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## HOW STATES USE LIQUOR MARKUPS TO HIDE THE BILL FROM TAXPAYERS

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### EXECUTIVE SUMMARY

In states that hold a monopoly on the sale of spirits, liquor prices usually are set by a formula that includes at least one of three different components: taxes, fees and price markups. Markups are formally enacted by liquor regulators—usually in the form of a board—who are tasked to oversee alcohol sales in the state. In recent years, governments in these so-called “control states” have relied more and more on the revenue derived from these markups, as state lawmakers frequently have included calls for higher markups in their budget proposals.<sup>1</sup>

These artificially created price bumps exceed the level of increase that would be sustained on the open market and the revenue from these increases often accrues directly to a state’s general fund. In this way, they function very similarly to taxes. Furthermore, liquor markups are readily distinguishable from nearly every other form of government-imposed fee, since they target a good designed for private consumption. Perhaps worse is that, despite their clear resemblance to taxes, markups frequently do not need to be ratified by state legislatures in the way that other taxes do.

This allows lawmakers in control states effectively to hide the cost from state taxpayers.

### A TAX IN EVERYTHING BUT NAME

Retail liquor markups in control states usually are set as a percentage of the wholesale price of the liquor in question. For example, in Virginia, the Alcoholic Beverage Commission (ABC) assesses a 69 percent markup over the wholesale price for each bottle of distilled spirits sold in the state.<sup>2</sup> In Pennsylvania, the Liquor Control Board (PLCB) previously applied a 30 percent markup over wholesale, before recently transitioning to a variable markup scheme.<sup>3</sup>

The result is that many state liquor markups operate much like *ad valorem* taxes, which are charged according to the value of a good. With *ad valorem* taxes, as the price of a good rises, the amount of the tax rises proportionately.<sup>4</sup> In other words, a bottle of bourbon that costs \$10 at wholesale will be \$13 after a 30 percent markup is applied, while a \$20 wholesale bottle would be \$26 after the markup. The amount of the markup therefore rises in proportion to the price of the liquor—\$3 for the cheaper bottle rises to \$6 for the more expensive one.

Further, also like taxes, state liquor markups are readily differentiated from other types of government-imposed fees or citations, like tolls, bus fares or speeding tickets.<sup>5</sup> Fees are used by governments to recoup and pay for the cost of a certain public good the government provides, while citations are used to deter unlawful behavior. In the case of a bus fare, the \$3 charge covers the cost of a ride; with speeding tickets, the purpose is to dissuade citizens from breaking the speed limit. Liquor markups, however, apply whenever a citizen purchases a bottle of liquor for their own private consumption. In nearly every other situation involving private goods—for example, excise taxes on cigarettes—states use taxes rather than government-mandated markups to generate revenue.<sup>6</sup>

Moreover, money collected from state-imposed liquor markups frequently flows to the general coffers of state governments,<sup>7</sup> where the funds may be used, for example, to finance state employee pensions or for other purposes unrelated to the costs of liquor retailing. This is significant, because courts that have attempted to distinguish government-imposed fees from taxes have generally done so by probing the primary purpose of the tax or fee. Where the primary purpose is to raise general revenue for the government, rather than to fund the particular expense of a regulation, courts frequently have construed the fee to be a tax.<sup>8</sup>

Accordingly, liquor markups in control states are most properly viewed as a form of taxation, which raises fundamental issues about how they are enacted.

## TAXES SHOULD BE PASSED BY LEGISLATORS

Often, the decision to raise liquor markups is delegated to state liquor agencies, which mostly operate independently of state legislatures and governors. While several control states set some form of statutory—i.e., legislatively determined—range or cap for markups, many do not.<sup>9</sup>

This lack of legislative guidance is problematic. From the earliest roots of democratic, constitutional government, it has been recognized that the power of taxation should rest with representatives of the citizenry. This has traditionally been understood to mean that taxes should be ratified by the branch of government that resides closest to the people—the legislature.

