

# spotlight

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## NORTH CAROLINA'S E-CIGARETTE TAX

*Where bad tax policy meets special interest politics*

### KEY FACTS:

- North Carolina passed a law during the 2014 legislative session taxing the liquid used in electronic cigarettes at an additional 5 cents per milliliter. Electronic cigarettes are already subject to the state sales and use tax.
- Add-on electronic cigarette taxes have been introduced in 20 states, but only two have enacted them — Minnesota in 2012 and North Carolina in 2014. Eighteen states have said no.
- The electronic cigarette market in North Carolina is currently dominated by small businesses. This tax will hurt small businesses because it will require a tobacco license to sell, distribute, or import electronic cigarette products and force them to expend huge sums for lawyers and accountants to ensure compliance.
- This tax violates the most important principle of good tax policy—neutrality. It is bad economics for the government to tax some goods and services more heavily than others. This new tax distorts economic and personal decisions by penalizing some consumer choices relative to others.
- The North Carolina General Assembly should make history and become the first state in the country to repeal an electronic cigarette tax.

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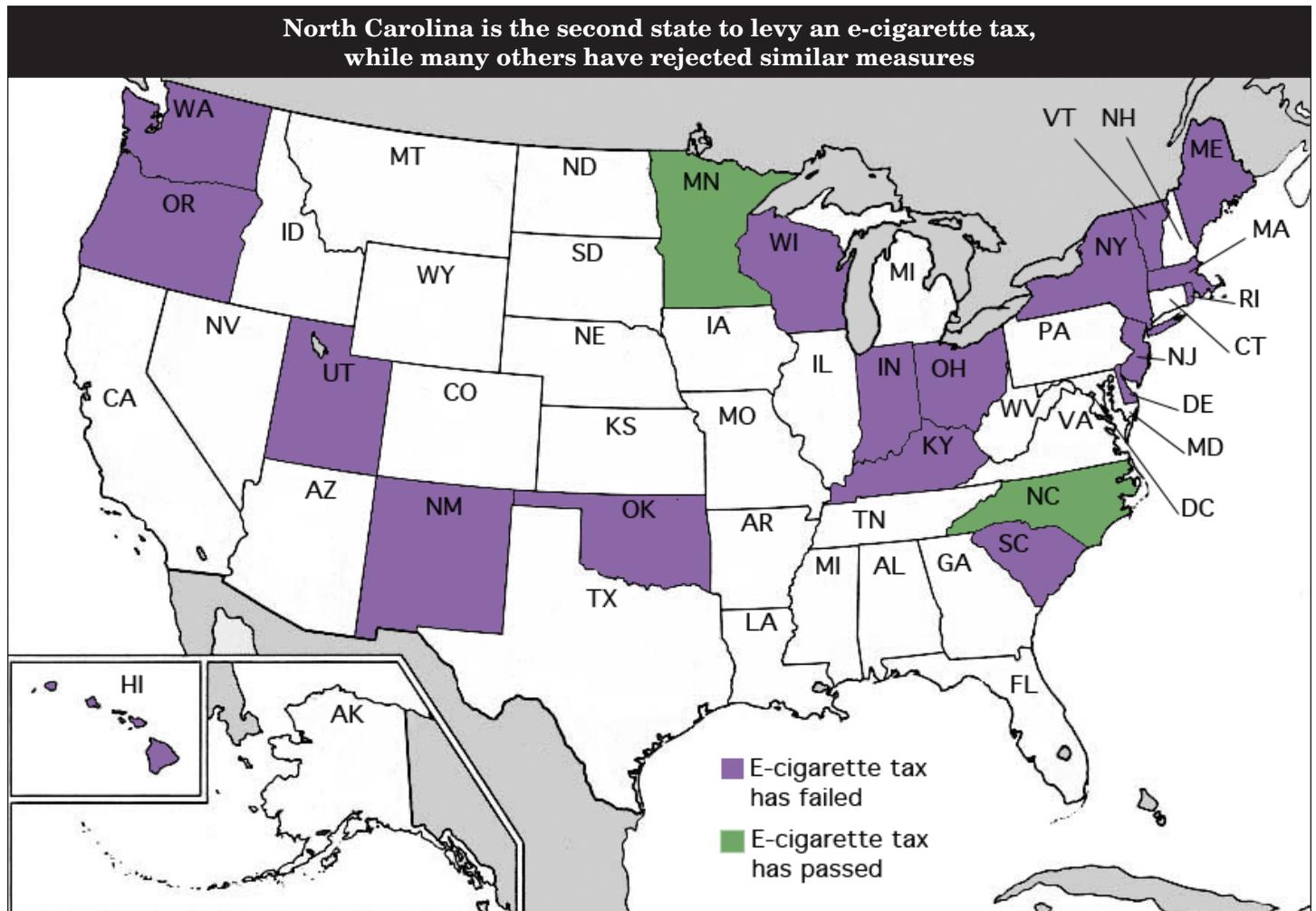
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Over the last decade, there has been increased use of electronic cigarettes or vapor products. Not surprisingly, this has caught the eye of legislators who are often on the look out for new and creative ways to extract revenues from the citizenry. Add-on e-cigarette tax bills have been introduced in 20 states, but only two have enacted them — Minnesota in 2012 and North Carolina in 2014. Eighteen states have said no. E-cigarettes are already subject to state sales taxes in all states.

