

# spotlight

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## **EXORCIZING EXCISE TAXES**

*Bringing Transparency to Hidden Taxes*

- KEY FACTS:**
- **The largest excise tax collection in North Carolina is on fuel, amounting to \$1.5 billion annually.**
  - **North Carolina excise taxes generated \$2.4 billion in revenue in FY2011, amounting to 13 percent of total tax revenue collected.**
  - **Historically, all excise tax increases in North Carolina have been coupled with a recessions or budget shortfalls.**
  - **Excises are typically used to manipulate choices freely made by taxpayers.**

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*for Truth*



When discussions of tax reform are publicized, excise taxes are frequently ignored, meaning they are sometimes increased without much public knowledge. Because these taxes often are tied closely to moral or social considerations, they often receive less resistance than others.

While the federal government has left sales taxes to the states as a revenue source, it levies a variety of excise taxes. The revenue generated from federal excise taxes is small compared to other federal taxes. In FY2012, \$79 billion in excise taxes was collected, amounting to 3.7 percent of total federal receipts and equal to 0.6 percent of Gross Domestic Product.<sup>1</sup> The same cannot be said about state levies. North Carolina levied excise taxes generated \$2.4 billion in revenue in FY2011, amounting to 13 percent of total tax revenue collected.<sup>2</sup>

### What is the Difference between Sales and Excise Taxes?

A sales tax is considered an *ad valorem tax*, that is, a percent of the price of the item is added when the consumer buys it. Sales taxes are applied to a wide base of products, whereas excise taxes are applied to items specified by lawmakers. In practice, an excise tax usually is based solely on quantity; the consumer pays a flat amount per item.

According to the Internal Revenue Service, “excise taxes are taxes paid when purchases are made on a specific good, such as gasoline. Excise taxes are often included in the price of the product.”<sup>3</sup> For example, very few would be able to identify the excise taxes applied to the case of Coke in Figure 1.

<b>Figure 1: Sales vs. Excise Taxes</b>	
2 shirts for \$25.68 + 4.75% NC Sales Tax = \$26.90	
24 pack of Coca-Cola for 5.75 + 1¢ NC Soft Drink Excise Tax <sup>4</sup> = \$5.99 + 4.75% NC Sales Tax = \$6.27	

### Transparency and Liberty

Taxes should be rooted in a respect for liberty and the free market – what is referred to in economics as neutrality.<sup>5</sup> In a free society, the tax system should not be used to punish activities that are disfavored by politicians or to reward activities that politicians consider virtuous. Since first enacted at the federal level in 1791, excise taxes have often been used for exactly these purposes.

In addition, excise taxes lack transparency. In a democracy, in order to make intelligent decisions in the voting booth, people need to be aware of how much their government is costing them. This is only possible if they are aware of the taxes they are paying. The gasoline tax is a good example. If five gallons of gasoline is purchased at \$3.15 per gallon, the price will be \$15.75. Unless you know the federal excise tax is 18.4¢ per gallon<sup>6</sup> and the North Carolina excise tax is 37.5¢ per gallon,<sup>7</sup> you won’t know that \$2.80 of that gasoline purchase price was hidden excise taxes. While, like other excise taxes, the gasoline tax suffers from a lack of transparency, it is different in that it is typically considered to be a user fee. So long as revenues are used to build and maintain roads, which is mostly but not always the case, these taxes are consistent with principles of liberty and neutrality, if not transparency.

Gasoline taxes being an exception, the goods subject to North Carolina’s excise taxes should not be taxed at a greater rate than products subject to the state sales tax. The multiple layers of taxation are disproportionate and non-transparent, and they represent an unwarranted interference with the decision-making of taxpayers. Indeed, the government should respect taxpayers’ freely made choices, even if a large proportion of society frowns upon those choices.

