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BTC Brief

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NORTH CAROLINA'S WORTH IT:

Five Strategies to Rebuild North Carolina's Recession-Battered Public Structures

Timely, accessible, and credible analysis of state and local budget and tax issues

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KEY FINDINGS:

- **The Great Recession caused the deepest decline in state tax revenues in more than half a century. While revenues have made a modest recovery in recent months, they are still far below their historical levels.**
- **Although the severity of the economic downturn and continued high unemployment are the primary factors driving revenues to such low levels, North Carolina's outdated, increasingly inadequate revenue system also shoulders some of the blame for continued low revenues.**
- **Policymakers could pursue five strategies to improve revenue collections in the near term that would also push North Carolina in the direction of a modernized revenue system. Taken together, these five strategies could raise over $1.5 billion to partially restore cuts to a range of public investments.**

Revenue Key to Rebuilding Opportunity

The United States and North Carolina are experiencing the longest stretch of high unemployment since the Great Depression.[1] North Carolina's jobs deficit – the number of jobs needed to reach pre-recession employment levels – stands at more than half a million jobs.[2] As long as North Carolina's jobs deficit persists, revenue collections will remain far below historic levels and – more importantly – below what is needed to rebuild the state's economy.

Only when the state collects adequate revenue can it educate students, train workers, and keep communities safe and healthy. These last four years have taken a severe toll on North Carolina's public structures and systems, including public schools, colleges and universities, roads, courts, parks, and hospitals. After responding to the initial recession-driven collapse in state revenues with a balanced approach of targeted spending cuts and additional revenues in 2009,[3] state policymakers have taken a harmful cuts-only approach to dealing with diminished revenues and growing demand for education, health care, and other core public services.[4]

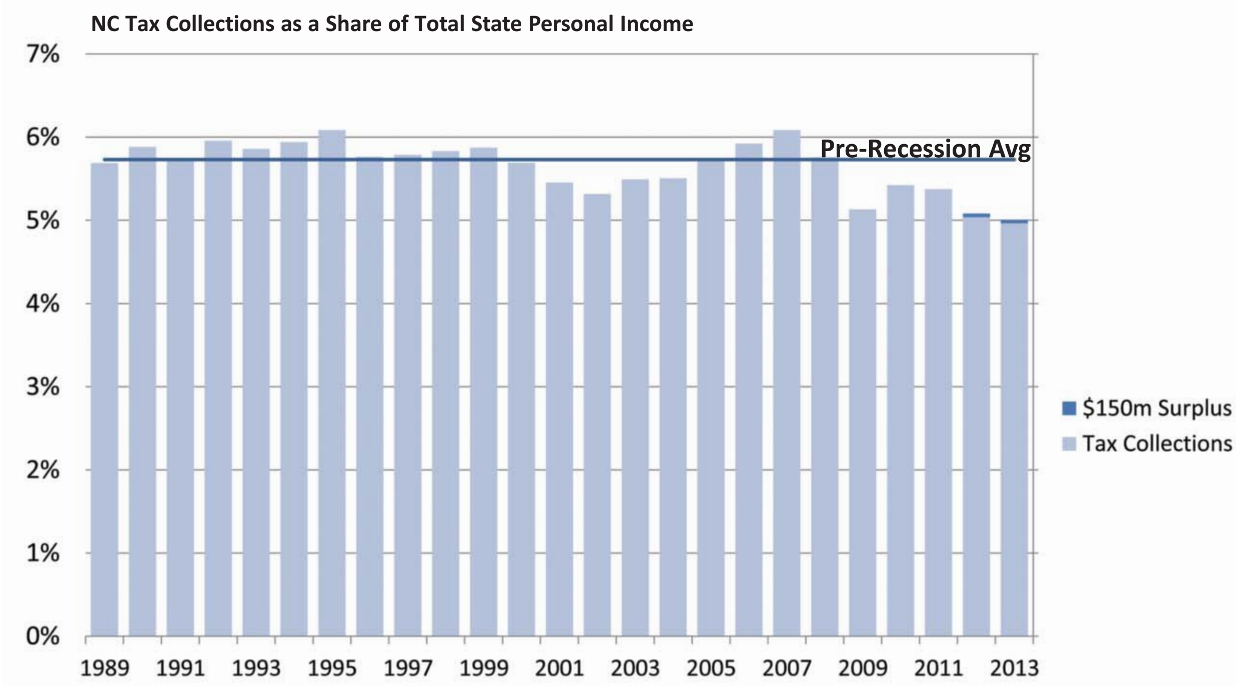
In fact, industry-standard economic modeling finds that the 2011-13 state budget will result in tens of thousands fewer jobs in North Carolina's public and private sectors over the two years of the budget.[5] In the long term, there is significant evidence that cuts to tax-financed investments in education, health, and public works threaten the state's ability to sustain a robust, sustainable economic recovery.[6]

Revenue Collections Remain Well Below Historic Levels

Despite news that state revenue collections were running $150 million above mid-year targets as of the end of 2011,[7] revenue collections remain at historic lows.