### Bad Economics and Bad Politics

All excise taxes, by definition, distort economic and personal decision making by penalizing some consumer choices relative to others. For economists, the first principle of efficient taxation is neutrality, that is, the government should extract the money it needs from taxpayers without distorting their freely made decisions. As a matter of pure economics, it is not appropriate for the government to tax some goods and services more heavily than others. This distorts relative prices and therefore efficient resource allocation. Currently North Carolina's tax policy with respect to the sale of e-cigarettes gets it right.<sup>1</sup> They are taxed at the same state and local sales tax rates that apply to other consumer goods throughout the economy.

In May, state legislators decided to change this by placing a new excise tax on e-cigarettes. Defying sound principles of taxation, beginning on June 1 of 2015, the liquid in e-cigarettes will be taxed at an additional 5 cents per milliliter. What is particularly hypocritical is that many, if not most, members of the General Assembly who voted for this tax, Democrats and Republicans alike, clearly understand the principle of neutrality and have invoked it to rightfully



argue in favor of extending the state sales tax to services like haircuts and legal assistance. At the present time, it only applies to tangible goods. However, there was never any movement to block the new e-cigarette excise tax on these same grounds. For this legislature, with its ushering in of tax reform in 2013, the neutrality argument has turned out to be one of convenience rather than principle.

North Carolina's e-cigarette tax piqued the interest of legislators when it was requested by Winston-Salem based R. J. Reynolds Tobacco Company.<sup>2</sup> While not currently in the e-cigarette market, R. J. Reynolds is expected to be a big, if not the biggest, player in the near future. They argued the Minnesota tax was too high, and they asked North Carolina legislators to set an example for other states proposing taxes on e-cigarettes. In other words, the imposition of this tax is primarily about yielding to pressure from a special interest in the tobacco industry. There appears to be no other explanation, since it clearly is not about good tax policy or even the need for additional revenues. The new tax is only expected to raise about \$5 million,<sup>3</sup> which is meaningless in the context of a \$20+ billion budget.

Making this process even more suspicious is the manner in which the tax made its way through the legislature. During the interim between the long and short sessions, the Revenue Laws Study Committee met to address issues that arose from the 2013 tax reform legislation. The committee drafted a bill to correct and clarify some of the provisions in the tax reform law but decided to add the e-cigarette tax to the Omnibus Tax Law Changes bill at the request of lobbyists representing R. J. Reynolds. The bill was later heard in a House committee, but due to political maneuvering,<sup>4</sup> the only amendment submitted to remove the tax from the bill was defeated.