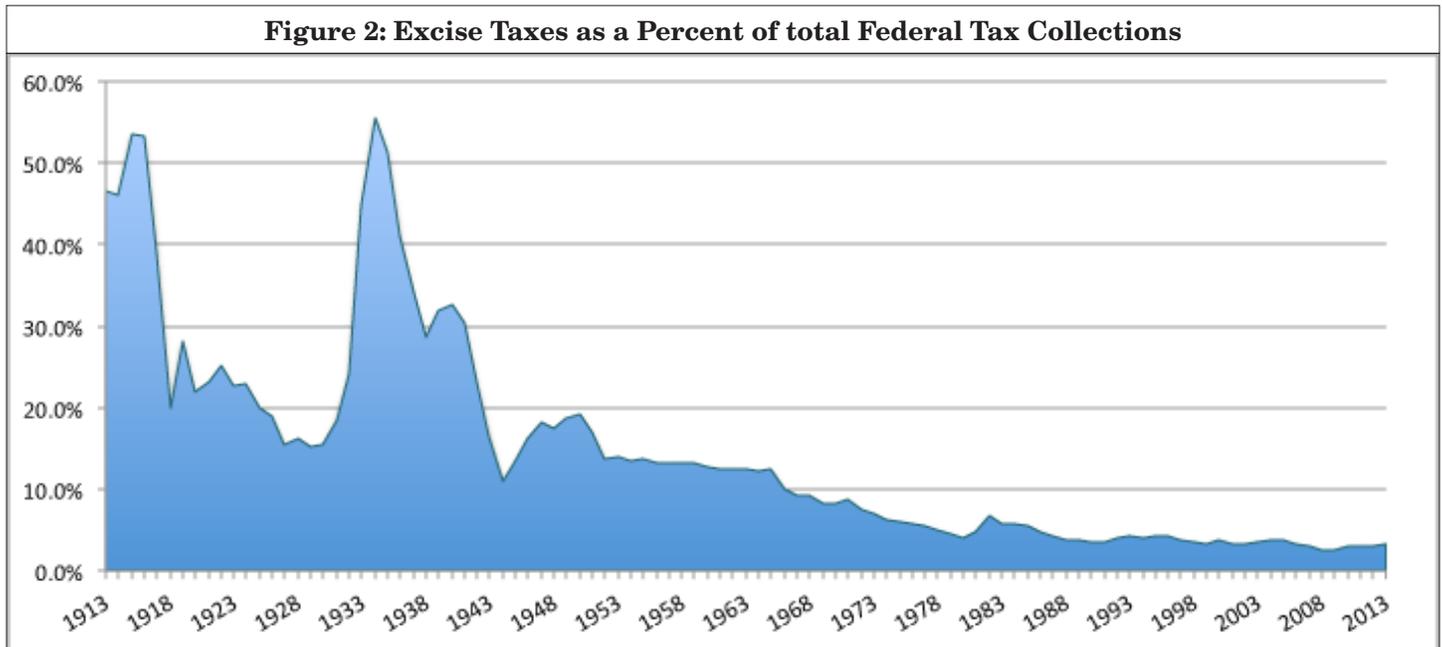
### Historical Development of Federal Excise Taxes

As referenced above, federal excise taxes date back to 1791.<sup>8</sup> The first excise tax was levied on distilled spirits as a method to repay budget deficits following the Revolutionary War and compensate for lower than expected import

duty receipts.<sup>9</sup> Though unpopular, “luxury” items such as carriages, snuff, and sugar were taxed, which eventually led to the violent Whiskey Rebellion in 1794. Ultimately repealed in 1802,<sup>10</sup> excise taxes had proven an easy way to raise revenue on consumption. It did not take long for the federal government to revive excise taxes. They were reinstated in 1814 to pay for the War of 1812.<sup>11</sup> There were no excise taxes levied from 1817 until the Civil War.

In 1862, excise taxes were levied again on a number of items ranging from billiard tables to sheep.<sup>12</sup> In addition, stamp taxes were imposed on many activities, most notably transportation, professional licensure, financial institutions, and advertising.<sup>13</sup> Shortly after the war, all excise taxes were removed once again, except those on spirits, fermented liquors, and tobacco.<sup>14</sup> Once more, in 1898, the federal government reinstated excise taxes to fund the Spanish-American War. Excise taxes provided 55 percent of total tax receipts for the federal government until 1902.<sup>15</sup> Again, excise taxes were removed after the wartime debt was repaid. The only remaining excise taxes were on liquor, tobacco, margarine, and playing cards.<sup>16</sup>

Starting in 1913, a series of Revenue Acts were passed, which introduced the federal income tax and raised excise tax rates significantly. Excise taxes would only comprise a significant portion of federal tax collections once more in history, during the Great Depression. See Figure 2 for the nation’s portion of tax collections from excise taxes over the last 100 years.<sup>17</sup>



Unsurprisingly, World War I and II saw the federal government raise existing excise taxes and introduce new ones. Yet excise taxes still made up only around a quarter to a third of overall tax revenues, largely due to a concurrent increase in income taxes. Again, after WWII, excise taxes were reduced until the Korean War necessitated additional funds, which the government chose to raise through increased excise taxes.

