increase in the amount of the tax on cigarettes results in our having to increase our coverage with our insurance carrier. In addition our line of credit usage goes up with our lending institution, mind you for now increase in sales or profit. You may wonder why we have an increase in our line of credit usage given that we receive 30 days to pay the cigarette tax from the state of Ohio. The reason our line of credit usage goes up when the tax increases is based on the fact that we purchase stamps once per week at the beginning of the week to use throughout the duration of the week. Once we pick up a roll from the tax department, the clock begins to run on our terms. We affix the stamp to our inventory as soon as the cigarettes arrive in our warehouse. We generally try to maintain a 2 week inventory in our facility. Thus the cigarettes received from the manufacturer and stamped today, will be sold anywhere from 9-11 business days from now. This level of inventory is maintained to mitigate any supply chain disruption and also maximize the efficiency of our vendors trucking carriers when delivering to our facilities. Once those cigarettes are sold to our customers, we wait for payment from our customers on the receivable. Credit worthiness determines the length of the receivables with our customers but payment is generally collected within 12 business days. Once we receive payment the funds deposited into our bank are not available on the same day deposited, there is a 1 day hold on our funds. Thus a roll of tax stamps picked up by the Keilson Dayton Co. from the tax department on March 6, 2017 will be paid for on or before April 5, 2017, however Keilson Dayton Co. will likely not

receive the full value of the tax on that roll from its customers until April 14, 2017. The line of credit usage increase is a result of the increase of the tax during this period of time. I have estimated that the cigarette tax increase proposed in HB49 would lead to a \$350,000.00 increase in our LOC usage, again for no additional unit sales or profit, yet HB49 wants to cut out stamping compensation and thus require us to incur the additional insurance and interest costs associated with a higher excise tax with less compensation than we receive today? Please understand, we collect this tax on behalf of the state of Ohio and do a very good job at it. When a retailer goes bankrupt and does not pay my company for the product, that retailer also does not pay the tax, yet my company still remits the tax to the State of Ohio today. In 2016, Keilson Dayton Co paid approximately \$4,250.00 in excise taxes to the state of Ohio which we were unable to recover from retailers who chose not to pay us for the product delivered.

Part 4 – Why an Other Tobacco Products (OTP) rate of 69% in Ohio is a really bad idea.

Similar to the previous charts provided for cigarettes, the two charts below show the excise tax rate in Ohio compared to those states that Ohio borders.

Other Tobacco Products Tax Rate Current 3/9/2017	
Pennsylvania	Weight Based
Michigan	32%
Indiana	24%
Ohio	17%
Kentucky	15%
West Virginia	12%

Other Tobacco Products Tax Rate Proposed 7/1/2017	
Ohio	69%
Pennsylvania	Weight Based
Michigan	32%
Indiana	24%
Kentucky	15%
West Virginia	12%

Immediately you can see that Ohio goes from being in a good place right in the middle of its border states, higher than some, lower than others. To a position that is over 2x what the next closest ad valorem state is (Michigan), almost 3x the excise tax rate in Indiana, 4x Kentucky’s tax rate, and almost 6x the tax rate in West Virginia. It is difficult to compare Ohio to Pennsylvania on the OTP side due to the broken up nature of how they tax the OTP category. In Pennsylvania cigars are not subject to OTP tax, but all other tobacco products are taxed at \$.55 per oz. You as legislators should note that unlike cigarettes where the tax rate is set a fixed amount per pack. OTP is taxed in Ohio based on a percentage of the manufacturer’s list price to a wholesaler. Thus as manufacturers take price increases year after year, Ohio receives tax increases every year naturally as the manufacturer’s price to wholesale increases.

When I as a wholesaler sell an OTP product to a retailer I make about 4% today. Smugglers who come into Ohio from Pennsylvania with untaxed OTP with untaxed cigars are able to make in excess of 17% today and undercut my prices. If the OTP rate in Ohio goes to 69% would you guess that the amount of smuggling coming into Ohio would increase, decrease or remain the same? OTP is much different than cigarettes in that there is no tax stamp marking on the product to indicate that the tax has been paid. A roll of Copenhagen sold in Ohio looks identical to a roll of Copenhagen sold in Pennsylvania. A State of Ohio enforcement agent in a retail store has no true way to tell if a retailer’s OTP product came from a legitimate taxpaying Ohio wholesale dealer, or from a smuggler who brought it in from Pennsylvania. The retailer can buy a few rolls of Copenhagen from a legitimate wholesaler to have an invoice on hand that satisfies a tax enforcement agent, while buying cases of rolls from a smuggler.

