In Slump, Localities Resort to Excise Taxes

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Nobody likes excise taxes—those annoying extra costs people notice only because of how narrow and random they are. They show up on hotel bills and cell phone bills. They are added on to the cost of alcohol, gasoline, and cigarettes. And the list keeps growing. For example, in 2010, Newark, New Jersey, imposed a 5% tax on rental cars[1] while Baltimore imposed a 2-cent per bottle tax on soda.[2]

New data from the Census Bureau shows just how much local governments relied on increases in excise taxes to fill budget holes during the recession. PPI calculates that excise tax revenues collected by local governments—not including gas or tobacco—increased 5.2% from 2007 to 2009, compared to a decline of 8.1% in national retail spending by consumers, including restaurants. Even when you add in gas and tobacco, excise tax revenues rose by 4.5% during the recession, while local government general sales tax revenues went up 1.6% and national output (GDP) declined by 0.6%.

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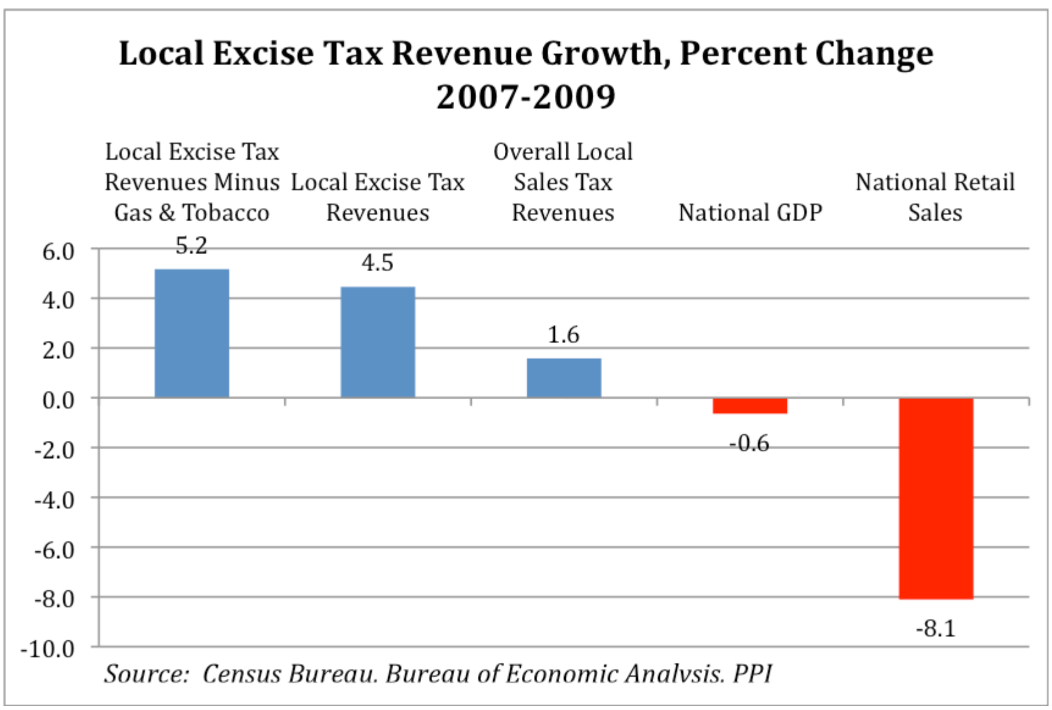

The large growth in excise taxes relative to the drop in retail sales shows that during a time when incomes were down, local government turned to these narrow, selective taxes imposed on consumers to make up the balance. For example, two tourist meccas, Las Vegas and New York City, raised hotel room taxes in 2009.[3]

While the data reported in the chart applies only to local governments, state governments also looked to excise taxes to solve their financial woes. In fact, 22 states raised excise taxes on tobacco, alcohol, or motor fuel in 2008 and 2009, with 24 states enacting other types of excise tax increases during the same period.[4]

The Problem with Excise Taxes

Excessively relying on narrow excise taxes is problematic for several reasons, even if lawmakers often see them as an easy solution to budget woes. Here's why:

