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THE FUTURE IS NOW:

A Plan to Modernize North Carolina's Revenue System

February 2011



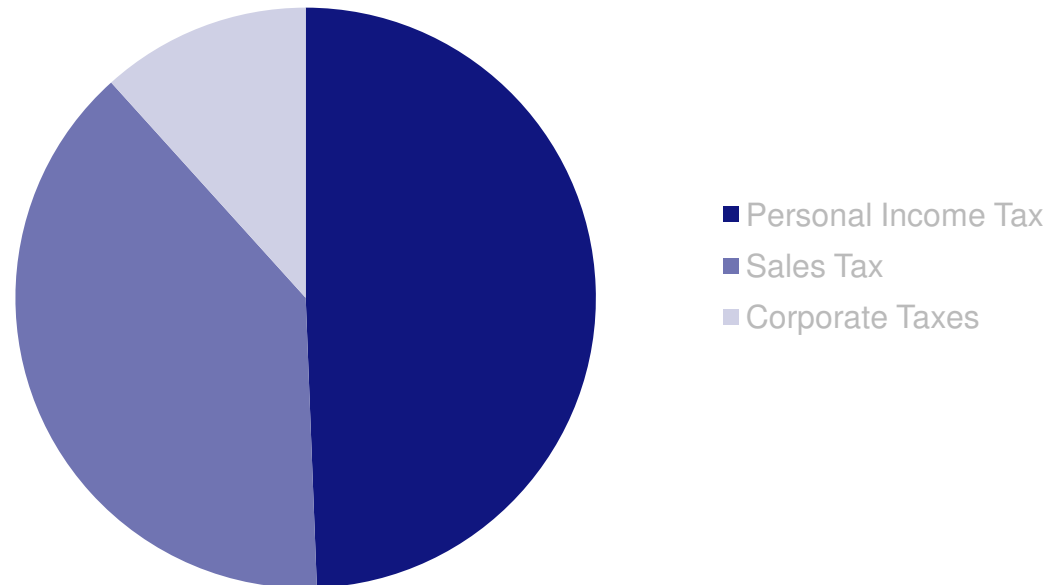
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Revenue Plan Goals

Protect effective public investments
with a modernized revenue system (and raise \$1.28 billion)

Half of new revenue will come from modernizing the personal income tax.





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Revenue Plan Goals

A modern revenue system should improve long-term adequacy, minimize volatility and ensure equity so that the state can invest in North Carolina's shared prosperity.



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More than the Recession

North Carolina has been hit hard by the global economic downturn.

However, tax revenues are falling at a greater rate than the larger economy because of **the state's flawed and outdated tax system.**



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The Case for Revenue Reform

- There are problems with North Carolina's current revenue system that undermine the state's ability to fulfill its mission and support the economic recovery.
- Research shows that revenue reform can improve the economy's ability to grow and innovate in the long-term.
- Revenue reform can minimize the devastating impact of a cuts-only approach to the budget shortfall and set North Carolina on a path to economic recovery.



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The Problems with NC's Revenue System

It is regressive: requires a greater tax contribution (as % of income) from low- and moderate-income taxpayers than from higher-income taxpayers

