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Permanence for Alcohol Excise Tax Reforms

Erica York
Analyst

Key Findings

- The United States levies several excise taxes, which are taxes on specific goods or activities rather than a general tax base like income. Alcohol excise taxes fall under this category and are levied on manufacturers and importers of the three main alcohol commodities: beer, wine, and spirits.
- While excise taxes do have a role as a public policy tool, the current excise tax rates on alcohol do not conform to the principles of sound tax policy. Rather than purposefully setting rates at an efficient level to discourage risky behavior, alcohol excise tax rates have been arbitrarily set at high levels for the purpose of revenue generation.
- Research shows that casual drinkers, who impose little to no cost on society through their drinking behavior, bear a disproportionally large share of the alcohol excise tax burden.
- The Tax Cuts and Jobs Act made the first reforms to the federal alcohol excise taxes since 1990, lowering the rates for all three commodities. The lower rates will only be in effect for two years, sunsetting after the end of 2019.
- The temporary nature of the tax cuts, and the possibility of a tax rate increase on the horizon, means these reforms will not encourage additional business investment and activity.
- The federal alcohol excise tax reforms of the Tax Cuts and Jobs Act should be made permanent, so businesses have the certainty they need to invest and expand.

Editor, Rachel Shuster
Designer, Dan Carvajal

Tax Foundation
1325 G Street, NW, Suite 950
Washington, DC 20005

202.464.6200

taxfoundation.org

Introduction

By including major components of the Craft Beverage Modernization and Tax Reform Act in the Tax Cuts and Jobs Act (TCJA), Congress made the first major changes to federal alcohol excise taxes since 1990. This paper reviews the background and economics of excise taxes. Ideally, excise taxes should be set to reflect the externality, or societal harm, of a product, and not as a way to generate review. Additionally, these provisions in the TCJA expire after only two years, presenting challenges to business investment and activity. This paper examines the reforms made to alcohol excise taxes in the TCJA in this context.

Federal Alcohol Excise Taxes

Excise taxes are taxes levied on specific goods or activities rather than on general tax bases such as income or consumption. The federal government levies many types of excise taxes, including on the manufacturers or importers of the three main alcohol commodities: beer, wine, and spirits. Prior to the Tax Cuts and Jobs Act, federal excise taxes amounted to about five cents per 12-ounce can or bottle of beer, four cents per five-ounce glass of wine, and 13 cents per 1.5-ounce shot.[1]

Alcohol excise taxes were one of the first revenue sources for the United States government, dating to the first distilled spirits tax imposed in 1791, which sparked the Whiskey Rebellion.[2] Historically, they have been imposed to raise emergency revenue in times of war or over budget deficit concerns.[3] Federal alcohol excise taxes were last increased in 1991 under the Omnibus Budget Reconciliation Act of 1990.[4]

Evaluating Excise Taxes

Excise taxes violate the principle of neutrality,[5] which states that taxes should not distort relative prices or disproportionately treat different goods or activities.

Though alcohol excise taxes are levied at the manufacturer or importer level, these businesses do not bear the actual economic burden of the tax. Instead, alcohol excise taxes are passed along to the consumer level, pushing consumer prices higher.[6] For example, research shows that more than 40 percent of the retail price of beer goes to cover the applicable taxes.[7]

Consider the effect excise taxes have on consumers.[8] Consumers try to maximize their utility, or their well-being, as they make choices between a variety of options and prices. But when a good is subject

1 Sean Lowry, "Alcohol Excise Taxes: Current Law and Economic Analysis," Congressional Research Service, Dec. 23, 2015. It should be noted that states impose alcohol excise taxes separate from the federal alcohol excise taxes.

2 Michael Hoover, "The Whiskey Rebellion," U.S. Department of the Treasury, https://www.ttb.gov/public_info/whisky_rebellion.shtml.

3 Ibid.

4 Public Law No: 101-50, https://www.congress.gov/bill/101st-congress/house-bill/5835.

5 Andrew Chamberlain, "Ten Principles of Sound Tax Policy," Tax Foundation, Oct. 7 2005, https://taxfoundation.org/ten-principles-sound-tax-policy/.

6 Katharine Loughead, "How High are Beer Taxes in Your State?" Tax Foundation, May 24, 2018, https://taxfoundation.org/state-beer-taxes-2018/.

7 Beer Institute, "FACT Sheet Craft Beverage Modernization and Tax Reform Act of 2018," http://www.beerinstitute.org/wp-content/uploads/2016/11/S.-1562-Craft-Beverage-Modernization-and-Tax-Reform-Act-of-2015-One-Pager.pdf.