Thus, the present excise tax system in America, first developed to meet the need for emergency revenue in times of war or severe financial distress, is used today as an easy way to fund special interests or government projects.

**North Carolina Excise Taxes**

North Carolina’s first excise tax was levied on motor fuels in 1921 at 1¢ per gallon. No other excise taxes were implemented until tobacco, alcohol, and soft drinks were taxed in 1969. The most recent increase in rates was in

2009,<sup>18</sup> when the budget shortfall from the Great Recession gave cover for politicians to enact a tax increase. Historically, all excise tax increases in North Carolina’s history have been coupled with recessions or budget shortfalls. A well-funded rainy day fund would be one simple way to halt this cycle of taxation.

*Cigarette Excise Tax (Article 2A)*<sup>19</sup>

The current tax rate on cigarettes is 45¢ per package of 20, or an excise tax of 2.25¢ per cigarette. North Carolina is has the 6th lowest tobacco excise tax in the nation.

The excise tax rate for tobacco has changed significantly over the last ten years. In September 2005 the cigarette tax rate increased from 5¢ per pack of 20 cigarettes to 1.5¢ per cigarette, or 30¢ per pack of 20 cigarettes. Ten short months later in July 2006, the cigarette tax rate increased again by 0.25¢ to 1.75¢ per cigarette or 35¢ per pack. The most recent rate increase was implemented in September 2009, when it was raised to 2.25¢ per cigarette or 45¢ per pack of 20 cigarettes.

Prior to the first tax increase in 2005, the annual revenue garnered was around \$40 million. The amount jumped to \$165 million in 2005 and \$234 million in 2006. During fiscal year 2010-11, approximately \$258 million was collected from the cigarette excise tax.<sup>20</sup>

*Alcoholic Beverage Excise Taxes (Article 2C)*<sup>21</sup>

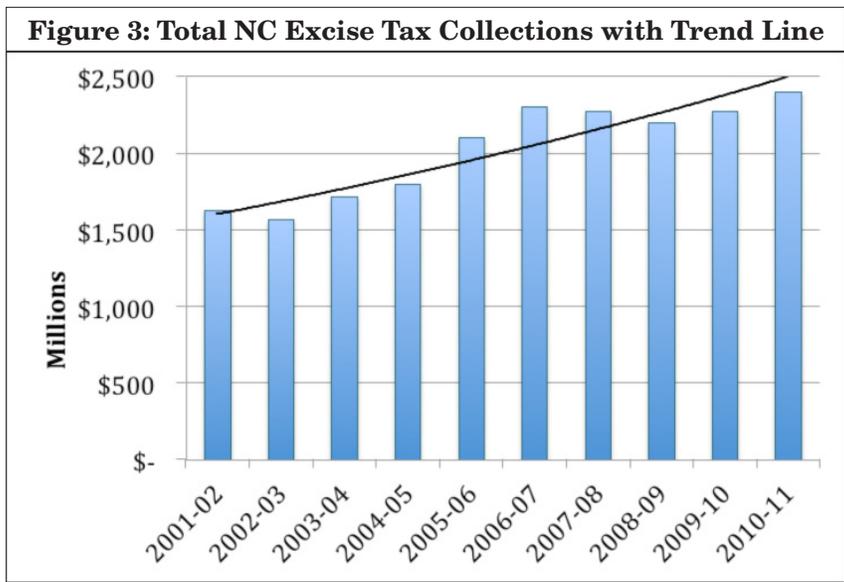
North Carolina is one of 18 states<sup>22</sup> that are considered controlled alcoholic beverage states, meaning the state has a monopoly over the wholesaling and/or retailing of spirituous liquor. Beer and wine can be sold in supermarkets and convenience stores. State law also requires local elections to permit the sale of spirituous liquor “by the drink” by qualified restaurants. This law allows an excise tax of \$20 on each four liters of spirituous liquor purchased by restaurants or clubs for sale by the drink on top of the excise taxes applied to the individual beverages sold.