“No taxation without representation” was, of course, a key rallying cry in 1760s America in the run-up to the Revolutionary War, but it traces back even earlier:

Where shall this power [to tax] reside? In the long battle for human rights this was always a foremost question.

The conflict between John of England and his barons arose from the fact that the king had been arbitrarily taking sums of money from his subjects, and one of the most important clauses in Magna Carta (1215) was a promise that in the future no contributions (aids) to the public treasure should be made except by the consent of the general council of the realm...

A similar question gave rise to the American revolution and the outcome of that contest confirmed the principle that in America taxes cannot be levied without either the personal consent of the people or the consent of their representatives. In this principle lies the cardinal fact of taxation; in all countries where civil liberty is enjoyed the taxing power resides in the legislature.<sup>10</sup>

The importance of placing the taxing power in the legislature was confirmed by the U.S. Constitution, in which the very first enumerated power of Congress is the “Power To lay and collect Taxes.”<sup>11</sup> The principle was further underscored by Alexander Hamilton in *The Federalist Papers*:

Nations in general, even under governments of the more popular kind, usually commit the administration of their finances to single men or to boards composed of a few individuals, who digest and prepare, in the first instance, the plans of taxation, which are afterwards passed into laws by the authority of the sovereign or legislature.<sup>12</sup>

As this history shows, lodging the taxing power with the

people’s elected representatives is one of the core features of America’s constitutional framework. This is no less true at the state level, where for the most part, the constitutional structure and separation of powers mirrors the tripartite system of the federal government.

The courts that have construed the taxing power have agreed. As the Supreme Court affirmed in the seminal case *McCulloch v. Maryland*, the power of taxation resides in the legislature explicitly to protect against governmental abuse:

It is admitted, that the power of taxing the people and their property, is essential to the very existence of government, and may be legitimately exercised on the objects to which it is applicable, to the utmost extent to which the government may choose to carry it. *The only security against the abuse of this power, is found in the structure of the government itself. In imposing a tax, the legislature acts upon its constituents. This is, in general, a sufficient security against erroneous and oppressive taxation.*<sup>13</sup>

At the federal level, while Congress has broadly (and in many cases, over-broadly) delegated its legislative powers to executive branch agencies, it has been notably less willing to delegate *taxing* power to agencies.<sup>14</sup> Thus, to place this type of *de facto* taxing power with state liquor agencies runs counter to these long-held ideals. It also allows politicians to obfuscate state budgeting decisions and revenue-raising measures.

## HIDING THE BILL FROM TAXPAYERS

State-controlled liquor sales and the markups they employ generate substantial income for state governments. For example, Virginia’s ABC system, dubbed “the golden goose of the commonwealth,”<sup>15</sup> has generated annual profits of more than \$150 million in recent years.<sup>16</sup> At least a portion of these profits are sent to the state’s general fund and therefore help finance the government at-large.<sup>17</sup>

In many states, the connection between markup revenue and general government funding has become explicit. For example, after a decision to raise markups on certain liquors in Pennsylvania this past year, a spokesman for the PCLB cited rising public-pension costs and unemployment benefits as the reason for the increase.<sup>18</sup> Pennsylvania’s governor has even proposed using the state’s liquor system profits as security for a loan that would help balance the state budget, further cementing the link between liquor revenues and general government funding.<sup>19</sup>

However, to use money generated from state-controlled liquor markups in this way allows public officials and lawmakers to hide the bill from taxpayers. Rather than rely on traditional tools of revenue generation—such as property,

sales or income taxes—these states lean on their government-run liquor system. This allows politicians in those states to draw on stealthily collected revenue streams and to avoid politically contentious policy positions, such as explicit tax increases or spending cuts.<sup>20</sup>

It is also worth noting that state liquor markups have the effect of singling out a specific industry—craft spirits—for adverse treatment. As the R Street Institute’s Kevin Kosar has pointed out: “Instead of presenting the public with the bill for the goods and services they consume, elected officials are hiding the true cost of government by shifting the burden to consumers of privately produced products [distilled spirits].”<sup>21</sup> In addition to consumers, makers of spirits face a double burden, since higher markups lead to increased prices and decreased demand.