8 John R. McGowan, "Excise Taxes and Sound Tax Policy, Tax Foundation, May 1997, 7, https://taxfoundation.org/excise-taxes-and-sound-tax-policy/.

to an excise tax, its price increases. A higher price discourages consumers from purchasing the good—instead they might buy less of that good, switch to a different good that isn't taxed, or decide not to spend that money at all. Consumers still try to maximize their well-being under these new circumstances, but their well-being is lower than it otherwise would have been without the tax.

Excise taxes also reduce economic efficiency elsewhere. As consumers shift their behavior in response to an excise tax, producers also shift their behavior. Producers might move their resources away from producing the now-taxed goods towards other, untaxed goods. This is suboptimal; after this tax-induced capital reallocation, economic output is lower than it otherwise would have been.

However, these effects are sometimes thought to be warranted[9]; in cases where the market may result in a "false price," excise taxes might correct for the perceived market failure. Specifically, if the costs of some activity are *external* to the transaction–thus borne by the rest of society–the government may impose an excise tax, referred to as a Pigouvian tax, on the activity to *internalize* those costs and more accurately price said activity.

A common example of an external cost, called a negative externality, is pollution. When a person engages in an activity that emits pollution, the harm reaches people who are not directly involved in the activity. Imposing a tax on the activity that emits the pollution would more accurately price that activity to capture the cost of the harm it causes others; this would both encourage the optimal level of that activity, given its true costs, and provide revenues that could be used to alleviate harm.

Thus, when negative externalities appear to occur, the effects of an excise tax are intentional. However, several problems exist with imposing excise taxes in response to negative externalities:[10]

- There is usually no way to accurately measure the societal cost or externality.
- It is difficult to measure the effectiveness of public policies in deterring externalities.
- Fully efficient taxes that endeavor to recover external social costs may vary by location and person; a theoretically correct tax would need to vary according to these differences.

In the case of alcohol excise taxes, these problems exist. Empirical evidence suggests that when alcohol excise taxes are increased, consumer prices increase in response; in some cases, excise taxes are over-shifted, meaning the burden to the consumer is greater than the amount of tax increase.[11]

9 Ibid, 9.

10 R.E. Cordato, "Social Costs, Public Policy, and Freedom of Choice, Fiscal Issues #7," Institute for the Research on the Economics of Taxation, 1992, as referenced in John R. McGowan, "Excise Taxes and Sound Tax Policy."

11 Douglas J. Young and Agnieszka Bieli´nska–Kwapisz, "Alcohol Taxes and Beverage Prices," *National Tax Journal* LV:1, March 2002, https://www.ntanet.org/NTJ/55/1/ntj-v55n01p57-73-alcohol-taxes-beverage-prices.pdf.

This means that *all* alcohol consumers bear the costs of alcohol excise taxes, not just the consumers with harmful behaviors. Research by Ayyagari et al. indicates that higher prices tend to make light and moderate drinkers decrease their consumption, while heavy drinkers are not deterred by the tax:[12]

> Only a subgroup responds significantly to price. Importantly, the unresponsive group drinks more heavily, suggesting that a higher price could fail to curb drinking by those most likely to cause negative externalities. In contrast, those least likely to impose costs on others are more responsive, thus suffering greater deadweight loss yet with less prevention of negative externalities.

While alcohol excise taxes do discourage consumption, they do so for the wrong group of consumers. They negatively affect individuals who don't impose societal costs, while having little to no effect curbing heavy drinking and abuse that does impose a societal cost.

The rationales for imposing alcohol excise taxes–wartime revenues and deficit reduction–are likewise flawed. It is also worth noting that the goal of raising additional revenue is in conflict with the goal of harm reduction. If the goal of alcohol excise taxes is to reduce consumption, this reduces the revenue source. Given the motivations for increasing alcohol excise taxes in the past, there is little indication that current rates have been set in a purposeful way to offset any negative externalities.

Alcohol excise taxes have been imposed for their revenue-generating potential rather than as a precise policy tool to carefully offset externalities, leading to price distortions that reduce consumer well-being. As currently structured, alcohol excise taxes are an ineffective public policy tool, causing more economic harm than benefit.

12 Padmaja Ayyagari, Partha Deb, Jason Fletcher, William T. Gallo, and Jody L. Sindelar, "Sin Taxes: Do Heterogeneous Responses Undercut Their Value?" National Bureau of Economic Research, July 2009, http://www.nber.org/papers/w15124.

The Tax Cuts and Jobs Act Lowered Federal Alcohol Taxes

The Tax Cuts and Jobs Act made the first changes to federal alcohol excise taxes since 1990, lowering the tax burden on all three major alcohol commodities: beer, wine, and spirits.

The Joint Committee on Taxation estimates the cost of lowering the federal alcohol excise taxes for 2018 and 2019 will be $4.2 billion.[13] However, the lower excise tax rates are only scheduled to be in effect for two years, expiring after December 31, 2019.