The point is that this brand new tax has little to do with the overall purpose of the omnibus legislation, and the only way to vote against the e-cigarette tax was to vote against the entire bill, which most people believed to be necessary. The legislative leadership made sure that this new tax would not get an up or down vote on its own merits. Had they been concerned about having an above board and transparent legislative process rather than pushing the new tax through, this proposal would have been pulled from the omnibus tax bill, debated separately, and voted on as freestanding legislation, allowing it to rise or fall on its own merits. The citizens of North Carolina deserve transparency in the law making process, and they did not receive it in this case.

### **Small Entrepreneurs Will Hurt the Most**

The e-cigarette market in North Carolina, at least for now, is dominated by small businesses. An example is Mooresville-based Madvapes, which began operations in a garage in 2009. Since then, it has grown to manufacture, distribute, and develop e-cigarette products throughout the state with retail operations in Hickory, Mooresville, Denver, Charlotte, Concord, Pineville, Fayetteville, Hope Mills, Jacksonville, and Morehead City. It also has expanded operations into South Carolina, Georgia, New Jersey, and Massachusetts as well as having significant online sales.<sup>5</sup> This one business occupies 90,000 square feet of warehouse and retail space in North Carolina and employs more than 100 people. There are over 80 small e-cigarette businesses in North Carolina doing the same thing, many with multiple locations across the state.<sup>6</sup>

This e-cigarette tax stands to hurt small businesses like Madvapes, in addition to potentially tens of thousands of traditional retailers and wholesalers, because it classifies a vapor product as a tobacco product and will therefore require a tobacco license to sell, distribute, or import e-cigarette products. In addition to the increased regulatory burden, this will also add costs to the product and provide an unfair advantage to large companies, including R. J. Reynolds, who already have these operations and licenses in place. Small businesses will be forced to spend huge sums for lawyers and accountants to ensure compliance with licensing and reporting requirements, as well as possibly posting bond with the state government. These extra costs could cause some of the existing e-cigarette businesses in North Carolina to shut down, again to the benefit of big competitors like R. J. Reynolds.

## Moving Forward

No matter how you slice it, the e-cigarette tax is bad tax policy. It runs counter to basic principles of economic efficiency and individual liberty. Furthermore, the legislative process that considered and enacted it lacked all transparency. The North Carolina General Assembly should recognize its mistake and come clean with the citizens of the state, who clearly deserve better. It can do this by making history and becoming the first state in the country to repeal an e-cigarette tax.

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2. Reynolds American suggests state tax rate for e-cigarettes, May 13, 2014, Fox 8 WGHP, accessed July 3, 2014, [myfox8.com/2014/05/13/reynolds-american-suggests-state-tax-rate-for-e-cigarettes](http://myfox8.com/2014/05/13/reynolds-american-suggests-state-tax-rate-for-e-cigarettes).
3. Sandra Johnson, Fiscal Research Division, NC General Assembly, E-Cigarettes, April 23, 2014, accessed July 7, 2014, [ncleg.net/DocumentSites/committees/revenuelaws/Meeting%20Documents/2013-2014%20Meeting%20Documents/05-13-2014/Tax%20Vapor%20-%20Prohibit%20in%20Jails%20fiscal%20memo.pdf](http://ncleg.net/DocumentSites/committees/revenuelaws/Meeting%20Documents/2013-2014%20Meeting%20Documents/05-13-2014/Tax%20Vapor%20-%20Prohibit%20in%20Jails%20fiscal%20memo.pdf).
4. John Frank, News and Observer, House Tax Bill marked by Political Gamesmanship, May 15, 2014, accessed July 3, 2014, [newsobserver.com/2014/05/15/3864096/house-tax-bill-marked-by-political.html](http://newsobserver.com/2014/05/15/3864096/house-tax-bill-marked-by-political.html).
5. Map showing store locations of Madvapes, accessed July 3, 2014, [madvapes.com/store-locations](http://madvapes.com/store-locations).
6. Figure was derived from listed companies on website, assessed July 3, 2014, [vaporsearchusa.com/nc.htm](http://vaporsearchusa.com/nc.htm).