There are different types of alcoholic beverages and each is treated differently under the law for excise tax purposes. The rates for alcoholic drinks, spirituous liquor, and wine was last increased in September 2009. Beer or malt beverages are currently taxed at the 9th highest rate in the nation at 61.71¢ per gallon. Unfortified<sup>23</sup> wine carries an excise tax of 26.34¢ per liter and fortified<sup>24</sup> wine an excise of 29.34¢ per liter. Spirituous liquor sold through ABC stores is taxed at 30% of cost. This excise tax, though not levied at a flat amount per unit as is typical of excise taxes, is included in the total cost of the sales price of the product thus behaving as a traditional excise tax. North Carolina’s excise tax on spirituous liquor is the 5th highest in the nation.

In 2008, prior to the last tax increase, annual alcoholic beverage excise tax collections were around \$250 million. After the tax rate increase, collections now average \$301 million annually.<sup>25</sup>

*Excise Tax on Motor Fuels (Article 36C) and Alternative Fuels (Article 36D)*<sup>26</sup>

North Carolina imposes an excise tax on two forms of fuel, motor and alternative. Both are currently taxed at a rate of 17.5¢ per gallon, plus a variable wholesale component of 3.5¢ or 7% of the average wholesale price – whichever



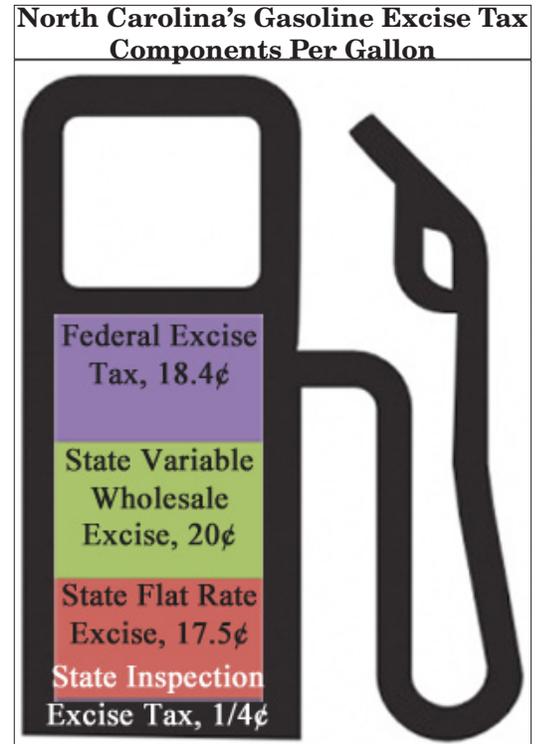
is greater. Fuels sold for non-highway use are subject to the sales and use tax.

Excise taxes collected on motor fuels totaled approximately \$1.2 billion over the last ten years, while the combined fuel type excise collections have been around \$1.5 billion. This is the largest excise collection of all the excise taxes in North Carolina.

*Piped Natural Gas Excise Tax (Article 5E)<sup>27</sup>*

This excise tax is imposed on piped natural gas received for consumption in North Carolina and was introduced on July 1, 1999. This excise tax is charged at a marginal tiered block rate based on the monthly volume of piped gas consumed by the end-user.

Manufacturers and farmers are exempt from this tax for qualified purposes since July 1, 2010.<sup>28</sup> These excise tax collections have averaged \$60 million annually since their inception. The manufacturer and farmer exemption reduced collections by \$5 million in its first year, but additional data will be needed to see the full impact of the exemption over the longer term.



Monthly Volume in Therms <sup>29</sup>	Rate per Therm
First 200	\$.047
201 to 15,000	.035
15,001 to 60,000	.024
60,001 to 500,000	.015
Over 500,000	.003

*Dry Cleaning Solvent Excise Tax (Article 5E)<sup>30</sup>*

The dry cleaning solvent tax was first established in 1997. It is imposed on retailers that sell cleaning solvent to dry cleaning facilities. There is also an excise tax on dry cleaning solvent purchased outside North Carolina but stored or used by a dry cleaning facility within state boundaries. The current rate is \$10 for each gallon of halogenated hydrocarbon-based dry cleaning solvent and \$1.35 for each gallon of hydrocarbon-based dry cleaning solvent.