Taking the OTP tax rate in Ohio to 69% would be incredibly detrimental to my business. It would also be a huge stimulant to the untaxed OTP smuggling in Ohio. Even though tobacco tax enforcement is active in the marketplace, Ohio does not enough enforcement agents to stop the smuggling problem altogether under today's rates. If the incentive to smuggle OTP into Ohio increases, more and more smuggling will take place. Tax enforcement agents will be faced with an increased workload; I will be faced with declining revenues. Danger for agents will increase as the state brings in more and more smuggled product from outside of Ohio. Let's face it, not all smugglers are going to surrender peacefully when they are caught. The penalties for smuggling untaxed OTP into Ohio are minor in comparison with the penalties for other crimes, such as drug dealing. When Ohio increases the incentive to smuggle untaxed OTP into the state with such an unusually high OTP excise tax rate, the criminal element will choose to participate in this type of smuggling over other crimes due to it being more lucrative and lower risk. As I said two years ago, when Ohio can stop OTP smuggling 100% of the time at the current 17% tax rate, then Ohio can consider raising the OTP rate, but raising the rate when Ohio cannot stop the smuggling problem it has today will lead to lower revenues for Ohio, lower revenues for my business, and increased profits for criminals.

Today Ohio is right in the middle of the states surrounding it. That is a good place to be, higher tax than some, lower tax than others, but overall Ohio is in parity with the surrounding states. Ohio should stay where it is on OTP excise taxes. 17% excise tax is much better than 0% on smuggled product. I cannot stress highly enough how a 69% OTP tax rate in Ohio would destroy my business and the OTP excise tax revenue collected by the State of Ohio would not increase proportionally.

Part 5 – OTP Compensation

While not as labor and cash flow intensive as cigarettes, collecting the OTP taxes for the State of Ohio does incur its share of costs. Wholesalers still are responsible for the paying the tax even if the retailer does not pay the wholesaler for the product. Wholesalers still have to pay professional labor to prepare the returns on a monthly basis. For Keilson Dayton Co, the monthly labor cost allocated to the activity of preparing the OTP returns is \$1,041.67. Currently the tax department is changing the methodology in which OTP returns are to be submitted to the department from a paper based methodology to an electronic filing methodology. The tax department communicated the requirements for submitting under this new methodology earlier this year. As a wholesaler making system software changes at our company to accommodate this new way of filing our returns will have an approximate cost to us of around \$5,000.00.

Interestingly enough, changes to the OTP excise tax rate or methodology would likely require additional programming changes on our end to accommodate the proposed e filing. I feel fairly certain that the tax department would need to make system changes to their filing system under similar circumstances.

Part 6- Consistency of Business Operations

As a business owner in Ohio who specializes in tobacco, the last few years have been troubling to me. Ohio has not given me any long term consistency and it makes me question the long term viability of continuing to do business in Ohio. In 2013, the State of Ohio Budget Bill was presented to raise the cigarette and OTP taxes. OTP was increased on a category of cigars at that time. In 2014, the MBR pursued increased cigarette and OTP taxes. Fortunately the legislature decided at that time not to pursue additional excise taxes. In 2015, again the State of Ohio Budget Bill pursued excise tax increase on cigarettes and other tobacco products. The legislature decided to go with a \$.35 per pack increase in the cigarette tax rate. In 2016 we had a year off of fighting this battle, but here we are again in 2017 fighting the same battle. Why would I make any long term investment in growing my business in Ohio when the focus of this

administration seems to be on establishing a tax rate that would effectively put me out of business? As a business owner, I want consistent policy that is set and then left alone for a lengthy period of time (such as 10 years or so). I do not want to see policy that changes every other year when Ohio establishes its budget. Ohio raised the OTP excise tax in 2013 with the cigar changes. Ohio raised the excise tax rate on cigarettes in 2015. It is 2017; 4 years since the last OTP change and 2 years since the last cigarette change and we are discussing raising excise tax rates again. That is not consistent tax policy and does not encourage me to continue to invest in Ohio.

The tax proposal as presented is a regressive tax. Only 27% of typical tobacco users have an income above \$60,000.00 per year according to the Harvard Faculty Study I referred to earlier in my testimony. Thus an excise tax increase that funds an income tax cut will most benefit Ohioan's at the upper end of the income spectrum (the majority of which are not tobacco users) at the expense of those Ohioan's at the lowest end of the income spectrum. Ohio cut income taxes in the 2015 budget off of a cigarette excise tax increase, did that cut really increase the prosperity of most Ohioans? Did any of you legislators receive a phone call or email from a constituent thanking you for the income tax cut in the 2015 budget?

The decision to revisit increasing excise taxes in Ohio again so soon after they have been increased is ill advised. Moving the excise tax rates of Ohio's cigarettes or other tobacco products above the excise tax rates of Ohio's Border States is ill advised. Cutting income taxes at the expense of Ohio's lowest income earners who do not benefit from an income tax cut is ill advised.

Thank you for your time and I hope that you will take this testimony into account when making the decision that is right for Ohio.

Regards,

Gregory Wellinghoff

Keilson Dayton Co.
107 Commerce Park Dr.
Dayton, OH 45405

Keilson Dayton Co.
800 Harrison Dr.
Columbus, OH 43204