E-Cigarette Tax by State							
State	Year	Bill Number	Status	Rate or Amount of Tax	Definition	Fiscal Note	Fiscal Impact
North Carolina	2014	<a href="#">H 1050</a>	Passed	5¢/mL of liquid	Vapor Product	<a href="#">Yes</a>	\$5.1 million estimated revenue
Delaware	2013	<a href="#">HB 138</a>	Failed	30% wholesale	Tobacco Product	No	
Hawaii	2014	<a href="#">SB 2495</a>	Failed	Unspecified	Tobacco Product	No	
Indiana	2014	<a href="#">HB 1174</a>	Failed	24% wholesale	Tobacco Product	<a href="#">Yes</a>	Revenue increase of \$4.5 to \$7.1 million in FY 2015 and \$4.5 to \$7.2 million in FY 2016
Kentucky	2014	<a href="#">Gov.'s Tax Reform Prop.</a>	Failed	20% of value	Tobacco Product	<a href="#">Yes</a>	\$124.5 million fiscal impact if all tobacco tax rates were increased in proposal
Kentucky	2014	<a href="#">HB 220</a>	Failed	40% device tax	Tobacco Product	No	
Kentucky	2014	<a href="#">HB 319</a>	Failed	15% device and component tax	Tobacco Product	No	
Maine	2013	<a href="#">HP 950</a>	Failed	\$2 Wholesale tax, equal to tax on a pack of cigs	Tobacco Product	No	
Massachusetts	2013	<a href="#">HB 2593</a>	Failed	90% wholesale	Smokeless Tobacco	No	
Minnesota	2012	<a href="#">HF 677</a>	Passed	95% wholesale	Tobacco Product	<a href="#">Yes</a>	<a href="#">\$1.16 billion estimate from all tobacco taxes in FY 2014-15</a>
New Jersey	2014	<a href="#">S. 1867</a>	Failed*	75% wholesale	Tobacco Product	No	
New Jersey	2014	<a href="#">Gov.'s Budget Prop.</a>	Failed	\$2.70 per pack (same as cigarettes)	Tobacco Product	No	\$35 Million estimated revenue from e-cigarette tax
New Mexico	2013	<a href="#">HB 428</a>	Failed	53% of product value	Tobacco Product	<a href="#">Yes</a>	\$6.733 million estimated revenue if all tobacco tax rates were levied in this bill
New York	2014	<a href="#">AB8594/ SB6610</a>	Failed	75% wholesale	Tobacco Product	No	
New York	2013	<a href="#">SB4365/ AB7106</a>	Failed	95% wholesale	Tobacco Product	No	
Ohio	2014	<a href="#">Gov.'s Tax Reform Prop.</a>	Failed	41%-49% wholesale	Tobacco Product	No	
Ohio	2014	<a href="#">HB 472</a>	Failed	41%-49% wholesale	Tobacco Product	<a href="#">Yes</a>	\$8 million (41% rate; FY 2015) to \$10 million (49% rate; FY 2016)
Oklahoma	2013	<a href="#">SB 802</a>	Failed	5¢/vapor product unit	Vapor/Tobacco-Derived Product	<a href="#">Yes</a>	unknown
Oregon	2014	<a href="#">HB 4129</a>	Failed	81.25% wholesale	Tobacco Product	No	
Rhode Island	2014	<a href="#">HB 7133</a>	Failed*	80% wholesale	E-Cigarette	No	
South Carolina	2013	<a href="#">H. 4074</a>	Failed	5¢ per mL	Vapor Product	No	
Utah	2013	<a href="#">HB 372</a>	Failed	<a href="#">86% of manufacturer sales price</a>	Tobacco Product	<a href="#">Yes</a>	\$1.628 million estimated revenue from all tobacco and nicotine products
Vermont	2014	<a href="#">HB 884</a>	Failed*	92% wholesale	Tobacco Product	No	
Washington	2014	<a href="#">SB 6569</a>	Failed	95% wholesale	Tobacco Product	<a href="#">Yes</a>	Revenue expected to increase \$3.4 million in FY 2013-15 and \$38.8 million in FY 2015-17
Wisconsin	2013	<a href="#">AB 481</a>	Failed	84% wholesale	Tobacco Product	<a href="#">Yes</a>	\$11.6 million increase in revenue

\*E-Cigarette Tax removed from legislation prior to passage