In October 2001, the tax was increased from its previous rate of \$5.85 for halogenated hydrocarbon-based solvent and \$0.80 rate for hydrocarbon-based solvent. Although the rate increase was scheduled to sunset in 2010, the rates were extended to January 2020 in 2009.

*Excise Stamp Tax on Conveyances (Article 8E)<sup>31</sup>*

This tax, also called the real estate transfer tax, is imposed each time real property is conveyed from one party to another. The current tax is \$1 for every \$500 worth of property that is transferred; including any fractional part. The tax is paid by the transferor to the register of deeds of the county in which the real estate is located prior to recording the property of conveyance. In addition to the excise tax rate for the state, seven counties - Dare, Camden, Chowan, Currituck, Pasquotank, Perquimans, and Washington - levy a local real estate transfer tax of \$1 per \$100 on the full value, including the value of any lien on the property at the time of sale.<sup>32</sup>

Over the last 10 years, the average state collection has been a little more than \$48 million annually, yet there have been some fluctuations in collection rates. For four years, 2004-08, collections averaged \$65 million, an obvious result of the housing bubble. Since 2008, collections have returned to their pre-bubble rate of approximately \$32 million annually.

*Unauthorized Substance Excise Tax (Article 2D)*<sup>33</sup>

This excise tax was first levied in January of 1990 and was created as a form of revenue for law enforcement agencies. In a court case decided by the 4th U.S. Circuit Court of Appeals in 1998, the tax was viewed as a criminal penalty and, as a result, these excise taxes were reduced. This tax has averaged \$9.3 million in annual collections over the last ten years.

The current excise taxes applied to unauthorized substances are in the following table:

<b>Unauthorized Substance</b>	<b>Rate<sup>34</sup></b>	<b>Minimum Quantity Before Tax is Due</b>
Marijuana stems and stalks separated from the plant	\$0.40 /gram*	More than 42.5 grams
Marijuana other than separated stems and stalks	\$3.50 /gram*	More than 42.5 grams
Cocaine	\$50 /gram*	7 or more grams
Any other controlled substance sold by weight	\$200 /gram*	7 or more grams
Any other controlled substance not sold by weight	\$200 /10 dosage units*	10 dosage units
Any low-street-value drug not sold by weight	\$50 /10 dosage units*	10 dosage units
Illicit spirituous liquor sold by the drink	\$31.70 /gallon*	No minimum
Illicit spirituous liquor not sold by the drink	\$12.80 /gallon*	No minimum
Mash	\$1.28 /gallon*	No minimum
Illicit mixed beverages	\$20.00 /4 liters*	No minimum

*White Goods Disposal Excise Tax (Article 5C)*<sup>35</sup>

White goods are defined as refrigerators, ranges, water heaters, freezers, unit air conditioners, washing machines, dishwashers, clothes dryers, and other similar domestic and commercial large appliances. The excise tax on these items was first levied on January 1, 1994 and was scheduled to expire July 1, 1998. The tax was \$5 if the article did not contain chlorofluorocarbon refrigerants and \$10 if the article contained such refrigerants. In 1998 the sunset provision was extended and the rate reduced. Predictably, in 2000 the state legislature made the tax permanent. The current rate is imposed on a retailer of white goods at a flat rate of \$3 on each good that is sold, regardless of the contents.

The first two years of the tax collected more than \$7.7 million annually. The change occurring in 1998 dropped tax collections to around \$4.5 million annually, and it has held at that amount with relatively little fluctuation since.

*Solid Waste Disposal Excise Tax (Article 5G)*<sup>36</sup>

This excise tax is North Carolina's most recent one. It became effective on July 1, 2008. The tax is imposed on any facility that collects solid waste, such as municipal solid waste landfills, construction and demolition landfills, and transfer stations which have historically sent waste out-of-state, at the rate of \$2 per ton of waste. This rate also applies to the transfer of solid waste for disposal outside the state. This excise tax collected more than \$18 million in fiscal year 2010-11.