Worst of all, even if state residents are cognizant of these markups, they cannot effectively use the ballot box to hold public officials accountable for them. This is because these state liquor regulators rarely are elected officials. If states are going to target liquor, they should at least do so in the open, where voters can force them to account for their actions.

## CONCLUSION

Liquor markups from government-operated liquor boards function in a near-identical manner to taxes. Despite this similarity, many states allow their liquor agencies to raise markups without legislative approval or guidance. This setup ultimately allows state officials to hide the bill from taxpayers and to rely on what amounts to backdoor taxes to plug budget gaps, all while avoiding politically contentious policy decisions.

At the very least, states with government-operated liquor systems should bring more transparency to the markup process by requiring explicit legislative approval of any increase in markups.<sup>22</sup> Better yet, control states should consider getting out of the liquor business entirely and transitioning to a private, market-based model.

## ABOUT THE AUTHOR

**C. Jarrett Dieterle** is a governance project fellow with the R Street Institute. He is also a member of R Street’s alcohol policy team and the editor of *DrinksReform.org*, which tracks and analyzes alcohol laws from around the country.

Jarrett joined R Street in January 2017, having previously worked as a regulatory attorney at a Washington law firm. In that role, he advised private companies about how to navigate complex regulatory regimes and helped them to challenge overreaching regulations. His practice also included appellate advocacy, including co-authoring several Supreme Court amicus briefs. He previously clerked for a federal judge on the U.S. Court of Federal Claims.