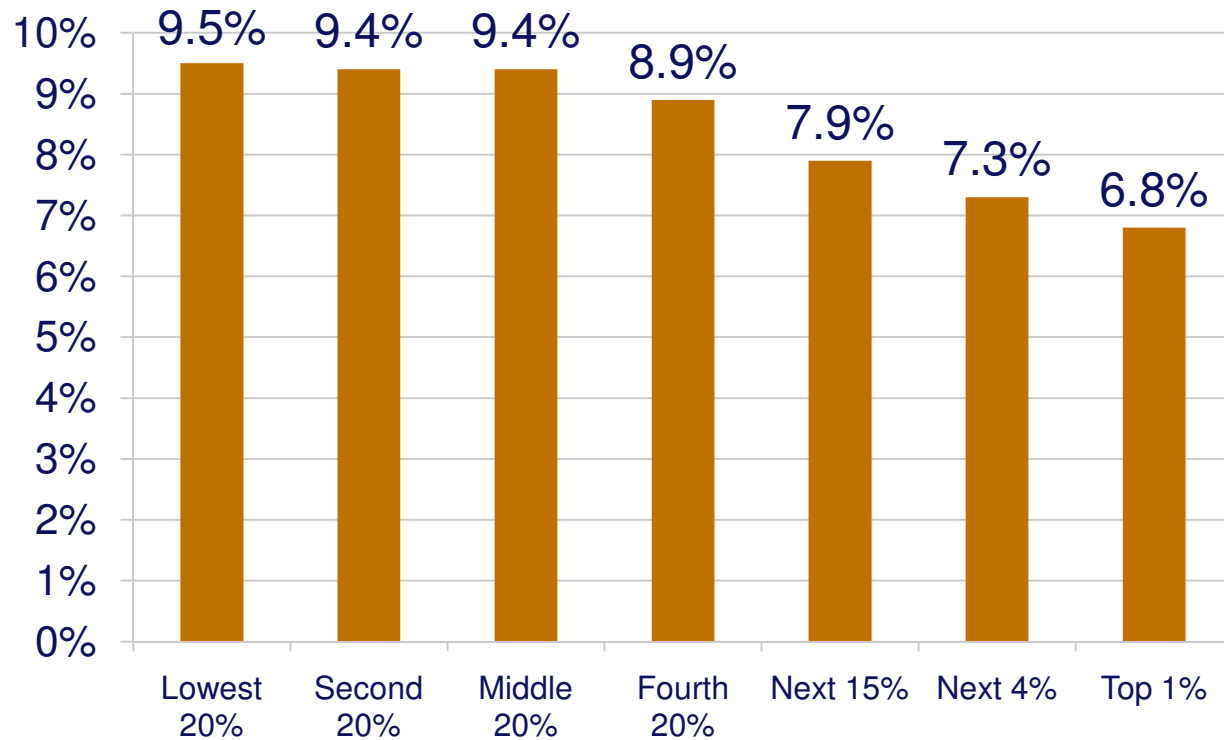
It is narrow: major tax schedules (sales, income, and corporate profits) capture an inadequate and decreasing portion of the state's economic activity

As a result, revenue growth does not keep pace with growth in the economy over time



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North Carolina's Low-income Households Pay a Greater Share of Their Income in Taxes than High Income Households



■ State and Local Taxes Share of Income*

Source: Institute on Taxation and Economic Policy, November 2009. Who Pays? 3rd Edition.

* Includes "federal offset" for state and local taxes deducted from federal income taxes.