**Recommendations**

A larger annual appropriation to the savings and reserves account would allow state budgets to use those funds during a budget shortfall rather than raising excise taxes. Excise taxes have not been shown to alter behavior significantly, so the increasing of excise taxes on products should be eliminated. If excise taxes are to be used as a user fee, as is the case with gasoline, then collections should be used accordingly. Much of North Carolina's current

**North Carolina's Excise Tax Collections (in \$thousands)**

<b>Product</b>	<b>2001-02</b>	<b>2002-03</b>	<b>2003-04</b>	<b>2004-05</b>	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
Cigarettes	38,330	38,431	39,811	38,953	165,328	234,438	228,848	220,158	243,918	257,949
Alcoholic Beverages	201,629	198,655	211,218	219,437	230,348	244,834	259,024	262,768	293,225	309,297
Beer	88,632	88,497	93,474	93,219	96,153	98,740	101,251	100,332	110,515	114,552
Fortified Wine	1,248	1,250	1,258	1,038	1,098	942	909	849	854	815
Unfortified Wine	9,341	10,254	11,242	11,844	11,844	13,537	14,723	15,163	18,701	21,408
Liquor	102,408	98,654	105,244	113,336	121,252	131,615	142,141	146,424	163,155	172,523
Motor and Alternative Fuels	1,275,102	1,219,071	1,333,076	1,408,708	1,558,391	1,676,312	1,656,837	1,595,497	1,616,930	1,718,263
Piped Natural Gas	65,325	65,875	65,503	62,084	58,507	61,514	59,772	59,680	59,805	54,702
Dry Cleaning Solvents	892	901	891	895	816	754	645	534	474	424
Conveyances	35,460	37,979	54,939	59,668	75,255	74,445	60,786	36,332	34,204	31,736
Unauthorized Substance	8,205	9,024	8,468	9,350	11,532	11,093	10,021	8,831	9,075	8,287
White Goods	4,562	4,433	4,532	4,778	4,927	5,247	5,003	4,284	4,450	4,170
Solid Waste	0	0	0	0	0	0	0	14,756	18,251	18,426
<b>Total Excise Tax</b>	<b>1,629,505</b>	<b>1,574,369</b>	<b>1,718,437</b>	<b>1,803,873</b>	<b>2,105,103</b>	<b>2,308,638</b>	<b>2,280,936</b>	<b>2,202,840</b>	<b>2,280,334</b>	<b>2,403,254</b>

gasoline tax goes to the General Fund or is spent on items other than highway construction and maintenance. More transparency needs to be incorporated so that taxpayers know exactly how much they are paying. Receipts for items on which an excise tax is levied should clearly list the base price of the item as well as the tax; this will allow the taxpayer to see how much is paid in each transaction.

