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BTC Brief

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THE OFT-IGNORED PART OF THE TEMPORARY TAX PACKAGE: Continuing High-Income and Corporate Surcharges Would Raise Needed Revenue and Support Economic Recovery

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

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KEY FINDINGS:

- **North Carolina's temporary tax package, created in 2009, was more than just the 1-cent sales tax; it included high-income surcharges on the state's wealthiest individuals and corporations. The package provided a critical short-term boost to state revenues in order to support investments in the state's public structures.**
- **Although the tax package is set to expire on June 30, 2011, the deep cuts to public education and human services necessary to balance the budget without new revenue provide compelling reasons for continuing both parts of the temporary tax package.**
- **Maintaining the surcharge on the wealthiest households and corporations is particularly important to ensuring that all households and businesses equitably share the responsibility for closing the state revenue shortfall.**
- **Economists have found that addressing state budget shortfalls through increased revenue from wealthy households has less of an impact on economic growth than budget cuts alone or broad-based taxes. In addition, because of federal tax decisions, North Carolina's wealthiest households have already seen the amount of taxes they pay reduced by $35,000 as of December 2010.**

TEMPORARY TAX PACKAGE MINIMIZED CUTS, SUPPORTED PUBLIC STRUCTURES

In 2009, policymakers developed a temporary tax package as part of a balanced approach, including budget cuts and federal recovery dollars, to close the then-$4.6 billion budget shortfall, which was driven by collapsing revenue from the economic downturn. The temporary tax package included a 1-cent sales tax increase and a surcharge of 2 percent to 3 percent on the taxable incomes of high-income households and a surcharge of 3 percent on profitable corporations. Raising nearly $200 million each year for fiscal years 2009-10 and 2010-11, these temporary surcharges impacted households with taxable income of more than $100,000 ($60,000 and up for single households) and

Income Tax Surcharge Breakdown

If Married Filing Jointly:

2% surcharge on tax liability for taxable incomes between $100,000 and $250,000

3% for taxable incomes above $250,000

If Single:

2% surcharge on tax liability for taxable incomes between $60,000 and $150,000

3% for taxable incomes above $150,000

If Head of Household:

2% surcharge on tax liability for taxable incomes between $80,000 and $200,000

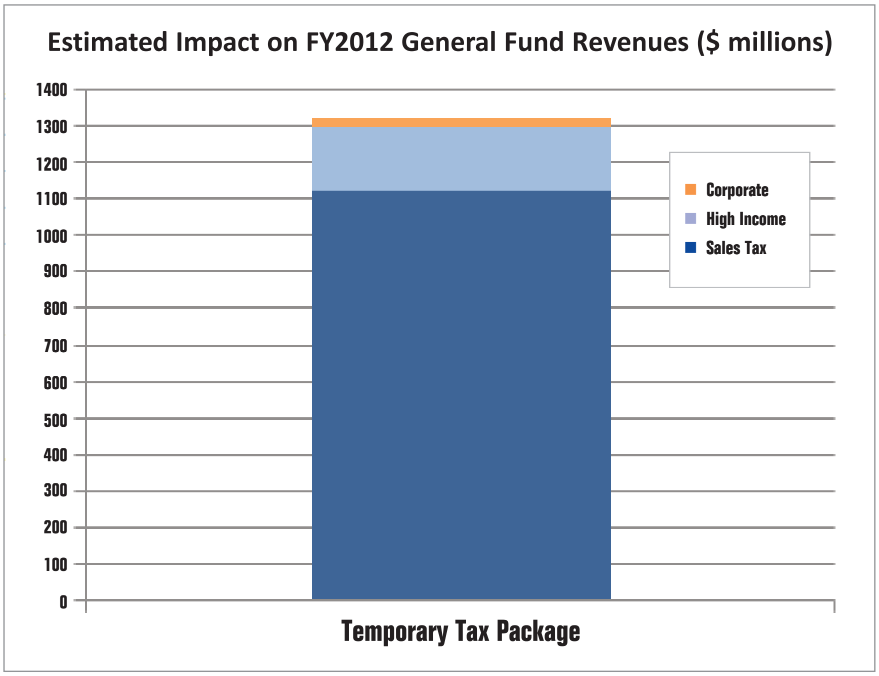
3% for taxable incomes above $200,000

Corporate Tax Surcharge:

3% surcharge on corporate income

corporations required to pay the state's corporate income tax.

The budget proposals of the North Carolina House and Senate illustrate the devastating cuts to critical public structures—including schools, courts, conservation and infrastructure—that will be necessary if policymakers do not replace the revenues generated by the 2009 tax package. Maintaining the surcharges on the wealthiest households and corporations is particularly important both for sustaining key public investments and for ensuring that all households and businesses equitably share in the responsibility for closing the state revenue shortfall. Furthermore, continuing the surcharges on wealthy households and corporations would help close the state revenue shortfall in the way economists argue is best to support economic recovery.



SOURCE: N.C. Fiscal Research Division

REVENUE MUST BE PART OF THE SOLUTION TO THE STATE'S BUDGET GAP

Despite the economic recovery, North Carolina's revenue collections remain far below the levels necessary to make adequate investments in the state's public structures. Rather than pursuing a balanced approach to the state's budget shortfall that includes raising revenue, state policymakers have focused on cutting public investments and reducing available revenue by cutting taxes and ending the temporary tax package.

The temporary tax package provides a short-term solution to ensure that the state can make the investments needed to support a strong economic recovery.