Although the severity of the economic downturn and continued high unemployment are the primary factors driving revenues to such low levels, North Carolina's outdated, increasingly inadequate revenue system also shoulders some of the blame.[8] Because North Carolina's revenue system exempts a large and growing share of the state's economic activity from taxation, the recession caused state revenues to plummet even more than the overall economy and state residents' incomes, and revenues are projected to continue shrinking as a share of the economy and incomes into next year.[9] **(Figure 1)**

FIGURE 1: Small Revenue Surplus Represents Only Minor Progress Out of Major Recession-Era Hole



SOURCES:: NC Fiscal Research Division; US Department of Commerce, Bureau of Economic Analysis

Five Strategies to Collect Revenue Necessary to Rebuild North Carolina's Public Structures

The choices of North Carolina's policymakers will impact the state's ability to collect adequate and responsible revenue. Although comprehensive revenue modernization is necessary to sustain North Carolina's public structures in the long term, there are five revenue-raising strategies state policymakers can take this year to provide a necessary bridge to future reforms:

1. **Raise roughly $200 million in additional revenue by capping tax subsidies that primarily benefit wealthy households.[10]**

   Specifically, state policymakers could cap allowable itemized deductions against state income taxes at $40,000 for couples and $20,000 for individuals. On the issue of scaling back tax subsidies for the wealthy, there is already substantial bipartisan consensus. In his recent response to President Obama's State of the Union Address, Republican Governor Mitch Daniels of Indiana stated that we must "stop sending the wealthy… so many tax preferences that distort our economy and do little or nothing to foster growth.

2. **Raise $1 billion in additional revenue by reinstating the temporary 1-cent sales tax and doubling the value of the state's Earned Income Tax Credit.**[11]

   Legislative leaders have cited their concern for struggling families as a major reason to not extend the temporary 1-cent sales tax last year.[12] By pairing the sales-tax extension with an increase in the state's Earned Income Tax Credit (EITC) for low- and moderate-income working families to 10% of the federal credit, state policymakers could raise substantial revenue while minimizing any adverse impact on struggling families.

3. **Raise roughly $250 million in additional revenue by extending the sales tax to services where most service providers already collect and remit sales tax on some purchases.**[13]

   Numerous legislative and private committees and researchers have looked at ways to reform North Carolina's revenue system, and almost all have concluded that the state should extend the sales tax to many currently untaxed consumer services.. A modest extension of the sales tax to some services where the administrative burden would be lowest (such as auto repair, warranty and installation services, and amusements) would raise revenue in the near term while also giving North Carolina a head start on comprehensive tax modernization.

4. **Raise up to $100 million in additional revenue by requiring multi-state corporations to pay taxes on all profits earned in North Carolina.**[14]

   North Carolina's current corporate tax laws enable many multi-state corporations to avoid paying their fair share in taxes by shifting profits earned in North Carolina to states that have no corporate income tax, like Delaware and Nevada. Large, multi-state corporations are able to take advantage of tax shelters because most are structured as parent corporations that each own many separate subsidiary corporations in states across the country.

   Enacting a reform known as "mandatory combined reporting" would require each parent corporation and its subsidiaries to "combine" for state tax purposes to file a joint tax return. The profits of the combined corporation would then be apportioned by formula to each state in which the corporation does business according to the share of total business activity located in that state, thereby nullifying many of the tax shelters abused by some multi-state corporations.[15]

5. **Raise up to $90 million by adding a new top bracket to North Carolina's income tax.**[16]

   Low- and middle-income families currently pay a greater share of their incomes in state and local taxes than wealthy North Carolinians do. A modest increase in the income taxes of the wealthiest North Carolinians, accomplished by adding a new top income-tax bracket for household income above $1 million per year ($600,000 for individuals), would help to partially offset this upside-down nature of North Carolina's tax code while also raising additional revenue. Even with this modest increase, the wealthiest one-percent of income-earners in North Carolina would still pay a smaller share of their incomes in state and local taxes than low-income and middle-class families.

Even pursuing all five of these revenue-raising strategies would not provide North Carolina with enough revenue to restore the billions in cumulative cuts to the state's public investments enacted over the course of the recent recession. Enacting these proposals would, however, provide an important step toward addressing the revenue challenges North Carolina will continue to face if no action is taken.

