BTC Brief

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FIVE STRATEGIES FOR A FISCALLY RESPONSIBLE BUDGET:

Paying for Investments that Spread Prosperity

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North Carolina's ability to compete and thrive in a dynamic 21st century economy requires a tax system that raises adequate revenue for public investments that promote broadly shared economic prosperity. Five years into a national economic recovery, North Carolina has failed to achieve financial stability. The slow pace of job creation is one reason, but the major cause is the reduction in revenue that resulted from the 2013 tax plan passed by state lawmakers, which largely benefited well-off North Carolinians at the expense of middle- and low-income earners.

In the first 100 days of the legislative session five strategies should be at the top of policymakers' agenda to ensure a financially responsible biennial budget is put in place. The following five revenue options should be on the table to close the anticipated gap between state revenue and what we need to fund education, health and other building blocks of a strong economy.

The five strategies are:

1. **Restore an income tax rate structure that ensures that all taxpayers carry an appropriate share of the tax load.**
2. **Restore a vital tax credit for low-income working families before any further expansion of the sales tax.**
3. **Make sure that large, profitable corporations are paying to support the services they use and enjoy.**
4. **Eliminate special-interest tax breaks that aren't helping the state's economy.**
5. **Avoid short-sighted budget cuts and the sale of state resources.**

While the majority of states are seeing a recovery in revenue that affords them the opportunity to start undoing the worst spending cuts made during the Great Recession, North Carolina continues to face a gap between the amount of revenue it is generating and what is needed to fund basic services like education and public safety. The state's revenue collections are 8 percent below pre-recession levels.[1] North Carolina is one of just seven states whose revenue collections have declined over the past year as the economic recovery strengthened across the country.[2]

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Official estimates project that revenue is coming in nearly $900 million lower than would have been the case in the absence of tax changes made in 2013, which included large tax cuts for the highest earners. The total loss could be more than $1 billion, according to estimates by the Institute on Taxation and Economic Policy, a non-partisan research group. This loss in revenue is likely to generate a shortfall in the state's current fiscal year budget, putting at risk North Carolina's ability to meet its obligations to students, working families, the elderly, and others. Unless lawmakers change the way they are doing business, fewer dollars will be available for these investments for the foreseeable future.

More than likely, policymakers will also have to grapple with the growing cost of the tax plan in the next fiscal year, which begins July 1, 2015 and ends June 30, 2016. This is because the revenue loss is compounded by the phase-in of additional personal income and corporate income rate reductions that went into effect on January 1, 2015.

The chronic shortage of revenue caused by the 2013 tax changes is making it more difficult for North Carolina to compete as our neighbors benefit from the economic recovery and reinvest in their schools, colleges and other assets. What follows are five strategies that should be at the top of state policymakers' agenda during the first 100 days of the 2015 legislative session to ensure a responsible approach is taken to address anticipated budget shortfalls and the development of a sustainable two-year budget.

Restore a Fair Income Tax Rate Structure

The cost of eliminating income tax rates that were tied to a family's or individual's ability to pay has been significant. The state's tax code is now even more upside down, asking much more from those earning less than $10,700 on average (the bottom 20 percent of North Carolina taxpayers) in state and local taxes as a share of their income, than the wealthiest taxpayers. A major reason is the state's new single-rate, or flat, income tax. It means that our tax system now treats someone earning $40,000 a year the same as a millionaire. By reinstating a tax system that applies a different tax rate to dollars earned above certain income levels and maintaining some of the changes that broadened the income subject to that tax rate – an additional $390 million could be generated for core public services.[3]

Protect Working Families Before Further Expansion of the Sales Tax

Sound tax policy calls for modernization of the state sales tax, which would require expanding it to include more services like dry cleaning and landscaping. The service industry is a growing area of the economy and applying the sales tax to additional services ensures that our tax code can continue to be in line with a changing economy. However, any further expansion of the sales tax should only be done alongside the re-establishment of a state Earned Income Tax Credit (EITC) for working families. A sales tax expansion would hit low-income families the hardest since they spend more of their disposable income on necessities than better-off households. The EITC is a proven way to combat poverty and gives children from low-income households a better shot at climbing the economic ladder. The restored state EITC should be set as a percentage of the federal EITC that is sufficient to ensure that the tax load doesn't further shift to middle- and low-income taxpayers when the sales tax is expanded. The revenue gained from a sales tax expansion should be used to pay for the state EITC and could be used to drop the overall sales tax rate. Additional revenue from expanding the sales tax should not be used to pay for broad-based income tax cuts.

Ensure Large, Profitable Corporations are Supporting North Carolina's Economy

Making sure that large, profitable corporations located in North Carolina pay taxes to the state to support the public investments – like quality schools and colleges, vibrant downtowns, and other infrastructure – that help make their businesses profitable is important and helps ensure a fair tax system. Policymakers should stop scheduled income tax cuts for corporations and maintain the current formula for how multi-state businesses designate their profits across states for taxation purposes. The 2013 tax plan allows the corporate income tax rate to drop to as low as 3 percent from 5 percent if specific revenue targets are reached. These additional tax rate cuts in future years would provide even more benefits to profitable corporation at the expense of hard-working North Carolinians. An even greater opportunity for North Carolina exists in pursuing what is known as combined reporting, which aims to prevent multi-state corporations from shifting profits out of state in efforts to avoid paying taxes.

Eliminate Wasteful Special Interest Tax Breaks

Special tax breaks for corporations and high-income taxpayers cost North Carolina tens of millions of dollars every year in lost revenue. Yet, most are never evaluated to measure the extent to which they are meeting their goals, such as job creation. Nearly half of companies receiving tax credits designed to spur economic development in North Carolina actually experienced a decline in employment growth from 1996 to 2006, according to an analysis by UNC-Chapel Hill's Kenan-Flagler Business School.[4] Similar analysis is needed to assess other tax breaks and subsidies—like preferential tax rates for boats and planes – and if there is evidence that they are ineffective, legislators should eliminate them.

Avoid Short-Sighted Budget Cuts

The slow economic recovery combined with North Carolina's chronic revenue shortage means that the state's budget challenges are likely to continue for some time. Balancing the budget by relying on one-time spending cuts, fees for services, or turning public services over to corporations that aim to maximize their own profits are short-term solutions that will only create bigger problems down the road. Policymakers must protect investments in areas that generate long-term savings, such as early childhood development, community-based health services, and community-based re-entry programs for ex-offenders. State policymakers also must consider the long-term costs of proposals to privatize public goods in exchange for quick cash infusions— such as selling off state assets or the rights to toll roads.

CONCLUSION

The anticipated budget shortfalls, resulting primarily from the higher-than-anticipated cost of tax cuts passed in 2013, presents an opportunity for policymakers to reconsider the path North Carolina is on. This is particularly urgent in light of the growing concern in other states, notably Kansas, over the harm done by similar self-inflicted financial crises. Policymakers in North Carolina can pursue a responsible approach that includes new revenue and a commitment to promoting opportunity for all the people of our state. Failure to do so will further threaten the education of our children, the health of our families, and the vibrancy of our communities, while putting our future prosperity at risk.

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3. Special Data Request to Institute on Taxation and Economic Policy, January 2015 based on a rate structure of 5.75% for taxpayers married filing jointly (MFJ) with taxable income up to $150,000, 6.5% for taxpayers (MFJ) with taxable income between $150,001 and $300,000 and 6.95% for taxpayers (MFJ) with taxable income over $300,001.
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