Does not include the temporary tax package passed in 2009

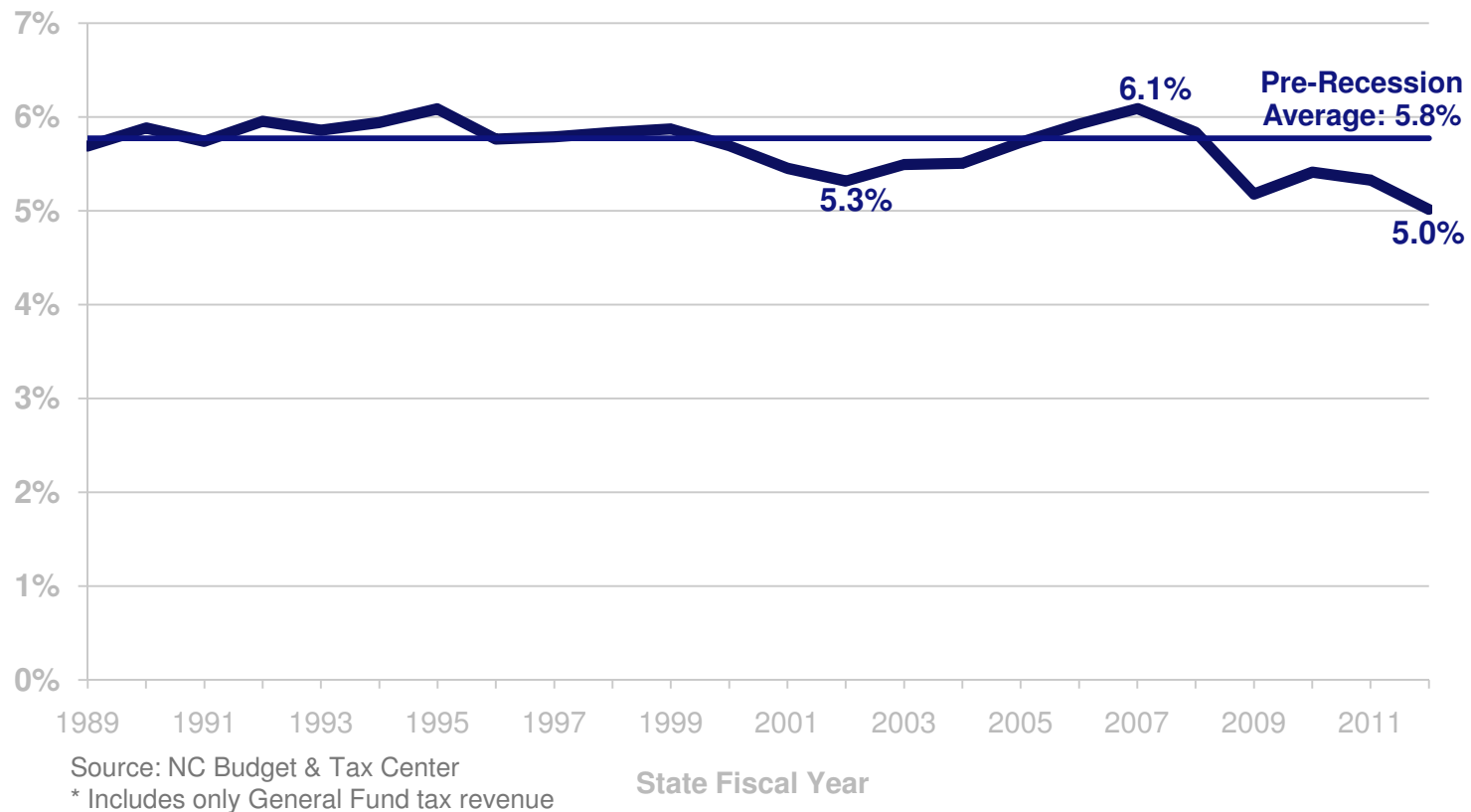


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North Carolina tax revenues projected to reach historic lows

State Tax Collections Will Dip to 5 percent of State Personal Income in FY 2012





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Take Steps to Modernize the State's Tax System

- **Broaden the base** of the personal income tax and make it more progressive
- **Broaden the base** of the sales tax to capture a greater share of economic activity
- **Close corporate tax loopholes** and eliminate ineffective business incentives



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Proposed Tax Changes: Personal Income Tax

Broaden the base by using adjusted gross income (AGI) instead of federal taxable income as the starting point for calculating state income taxes

Make state income tax better aligned to ability to pay

- 1) Adopt a more progressive rate structure
 - Move from 3 to 6 income brackets
 - Reduce rates for income under \$200,000 (married couples)
- 2) Convert all deductions to credits
 - Disallow all itemized deductions other than mortgage interest, medical expenses, and charitable contributions
 - Increase value of standard deduction
 - Allow 3% credit for standard deduction or total of 3 allowed itemized deductions (whichever is higher)
- 3) Merge personal exemption and child tax credit into a per-person credit
- 4) Increase Earned Income Tax Credit (EITC) to 10%
- 5) Phase out credit for standard deduction and \$180 Per-Person Credit for top incomes



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Proposed Tax Changes: Personal Income Tax

Households will pay lower tax rates on income under \$200,000 for married couples, under \$120,000 for single filers