In a time of persistent economic insecurity and challenging economic transitions for North Carolina's families and businesses, now is an especially important time for North Carolina's policymakers to strengthen the public structures and systems that will promote a future of shared prosperity and economic security for all North Carolinians.

1 Douglas Elmendorf. "The United States is Experiencing the Longest Stretch of High Unemployment Since the Great Depression," Congressional Budget Office Director's Blog, February, 16, 2012, http://cboblog.cbo.gov/?p=3333.

2 Analysis of data from the Bureau of Labor Statistics by the Economic Policy Institute. Available at http://www.ncjustice.org/?q=node/880.

3 Elaine Mejia, Meg Gray Wiehe, and Stephen Jackson. "BTC Report: The 2009-2011 State Budget: Trifecta of spending cuts, tax increases and federal aid used to address historic shortfall," NC Budget and Tax Center, September, 2009, http://www.ncjustice.org/sites/default/files/BTC%20Reports%20-%20The%202009-2011%20State%20Budget-WEB.pdf

4 See the following publications of the NC Budget and Tax Center: "The Final FY 2010-11 Budget for North Carolina: Will It Support Economic Recovery?" (http://www.ncjustice.org/?q=node/572) and "The 2011-2013 Final Budget – Neglecting a Balanced Approach, Budget Costs Jobs and Delays Economic Recovery," (http://www.ncjustice.org/?q=node/889).

5 Allan Freyer. "BTC Report: The Jobs and Economic Impact of the FY2011-13 North Carolina State Budget - A Whole-Budget Analysis Shows Widespread Private-Sector Job Losses Across all North Carolina Regions," NC Budget and Tax Center, August, 2011, http://www.ncjustice.org/?q=node/924.

6 Edwin McLenaghan. "BTC Brief: Taxes as Job Creators - Research shows investing in public structures creates jobs," NC Budget and Tax Center, October, 2011, http://www.ncjustice.org/?q=node/999.

7 Office of Governor Bev Perdue. "Revenue Collections Up for First Half of Year: Individual and Business Income Put N.C. $150 Million Above Budget Forecast," January 10, 2012, http://www.governor.state.nc.us/NewsItems/PressReleaseDetail.aspx?newsItemid=2204.

8 Edwin McLenaghan. "BTC Brief: How We Got Here: North Carolina's Broken Revenue System Partly To Blame for Severity of State Revenue Shortfall," NC Budget and Tax Center.

9 NC Budget and Tax Center analysis of data from the Bureau of Economic Analysis and the NC Office of State Budget and Management.

10 Revenue estimate from the Institute on Taxation and Economic Policy, "'Writing Off' Tax Giveaways," August, 2010, http://itepnet.org/pdf/itemize0810.pdf.

11 Revenue estimate for the extension of the 1-cent increase in the sales tax is from the NC General Assembly's Fiscal Research Division (as cited in an April, 2011, report by the UNC Center for Competitive Economies). Revenue-reduction estimate for increasing the state Earned Income Tax Credit to 10% of the federal credit from the Institute on Taxation and Economic Policy, special data request in February, 2011.

12 For example, see: Speaker Thom Tillis, "Should N.C. raise sales tax to help education? 'No'," The Charlotte Observer. January 22, 2012, http://www.charlotteobserver.com/2012/01/22/2947555/tillis-dont-raise-nc-sales-tax.html.

13 Revenue estimate from the NC General Assembly's Fiscal Research Division, based on the Division's analysis of the NC Senate's "21st Century Tax Rate Reduction Plan" from April, 2009, including extending the state sales tax to "Warranties, installations, repairs to tangible property" and converting the "amusement/movies privilege tax" to a sales tax at a state tax rate of 4.75 percent. Estimates available here: http://www.ncmedsoc.org/non_members/media/Tax-proposal-Spreadsheet.pdf

14 Revenue estimate for enacting mandatory combined reporting for North Carolina's corporate income tax is based on public statements by Department of Revenue Secretary David Hoyle. Secretary Hoyle has stated that mandatory combined reporting would raise an average of $80-$100 million per year.

15 For more information about mandatory combined reporting, see: Edwin McLenaghan, "BTC BRIEF: Shutting Down Corporate Tax Shelters: North Carolina Should Follow the Lead of Other States by Adopting Key Corporate Tax Reform," NC Budget and Tax Center. June, 2011, http://www.ncjustice.org/?q=node/872.

16 Revenue estimate from the NC General Assembly's Fiscal Research Division, based on the Division's analysis of House Bill 879 "Raise Income Tax on Millionaires" in the 2011 legislative session.

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