





## The Smartest Way to Raise \$1 Billion to Balance the Budget


### Earlier proposals hold the key to a progressive plan

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#### EXECUTIVE SUMMARY:

 A PLAN THAT WOULD RAISE MORE MONEY than either the Senate or the House is possible, and can be achieved by combining existing proposals from both chambers.

 A SOLID COMPROMISE BETWEEN THE TWO PLANS would take the Senate's proposal to broaden the tax base and lower rates on low- and middle-incomes, and add the House plan to add at least one new upper-income tax bracket.

 TO MAKE TAX CHANGES MORE FAIR, the state should increase the Earned Income Tax Credit more. Increasing it to at least 10% of the federal credit would cost approximately \$70 million annually and would help more than 835,000 low- and moderate-income working families.

**IT'S BACK TO THE DRAWING BOARD FOR STATE LEADERS TRYING TO FINALIZE A TAX PLAN** that will raise revenue, protect vital services and programs, and not place an undue burden working families. Thankfully, they don't have to go back to square one. They just need to go back to proposals put forth earlier in the year by the Senate and the House, both of which included key elements from the plan published by the NC Budget & Tax Center in March.

The Senate and House proposals, taken together, include all the elements necessary to create a revenue package that Governor Perdue would be happy to sign – one that raises needed revenue without hurting working families. Plus, these proposals could give the state a more stable and fairer tax system for the future.

Here are the elements state leaders need to be discussing.

#### The Personal Income Tax

A compromise between two previous proposals makes the most sense.

The Senate's revenue package proposed broadening the income tax by changing the starting point for calculating state income taxes from federal taxable income (after deductions) to adjusted gross income (before deductions). They also want to create a new zero-percent tax bracket for first \$10,000 of adjusted gross income for married couples filing jointly (\$5,000 for single filers). Finally the plan would lower all other marginal tax rates including reducing the top rate from 7.75% to 7.5%.

The House proposed creating two new upper-income tax brackets. This would make the state's outdated tax code more efficient because the incomes of the wealthy grow more quickly than those of low-income families. In addition, the wealthy can absorb modest tax increases in a recession; studies show they will save less but continue to spend. In fact, raising taxes on the wealthy has less of an impact on economic activity than cutting services and jobs.

So, let's consider a compromise of the two plans. Take the Senate plan to broaden the tax base and lower rates on low- and middle-incomes, and then follow the House's lead and add at least one new upper-income tax bracket set at 7.75% for married income above \$200,000. These changes would generate an estimated \$195 million in FY09-10 and more than \$476 million in FY10-11 in income tax revenues.

## **The Sales Tax**

The House recommended expanding the sales tax base to include warranties, installations and repairs; digital downloads; and converts the privilege tax on amusement to a sales tax.

The Senate's base-broadening plan includes the House elements, but expands to more services, particularly in the areas of personal care, home and real property, and storage. It also appears that the latest version of the Senate tax plan includes taxing electricity consumption at the general state sales-tax rate, an increase from 3% to 6% once fully implemented.

While this move on its own would be even more regressive than raising an equivalent amount of revenue from the retail sales tax, it is generally good tax policy to eliminate differential rates and currently electricity is taxed at a lower rate than other sources of power such as natural gas.

The Senate plan to broaden the sales tax base considerably is the better option. Doing so would have a lesser impact on low-income families than the House proposal to raise the rate and makes the sales tax more stable over time. Implementing the Senate's original proposal and adding the increase in the sales tax on electricity generate an estimated \$511 million in the next fiscal year.

## **Business Taxes**

The House called for the implementation of "combined reporting" for multi-state corporations, a move that will end the manipulations that enable large companies to avoid paying millions in taxes to North Carolina. Enacting this measure would demonstrate how much state legislators respect and support small businesses, which have been at a disadvantage when competing against these corporate tax avoiders. The House also recommended some smaller, but very important measures to improve the corporate income tax including closing the so-called "Nowhere Income" loophole ending a special tax break for banks.

Both the House and Senate expand the franchise tax to include limited liability business entities. Implementing the business tax plans from both the Senate and the House would raise additional revenue (\$183 million in FY09-10 and \$354 million the following year) and dramatically improve the fairness of the state's business taxes.

## **Mitigating the Impacts on Low- and Moderate-Income Families**

While these changes would raise needed revenue and modernize our tax system, the sales tax changes would disproportionately affect low and moderate-income families. The income tax changes could adversely affect fixed-income households. The legislature should consider two measures that would help to offset the increased taxes for those who are already struggling.

The state should increase the Earned Income Tax Credit. The state EITC will increase from 3.5% of the federal credit to 5% during the current tax year. Increasing it more – to at least 10% of the federal credit – would cost approximately \$70 million annually and would help more than 835,000 low- and moderate-income working families.

In addition, state leaders should consider establishing an alternative refundable credit that would benefit all low-income taxpayers regardless of work status, in order to offset the tax increases on older residents with fixed incomes or without families who do not benefit from the current state EITC.

## **Conclusion**

The combination of the Senate and House tax plans outlined here would raise more revenue than either chamber raised originally - more than \$1 billion in FY09-10. Additional revenue will help prevent thousands of teachers and other workers from being laid off at a time when the state's unemployment rate is at a record level. Additional revenue will also allow the state to continue enrolling eligible children in the State Children's Health Insurance Program and accommodate the flood of new students seeking re-training at the state's 58 community colleges.

The good news is state leaders are on the right track. If they make the right choices, North Carolina will be better able to recover from the recession, and they will ensure families throughout the state survive this difficult time without suffering financial setbacks from which they might never bounce back