Standard Deduction and Per-Person Credit phase out starting with 7.5% bracket; Itemized Deductions Capped

Current Personal Income Tax Brackets				
MFJ	Single	HOH	MFS	Rate
\$0	\$0	\$0	\$0	6.00%
\$ 21,250	\$ 12,750	\$ 17,000	\$ 10,625	7.00%
\$ 100,000	\$ 60,000	\$ 80,000	\$ 50,000	7.75%

BTC Proposed Personal Income Tax Brackets				
MFJ	Single	HOH	MFS	Rate
\$0	\$0	\$0	\$0	5.00%
\$ 25,000	\$ 15,000	\$ 20,000	\$ 12,500	6.00%
\$ 50,000	\$ 30,000	\$ 40,000	\$ 25,000	7.00%
\$ 100,000	\$ 60,000	\$ 80,000	\$ 50,000	7.50%
\$ 200,000	\$ 120,000	\$ 160,000	\$ 100,000	8.00%
\$ 400,000	\$ 240,000	\$ 320,000	\$ 200,000	8.50%

New Standard Deduction			
MFJ	Single	HOH	MFS
\$ 10,000	\$ 6,000	\$ 8,000	\$ 5,000

Current Standard Deduction			
\$ 6,000	\$ 3,000	\$ 4,400	\$ 3,000

MFJ = Married, Filing Jointly

HOH = Head of Household

MFS = Married, Filing Separately



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Impact of Proposed Tax Changes: Personal Income Tax

More than half of households receive a net income tax cut

Even High-Income Households Still Receive Substantial Net Federal & State Tax Cut

2011 Income	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income	Less than	\$17,000 –	\$29,000 –	\$48,000 –	\$77,000 –	\$158,000 –	\$367,000 –
Range	\$17,000	\$29,000	\$48,000	\$77,000	\$158,000	\$367,000	Or More
Average Income in Group	\$11,000	\$23,000	\$38,000	\$62,000	\$105,000	\$223,000	\$929,000

Personal Income Tax Changes							
Tax Change as % of Income	-0.8%	-0.6%	-0.1%	+0.2%	+0.3%	+0.6%	+0.8%
Average Tax Change	\$ -81	\$ -130	\$ -29	\$ +97	\$ +319	\$ +1,311	\$ +7,454
% with Income Tax Cut	+59%	+71%	+59%	+50%	+33%	+3%	—
% with Income Tax Increase	+1%	+9%	+31%	+44%	+64%	+96%	+99%

Revenue Change	
\$ +634,000,000	

Total Share w/ Tax Cut	52%
Total Share w/Tax Increase	31%

Net Tax Cut - Federal & State Combined	
Top 1%	\$ -42,533
Next 4%	\$ -7,786

Source: ITEP Microsimulation Model



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The State Earned Income Tax Credit is critical to addressing the upside-down nature of the tax system.

806,233 taxpayers in North Carolina filed for the state EITC.

\$59.9 million in state EITC dollars were received by taxpayers across the state.

The state EITC supplemented federal EITC dollars to bring an **average value of \$2,248** to eligible NC taxpayers



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Proposed Tax Changes: Sales Tax

Broaden the base of the sales tax to include services taxed by any other state in the United States

- Exempt only food (from state), prescription drugs, business-to business services , health care and education

Reduce state rate from 4.75% to 3.75%



Impact of Proposed Tax Changes: Sales Tax

Broader Tax Base & Lower Rate Raises \$500 million
Would also stabilize revenues and help prevent future rate hikes

2011 Income	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income	Less than	\$17,000 –	\$29,000 –	\$48,000 –	\$77,000 –	\$158,000 –	\$367,000 –
Range	\$17,000	\$29,000	\$48,000	\$77,000	\$158,000	\$367,000	Or More
Average Income in Group	\$11,000	\$23,000	\$38,000	\$62,000	\$105,000	\$223,000	\$929,000

State Sales Tax Changes							
Tax Change as % of Income	+0.3%	+0.3%	+0.2%	+0.2%	+0.1%	+0.1%	—
Average Tax Change	\$ +34	\$ +61	\$ +75	\$ +93	\$ +107	\$ +132	\$ +398

Revenue Change
\$ +500,000,000

Source: ITEP Microsimulation Model



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Why Tax Services?