## ENDNOTES

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2. “Liquor Sales in Virginia: How Virginia Drinks,” *The Washington Post*, Aug. 5, 2010. <http://www.washingtonpost.com/wp-srv/special/metro/alcohol-sales-in-virginia>.
3. See, e.g., Nathan Lutchansky, “Maintaining State Revenue in a Privatized System,” PLCB Users Group, March 17, 2011. <http://plcbusersgroup.org/2011/03/maintaining-revenue.html>; and Harold Brubaker, “The PLCB and its new pricing power,” *Philly.com*, Dec. 16, 2016. <http://www.philly.com/philly/business/retail/The-PLCBs-new-pricing-power.html>.
4. Christopher T. Conlon and Nirupama S. Rao, “The Price of Liquor is Too Damn High: Alcohol Taxation and Market Structure,” *NYU Wagner Research Paper* No. 2610118, Sept. 15, 2015, 8. [https://wagner.nyu.edu/files/faculty/publications/Liquor\\_Paper\\_Submission.pdf](https://wagner.nyu.edu/files/faculty/publications/Liquor_Paper_Submission.pdf).
5. It is possible to think of other government markups for private goods, such as souvenirs or concessions sold at government park gift shops. While these types of goods are beyond the purview of this paper, it is worth noting that they operate on a much smaller scale than the millions of dollars derived from state-run alcohol control systems.
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7. See, e.g., Virginia Department of Alcoholic Beverage Control, *Annual Report 2016*, p. 2. <https://www.abc.virginia.gov/library/about/pdfs/2016ar.pdf?la=en>; Pennsylvania Liquor Control Board, *Fiscal Year 2015-16 Annual Report*, p. 50. [http://www.lcb.pa.gov/About-Us/News-and-Reports/Documents/Annual%20Report%202015\\_2016.pdf](http://www.lcb.pa.gov/About-Us/News-and-Reports/Documents/Annual%20Report%202015_2016.pdf); and Alabama Alcoholic Beverage Control Board, *Annual Report Fiscal Year 2014-15*, p. 14. [http://www.abcboard.state.al.us/\(S\(xtcegoj35qon1xsgj5ezeek\)\)/PDFs/Annual\\_Reports/AnnualReport\\_FY2015.pdf](http://www.abcboard.state.al.us/(S(xtcegoj35qon1xsgj5ezeek))/PDFs/Annual_Reports/AnnualReport_FY2015.pdf).
8. See, e.g., *San Juan Cellular Telephone Co. v. Public Service Com’n of Puerto Rico*, 967 F.2d 683 (1st Cir. 1992), which noted that in distinguishing between regulatory fees and taxes courts have tended “to emphasize the revenue’s ultimate use, asking whether it provides a general benefit to the public, of a sort often financed by a general tax, or whether it provides more narrow benefits to regulated companies or defrays the agency’s costs of regulation”). See also, *Schneider Transport, Inc. v. Cat-tanach*, 657 F.2d 128 (7th Cir. 1981); *Clean Water Coalition v. The M Resort, LLC*, 255 P.3d 247 (Nev. 2011); *Hawaii Insurers Council v. Lingle*, 201 P.3d 564 (Hawaii 2008); *Health Services Medical Corp. of Cent. New York, Inc. v. Chassin*, 668 N.Y.S.2d 1006 (1998).
9. The following control states have at least some statutory guidance regarding liquor markups: Iowa (Iowa Code § 123.24); Michigan (Mich. Comp. Laws § 436.1233); Mississippi (Miss. Code Ann. § 27-71-11); Ohio (Ohio Rev. Code Ann. § 4301.10); Utah (Utah Code Ann. § 32B-2-304); and Wyoming (Wyo. Stat. Ann. § 12-2-303).
10. “Taxation, The Source of the Taxing Power,” *The Encyclopedia Americana*, ed. Frederick Beach, XV, 1904.
11. U.S. Const., Art. I, Sec. 8.
12. *Federalist Paper* No. 36 (emphasis added).
13. *McCulloch v. Maryland*, 17 U.S. 316 (1819) (emphasis added). States courts have held similarly. See *Scovill v. City of Cleveland*, 1 Ohio St. 126 (1853) (citing *Providence Bank v. Billings*) (“This vital power [of taxation] may be abused; but the interest wisdom and justice of the representative body, and its relations with its constituents, furnish the only security against unjust and excessive taxation, as well as against unwise legislation”).
14. See James R. Hines Jr. and Kyle D. Logue, “Delegating Tax,” 114 *Mich. L. Rev.* 235, 248 (2015).
15. Michael Martz, “ABC raises liquor prices an average 24 to 29 cents a bottle,” *The News & Advance*, Nov. 17, 2014. [http://www.newsadvance.com/news/state/abc-raises-liquor-prices-an-average-to-cents-a-bottle/article\\_fe248ce8-6e45-11e4-aa2e-770b1cb921bf.html](http://www.newsadvance.com/news/state/abc-raises-liquor-prices-an-average-to-cents-a-bottle/article_fe248ce8-6e45-11e4-aa2e-770b1cb921bf.html).
16. Virginia ABC, *Annual Report 2016*, p. 2.
17. *Ibid.*; PLCB, *Fiscal Year 2015-16 Annual Report*, p. 50; Alabama ABC, *Annual Report Fiscal Year 2014-15*, p. 14.
18. Justine McDaniel, “Price hikes at Pa. liquor stores: Will buyers notice?,” *Philly.com*, Aug. 28, 2017. <http://www.philly.com/philly/news/pennsylvania/liquor-stores-reform-plcb-prices-20170827.html>.

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20. In many ways, this situation mirrors the recent trend among states and localities to use fees and tickets to generate substantial revenue. Using liquor markups for these revenue-generating purposes is arguably even more problematic, however, given that they attach to private consumption goods rather than public goods and services. See, e.g., C. Jarrett Dieterle, "Citation Nation," *City Journal*, April 4, 2017. <https://www.city-journal.org/html/citation-nation-15093.html>.

21. Kevin Kosar, "Pennsylvania's Stealth Tax on Drinks," *The American Spectator*, Sept. 13, 2017. <https://spectator.org/pennsylvanias-stealth-tax-on-drinks>.

22. C. Jarrett Dieterle, "Raising alcohol taxes is a bad bet for West Virginia," *Charleston Gazette-Mail*, April 1, 2017. <http://www.wvgazette.com/daily-mail-commentary/20170401/c-jarrett-dieterle-raising-alcohol-taxes-is-a-bad-bet-for-west-virginia-daily-mail>.