Beer

Prior to the TCJA, large producers, defined as producing more than two million barrels, faced an excise tax of $18 per barrel, amounting to five cents per 12-ounce can or bottle of beer.[14] Small producers faced a lower tax on their first 60,000 barrels and paid the same tax as large producers on barrels above 60,000 up to two million. The TCJA lowered both of these excise tax rates for two years, retaining the same threshold for small versus large producers.

TABLE 1.

Federal Excise Taxes on Beer Before and After TCJA

Before TCJA	
	Per Barrel (31 gallons)
Regular rate for large producers	$18
Reduced rate for small producers (no more than 2 million barrels)	$7 on first 60,000 $18 after first 60,000
After TCJA	
Regular rate for large producers	$16 on first 6 million $18 after first 6 million
Reduced rate for small producers (no more than 2 million barrels)	$3.50 on first 60,000 $16 after first 60,000

Source: Alcohol and Tobacco Tax and Trade Bureau, "Tax and Fee Rates"

Wine

The excise tax rates levied on wine vary by alcohol content and carbonation level. Prior to the TCJA, table wine was defined as still wine having 14 percent alcohol or less and was taxed $1.07 per gallon, amounting to four cents per 5-ounce glass of wine.[15] The TCJA eased the threshold for table wine, increasing it to 16 percent or less of alcohol content, but that is only for two years.

13 The Joint Committee on Taxation, "Estimated Budget Effects Of The Conference Agreement For H.R.1, The "Tax Cuts And Jobs Act"" Dec. 18, 2017, 6, https://www.jct.gov/publications.html?func=startdown&id=5053.

14 Sean Lowry, "Alcohol Excise Taxes: Current Law and Economic Analysis."

15 Ibid.

Prior to the TCJA, small wine producers were able to claim credits against their excise tax liability. This credit allowed up to $0.90 per wine gallon on the first 100,000 gallons produced per year. The credit phased out 1 percent per 1,000 gallons above 150,000 gallons, meaning it was unavailable to producers making more than 250,000 gallons per year. The TCJA changed the credit amount and eliminated the phaseout, making it available to all wine producers, not just small producers.

TABLE 2.

2018 and 2019 Tiered Wine Credit System

Credit per Gallon	Threshold
$1.00	0 to 30,000 gallons
$0.90	30,001 to 130,000
$0.535	130,001 to 750,000

Source: Alcohol and Tobacco Tax and Trade Bureau, “Tax Cuts and Jobs Act of 2017, Summary of Distilled Spirits, Wine, and Beer Excise Tax Provisions”

The new wine credits offset $1.00 of excise tax on the first 30,000 gallons produced, $0.90 on the next 100,000, and $0.535 on the next 620,000. This effectively means wine faces a graduated excise tax schedule, as shown in the table below, for the next two years.

TABLE 3.

Wine Tax Rates for 2018 and 2019

	Wine Gallons per Calendar Year			
Type	First 30,000	Over 30,000 up to 130,000	Over 130,000 up to 750,000	Over 750,000
Still wine up to 16%	$0.07	$0.17	$0.535	$1.07
Still wine over 16% up to 21%	$0.57	$0.67	$1.035	$1.57
Artificially carbonated wine	$2.30	$2.40	$2.765	$3.30
Naturally sparkling wine	$2.40	$2.50	$2.865	$3.40
Hard cider	$0.164	$0.17	$0.193	$0.226

Source: Alcohol and Tobacco Tax and Trade Bureau, “Tax and Fee Rates”

Spirits

Prior to the TCJA, all spirits faced a $13.50 excise tax per proof gallon, amounting to 13 cents per 1.5-ounce shot.[16] The TCJA introduced a graduated excise tax, lowering the tax burden on spirits for all producers and importers. The Alcohol and Tobacco Tax and Trade Bureau (TTB) defines proof gallons as one liquid gallon of spirits that is 50 percent alcohol at 60 degrees F.[17]

TABLE 4.

2018 and 2019 Graduated Federal Excise Tax Rate on Spirits

Proof Gallons per Calendar Year	Tax Rate Per Proof Gallon
0 to 100,000	$2.70
Above 100,000 up to 22,230,000	$13.34
Above 22,230,000	$13.50

Source: Alcohol and Tobacco Tax and Trade Bureau, "Tax and Fee Rates"

Evaluating the Alcohol Excise Tax Cuts

The structure of the current excise tax rates on alcohol violates some of the criteria for sound tax policy: administrability, simplicity, neutrality, and economic efficiency.[18]

Administrability and Simplicity

The graduated structure of the rates, and their application to domestically produced and imported alcohol, will require administrators to track new information, such as which barrel exceeds a rate threshold, in order to enforce the new law. This information might not be readily available or verifiable, especially in the context of importation.