- Services a growing share of North Carolina's economy
- Only one-third of household consumption subject to state sales tax
- Revenue to grow slower than economy and need for public investments
- Consumption of services more stable than goods



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Proposed Tax Changes: Corporate Tax

- Eliminate unnecessary corporate income tax exemptions and ineffective corporate incentives
- Adopt mandatory combined reporting for multi-state corporations

Corporate Income Tax Breaks	2010 Revenue Estimate (millions)
Disallow net capital losses not deductible from federal taxable income	\$15
Eliminate ineffective Article 3J tax credits	\$17
Eliminate corporate deduction for contributions made to non-NC charities	\$3.5
Adopt throwback rule for corporate "Nowhere Income"	\$12.5
Adopt Mandatory Combined Reporting for multi-state corporations	\$101
TOTAL	\$149 million



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North Carolina is a Low-cost State for Business

- Annual report by pro-business *Council on State Taxation* put North Carolina as being tied for the lowest business-tax state in the country in FY2009
- *Forbes* recently ranked North Carolina as having the third-lowest business costs of any state



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Proposed Tax Changes: Tax-Code Spending

What is Tax-Code Spending?

- **Tax-code spending** includes special tax credits, deductions, exemptions, and preferential rates that:
 - ...represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.**
- **In fiscal year 2009-10**, tax-code spending in North Carolina totaled over \$5.8 billion**

* Stanley Surrey, Assistant Treasury Secretary, 1961-1969

** 2010 Biennial Tax Expenditure Report – NC Department of Revenue



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Proposed Tax Changes: Tax-Code Spending

Treat Tax-Code Spending Like Other Spending

- In 2007, NC General Assembly commenced “Continuation Reviews” to evaluate cost-effectiveness of selected programs supported by state appropriations
- The General Assembly should implement a process similar to continuation reviews to evaluate \$5.8 billion in tax-code spending starting in 2011-12
- As in the State of Washington*, NC General Assembly could establish a Citizens’ Tax-Code Spending Review Commission to review and make recommendations on whether to preserve or terminate reviewed tax-code spending

* Citizen Commission for Performance Measurement of Tax Preferences -
<http://www.citizentaxpref.wa.gov/>



Governor's Budget on Revenue is not Reform-Minded

Governor Perdue's budget incorporated some new revenue to protect public investments, but the General Assembly should consider alternatives

- Preserving three-quarters of 1-percent sales tax increase raises over \$800 million per year but hits low- and middle-income families hardest
- Reducing corporate income tax rate without broader base reduces revenue with little evidence of potential job boost
- Governor's revenue changes do not address long-term problems with North Carolina's revenue system

Impact of Keeping 0.75-Cent Sales Tax							
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % of Income	+0.5%	+0.4%	+0.3%	+0.2%	+0.2%	+0.1%	+0.1%
Average Tax Change	+54	+82	+117	+148	+198	+290	+866

Source: ITEP Microsimulation Model – Preliminary Results



Summary of Revenue Modernization Plan

Revenue Target Breakdown - \$1.28 billion in FY2012

- Personal Income (\$634 Million)
- Sales Tax (\$500 Million)
- Corporate Tax (\$149 Million)

Modernized Revenue System Replaces Revenues of Temporary Tax Package, But Based on Ability to Pay

Tax Change as % of Income								
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	Total Revenue
BTC Revenue Modernization Plan	-0.5%	-0.3%	0.1%	0.4%	0.4%	0.7%	0.8%	\$1.13 Billion
Temporary Tax Package	0.7%	0.5%	0.4%	0.3%	0.3%	0.3%	0.3%	\$1.12 Billion

Source: ITEP Microsimulation Model



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