In particular, maintaining the surcharges on high-wealth individuals and corporations would provide resources to fully or partially restore the following cuts proposed by the Senate to critical public investments:

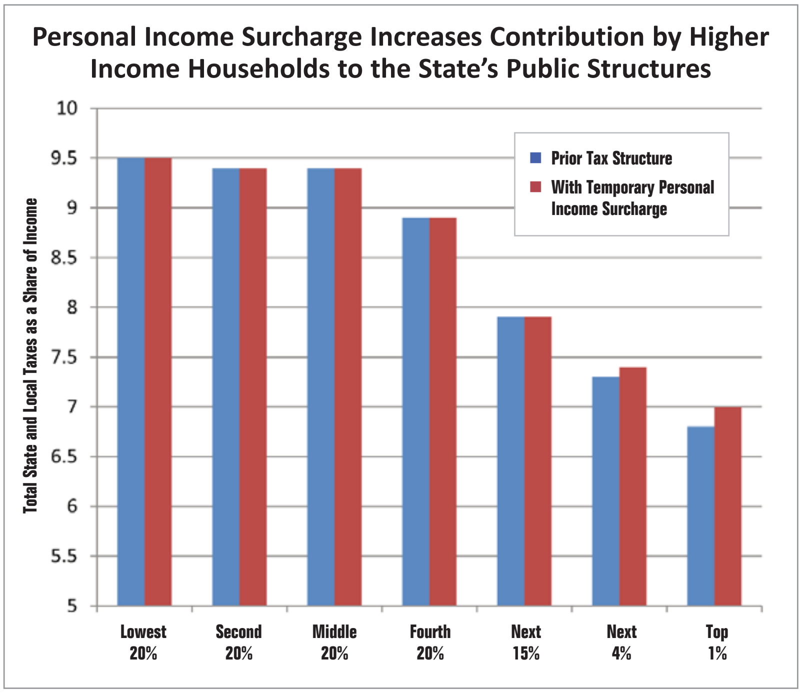
- Reduce funds for private assigned counsel to represent indigent defendants ($10.6 million)
- Cut instructional and non- instructional support for public schools ($82.4 million)
- Reduce funding for Adult Basic Skills courses at community colleges ($10 million)
- Cuts to community service funds ($20 million)
- Reduce funding available for grants to community health centers ($1.5 million)
- Cut Medicaid payment rates by 2 percent ($46.4 million)
- Modify or discontinue Medicaid optional services, a category that includes prescription drugs, prosthetics, dental care, and organ transplants ($16.5 million)
- Cut Smart Start funding by 20 percent ($37.6 million)
- Cut More at Four ($32 million)

KEEPING HIGH-INCOME AND CORPORATE SURCHARGES WOULD HELP BALANCE CONTRIBUTIONS OF LOW-, MIDDLE-, AND HIGH-INCOME HOUSEHOLDS

While falling far short of the revenue modernization that is needed to fix the state's fiscal challenges for the long term, keeping the temporary tax package – including the high-income and corporate surcharges – would ensure that the responsibility for sustaining critical public investments in education, health, and public safety is spread across families and businesses at all income levels.

North Carolina's revenue system requires low- and middle-income families in North Carolina to contribute a greater share of their incomes in state and local taxes than those in the top 1 percent. Indeed, the top 1 percent, earning more than $367,000, paid just 6.8 percent of their incomes in total state and local taxes, while those earning less than $17,000 paid 9.5 percent.[1]

The high-income surcharge raises the share of income paid by the wealthiest households in total state and local taxes to 7 percent, still far below the relative contribution of low- and middle-income families in North Carolina (Figure 2). Households in the top 1 percent, who on average earn $929,000, saw an average tax increase of $1,507. Households in the top 4 percent, who on average earn $223,000, saw an average tax increase of $231. Importantly, though, only 15 percent of those in this income bracket actually experienced a tax increase.



SOURCE: Institute of Taxation and Economic Policy, March 2011

Furthermore, based on tax return data from 2008, more than half of the benefit of ending the corporate income tax surcharge would accrue to 200 big corporations. Increasing the after-tax profits of these big corporations, most of which have the vast majority of their operations in other states, is unlikely to benefit the average North Carolinian. The rest of North Carolina's nearly 200,000 employers would benefit little or not at all.[2]

RAISING REVENUE FROM TAXES ON THE WEALTHY IS THE BEST OPTION IN DOWNTURNS

Economists have found that raising revenue from taxes on households with high incomes is the preferable way to address state revenue shortfalls in a downturn.[3] That is because these households are least likely to cut back on spending, and therefore these tax increases have less of an impact on economic growth than either tax increases on low- and middle-income families or budget cuts that eliminate jobs, undermine important public structures and reduce access to needed services.

High-income households have already seen a significant decrease in their tax responsibility over the past decade. The tax deal of December 2010 that extended the Bush tax cuts of 2001 and 2003 provided North Carolina's wealthiest households with a reduction in federal taxes paid of $2.6 billion in total annually, with each of the state's wealthiest households receiving an average tax cut of $35,000.[4]

CONCLUSION

North Carolina's policymakers have several revenue choices available to them to address the state's fiscal challenges. In the short term, it is increasingly important that policymakers ensure that the revenue system is adequate to support critical public structures for North Carolina families and a growing economy. Maintaining the current revenue levels—including the 1-cent sales tax and the surcharges on wealthy households and corporations—will minimize the worst of the cuts. This short-term solution will help set the state on a better path forward and provide policymakers with the time and opportunity to modernize the revenue system for the long term.

1 Institute of Taxation and Economic Policy, 2007, Who Pays?.

2 NC Department of Revenue

3 Nicholas Johnson. 2008. *Budget Cuts or Tax Increases at the State Level: Which is Preferable During an Economic Downturn?* Center on Budget and Policy Priorities: Washington, DC

4 Analysis by the Institute of Taxation and Economic Policy, January 2011.

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