Above all, excise taxes can unduly hurt poor and middle-class Americans. The fact that excise taxes are generally regressive is well-known.[5] Poor and middle-class Americans spend a greater proportion of their income on the goods and services that generally targeted for narrow taxes. Take telephone taxes, for example, which are known to be regressive.[6] Consumers whose income falls in the lowest 20% spent 3.1% of their income on telephone services during 2007-2009, compared to just 1.7% for consumers in the top 20%.[7]

What's less understood is the way that excessive excise taxes create the potential for economic harm to a locality. The narrow focus of excise taxes cause distortions in the behavior of producers and consumers which could eventually stifle the local economy, as consumer spending moves elsewhere and local businesses move away with them, or shut down. For example, when Baltimore instituted its soda tax, Pepsi moved production away and cut 77 jobs.[8] Why then did local governments increase their reliance on excise taxes during the recession? Because the same characteristics that can lead to economic harm are the very characteristics that make raising an excise tax so tempting.

Excise taxes that make for easy targets are placed on goods and services that are generally hard to substitute or physically tied to the location. For example, owners of hotels like to place them near convention centers. Immobile goods and services have no other reasonable choice but to be produced and consumed locally and consumers seemingly have no other choice but to pay.

It's easy to see why relying on excise taxes to fill budget holes is so tempting to politicians. Your jurisdiction needs money. So you increase tax rates on the stuff that can't get away very easily, and you end up taxing the core of your local economy.

But this temptation can be harmful from an economic standpoint. For example, excessively high hotel fees might cause event planners to locate the event in another city instead of booking the big annual convention in yours. Not only has your area lost the immediate hotel and convention business, but other local area businesses have also lost out from the spending of people coming to town for the event. In a worst-case scenario, a succession of similar cancellations might force local hotels to close, the convention center to close, and force shop keepers to consider a move to a more business friendly city. In this scenario, what was originally an effort to close a small deficit instead turned into a giant sinkhole that could cause the local economy to spiral downward.

Conclusion

Jacking up excise taxes during times of budget hardship is a poor solution for governments seeking to fill budget gaps. Excise taxes are regressive, imposing fresh burdens on poor and middle-income families at times when they can least afford it. Moreover, excessive hikes could trigger a downward spiral that could ruin any local or state economy if businesses are forced to close or move away. Instead, governments should stop assuming excise taxes are a "get out of jail free" card and realize there is always a price to pay, a price they may not be able to afford.

Endnotes

[1] Gary Stroller, "Rental Car Taxes Are Getting Jacked Up," USA Today, November 2009: http://www.usatoday.com/travel/news/2009-11-02-rental-car-taxes-rising_N.htm.
[2] Andrea Walker, "Pepsi to Stop Making Beverages in Baltimore," Baltimore Sun, January 2011: http://articles.baltimoresun.com/2011-01-10/business/bs-bz-pepsi-job-losses-20110110_1_beverage-tax-pepsi-officials-diet-pepsi.
[3] Dennis Cauchon, "Tourists Pay Price as States Jack Up Taxes to Balance Budgets," USA Today, July 2009: http://www.usatoday.com/travel/2009-07-05-traveltax_N.htm.
[4] Center on Budget and Policy Priorities, "State Tax Changes in Response to the Recession," March 2010: http://www.cbpp.org/cms/index.cfm?fa=view&id=3108.
[5] eNotes Reference Guide, "Excise Taxes": http://www.enotes.com/excise-tax-reference/excise-tax.
[6] Steven Maguire and Brent Mast "The Telephone Excise Tax: An Economic Analysis," Congressional Research Service, Report RL33382, June 29, 2006: http://assets.opencrs.com/rpts/RL33382_20060629.pdf.
[7] Author's calculations using data from the Bureau of Labor Statistics, Current Expenditure Survey.
[8] Andrea Walker, "Pepsi to Stop Making Beverages in Baltimore," Baltimore Sun, January 2011: http://articles.baltimoresun.com/2011-01-10/business/bs-bz-pepsi-job-losses-20110110_1_beverage-tax-pepsi-officials-diet-pepsi.

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