Thus, the new rates are particularly complex for businesses that import alcohol. Instead of immediately paying the lower tax rate, importers have continued paying the higher tax rates under the old law. Interim rules issued in August 2018[19] explained that importers would eventually get tax relief through refunds—but the rules did not specify when or how this might occur.[20] Thus, in the meantime, these importers are paying the full excise tax rates instead of lowered rates. This is inequitable and contributes to uncertainty regarding the new law. Because they are still paying the old, higher excise tax rates, these companies have less cash flow than they would have if they received tax cuts in real time.

16 Ibid.

17 U.S. Department of Treasury, Alcohol and Tobacco Tax and Trade Bureau, "Frequently Asked Questions TTB Form 5110.40," https://www.ttb.gov/forms_tutorials/f511040/faq_instructions.html.

18 For a discussion of these principles, see Scott Greenberg and Nicole Kaeding, "Reforming the Pass-Through Deduction," Tax Foundation, https://taxfoundation.org/reforming-pass-through-deduction-199a/.

19 U.S. Customs and Border Protection, Department of the Treasury, "Refund of Alcohol Excise Tax," Aug. 16, 2018, https://www.federalregister.gov/documents/2018/08/16/2018-17710/refund-of-alcohol-excise-tax.

20 Bernie Becker, "Headache for booze importers: Getting their tax cut," Politico Pro, Sept. 4, 2018, https://subscriber.politicopro.com/tax/article/2018/09/headache-for-booze-importers-getting-their-tax-cut-764858. [Subscription required]

In October 2018, further guidance was issued providing clarity on the procedures to make claims for refunds, as well as an indication that additional guidance is on the way to allow importers to contemporaneously pay the lower taxes going forward.[21] This guidance will include a way for importers to track their eligibility, and means that if the schedule is followed, importers could potentially access the lower tax rates at the end of October,[22] 10 months after the law was enacted.

Neutrality

Under prior law, the alcohol content of distilled spirits was taxed at a higher rate than that of beer and wine. In the past, this amounted to about 21 cents per ounce of pure alcoholic content of spirits, 10 cents per ounce of alcohol of beer, and eight cents per ounce of alcohol in wine.[23] The changes in the TCJA did not address the nonneutral rates across types of alcohol.[24]

The design of the excise tax rates applying to beer, lower rates for smaller producers and higher rates for larger producers, is also nonneutral. Small producers pay a tax of $3.50 on their first 60,000 barrels of beer produced, while large producers pay a tax of $16 on their first 6 million barrels of beer produced. Taxing the first barrels at different rates depending on overall production levels is discriminatory.

Economic Efficiency

If the goal of lowering the tax burden on alcohol producers and importers is to encourage additional investment and growth, doing so temporarily will not effectively achieve that end.

This is because investment is a forward-looking behavior. The possibility that a tax credit will expire, or a rate will increase in the future, makes long-term investments less appealing. If a business owner makes a long-term investment that will begin generating revenue in later years, a two-year tax cut does them no good.

If these lower excise tax rates were permanent, they would be more economically efficient, and administrators would have time to work out enforcement. Temporary policies and subsequent short-term extensions do little in the way of the long-term certainty needed to make investment decisions. Lawmakers ought to avoid allowing the lower rates to fall into the tax extenders trap like so many other provisions that were originally designed to sunset.[25]

21 Marc E. Sorini, "New CBMA Guidance Further Clarifies Excise Tax Rules for Imported Beverages," *The National Law Review*, Oct. 8, 2018, https://www.natlawreview.com/article/new-cbma-guidance-further-clarifies-excise-tax-rules-imported-beverages.

22 Ibid.

23 Sean Lowry, "Alcohol Excise Taxes: Current Law and Economic Analysis," 4.

24 This should not be misunderstood to mean rates should be *increased* to a neutral level. Alcohol excise tax rates have historically been increased for the purposes of raising revenue, not for the purposes of economic efficiency, and thus the high rates create more economic harm than benefit.

25 Erica York, "Recommendations to Congress on the 2018 Tax Extenders," Tax Foundation, April 17, 2018, https://taxfoundation.org/2018-tax-extenders/.

Conclusion

The Tax Cuts and Jobs Act made the first changes to federal alcohol excise taxes since 1990, lowering the rates on all three major alcohol commodities. While excise taxes may sometimes be used to address societal costs or discourage bad behavior, alcohol excise taxes have not historically fulfilled this role. Instead, they have been used as a source of emergency revenue, violating many principles of sound tax policy.

While lawmakers have successfully lowered the tax burden on alcohol, they have only done so temporarily, and temporary tax cuts are not economically efficient. If lawmakers want to encourage business activity and investment, they ought to make the federal excise tax cuts permanent.