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## End notes

1. U.S. Office of Management and Budget, *Budget of the U.S. Government*, fiscal year 2012, Historical Tables (Washington: GPO, 2012).
2. Author's Calculations
3. Internal Revenue Service, Excise Tax, [irs.gov/Businesses/Small-Businesses-&Self-Employed/Excise-Tax](https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Excise-Tax).
4. North Carolina's soft drink excise tax, 1¢ per unit of soft drink. In this example each can was taxed an additional 1¢ amounting to 24¢. The soft drink excise tax was repealed in 2002, but was used here as a simple example.
5. Roy Cordato, JLF *Spotlight* Reforming the Sales Tax, July 12, 2010, [johnlocke.org/research/show/spotlights/245](https://www.johnlocke.org/research/show/spotlights/245).
6. The Tax Foundation, *Facts & Figures 2013*, Selected Federal Rates 2013, p. 17, Table 11, [taxfoundation.org/article/facts-figures-2013-how-does-your-state-compare](https://taxfoundation.org/article/facts-figures-2013-how-does-your-state-compare).
7. The Tax Foundation, *Facts & Figures 2013*, State Gasoline Tax Rates as of January 1, 2013, p. 33, Table 22, [taxfoundation.org/article/facts-figures-2013-how-does-your-state-compare](https://taxfoundation.org/article/facts-figures-2013-how-does-your-state-compare).
8. Act of March 3, 1791, Chapter XV, 1 Stat. 199-214.
9. Thomas Ripy, Congressional Research Service, *Federal Excise Taxes on Alcoholic Beverages: A Summary of Present Law and a Brief History*, June 15, 1999, Report RL30238, p. 3.
10. Act of April 6, 1802, Chapter XIX, 2 Stat. 148-150; the Act also repealed other internal taxes (such as those on refined sugar, carriages, and retail licenses).
11. The Tax Foundation, *Federal Excise Taxes*, Chapter II – Historical Development of Excise Taxes, June 1956, p. 9, paragraph 6, [taxfoundation.org/sites/taxfoundation.org/files/docs/pn40-1.pdf](https://taxfoundation.org/sites/taxfoundation.org/files/docs/pn40-1.pdf).
12. Spirits, beer, tobacco, manufactured products, auction sales, carriages, yachts, billiard tables, plates, slaughtered cattle, hogs, and sheep.
13. Occupational licenses, railroads, steamboats, ferry boats, railroad bonds, banks, insurance companies, advertisements, and legacies.
14. The Tax Foundation, *Federal Excise Taxes*. p.11.
15. *Ibid.*
16. *Ibid.*
17. Author's Calculations using both Tax Foundation's Federal Excise Taxes Tables and the Office of Budget and Management Historical Table 2.1.
18. Session Law 2009-451 (SB202), effective September 1, 2009
19. *North Carolina Biennial Tax Expenditure Report 2011*, NC Department of Revenue, p. 26, [dor.state.nc.us/publications/nc\\_tax\\_expenditure\\_report\\_11.pdf](https://dor.state.nc.us/publications/nc_tax_expenditure_report_11.pdf).
20. North Carolina Department of Revenue, Statistical Abstract – Part III State Tax Collections, Table 8 – Tobacco Products Tax Collections, [dornrc.com/publications/abstract/2011/table8.pdf](https://dornrc.com/publications/abstract/2011/table8.pdf).
21. *North Carolina Biennial Tax Expenditure Report 2011*, p. 27.
22. Maine, New Hampshire, Vermont, Pennsylvania, Maryland, Ohio, West Virginia, North Carolina, Alabama, Mississippi, Iowa, Wyoming, Utah, Montana, Idaho, and Oregon
23. Any wine of 16% or less alcohol by volume.
24. Any wine of more than 16% and no more than 24% alcohol by volume, made with the addition of a spirituous liquor
25. North Carolina Department of Revenue, Table 11 – Alcoholic Beverage Tax Collections, [dornrc.com/publications/abstract/2011/table11.pdf](https://dornrc.com/publications/abstract/2011/table11.pdf).
26. *North Carolina Biennial Tax Expenditure Report 2011*, p. 124.
27. North Carolina Department of Revenue, Table 44 – Piped Natural Gas Excise Tax Collections, [dornrc.com/publications/abstract/2011/table44.pdf](https://dornrc.com/publications/abstract/2011/table44.pdf).
28. *North Carolina State and Local Taxes 2011*, North Carolina Department of Revenue, Policy Analysis & Statistics Division, p. 15, [dor.state.nc.us/publications/stateandlocal2011.pdf](https://dor.state.nc.us/publications/stateandlocal2011.pdf).
29. Equal to 100,000 BTUs (British Thermal Units); energy equivalent of burning 100 cubic feet of natural gas
30. North Carolina Department of Revenue, Table 43 – Dry-Cleaning Solvent Tax Collections, [dornrc.com/publications/abstract/2011/table43.pdf](https://dornrc.com/publications/abstract/2011/table43.pdf).
31. North Carolina Department of Revenue, Table 51 – Excise Stamp Tax on Conveyances, [dornrc.com/publications/abstract/2011/table51.pdf](https://dornrc.com/publications/abstract/2011/table51.pdf).
32. *North Carolina State and Local Taxes 2011*, pp. 13-14.
33. North Carolina Department of Revenue, Table 15 – Unauthorized Substance Taxes Collections, [dornrc.com/publications/abstract/2011/table15.pdf](https://dornrc.com/publications/abstract/2011/table15.pdf).
34. \*Indicates a fractional cost for less than the given unit of measure applies
35. North Carolina Department of Revenue, Table 42 – White Goods Disposal Tax Collections, [dornrc.com/publications/abstract/2011/table42.pdf](https://dornrc.com/publications/abstract/2011/table42.pdf).
36. North Carolina Department of Revenue, Table 46 – Solid Waste Disposal Tax Collections, [dornrc.com/publications/abstract/2011/table46.pdf](https://dornrc.com/publications/abstract/2011/table46.pdf).