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A "Laffable" Plan for Tax Reform:

The Civitas/Laffer/Senate Plan for North Carolina Shifts Load to the Poor, Middle-class

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EXECUTIVE SUMMARY

- This tax plan, if implemented, will provide the wealthiest 20 percent of taxpayers a significant tax cut, which would be paid for by increasing taxes on 60 percent of the state's taxpayers, primarily middle- and low-income taxpayers.
- The plan eliminates the personal income, corporate income and franchise taxes, which, combined, generate $12 billion in revenue for North Carolina schools, infrastructure and other public priorities. The revenue loss would be replaced via a higher sales tax that would cover more goods and services, a business license fee and a real estate transaction fee.
- North Carolina policymakers have embraced a tax plan that would provide a significant windfall to the wealthiest 20 percent of state taxpayers while requiring low- and middle-income households to pay more. A family earning $24,000 a year would see its taxes rise by $500, while one earning $1 million would get a $41,000 break.
- The plan is designed to raise no more revenue than the state does currently, meaning North Carolina would be unable to make adequate investments in education, transportation and other foundations of a strong economy.
- The underlying theory of this proposal, that income taxes are a barrier to economic growth, is wrong. Tax cuts have little-to-no bearing on economic performance, according to analyses of all 50 states and the historical record.

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A Non-Solution for a Non-Problem

North Carolina continues to face a sluggish economic recovery that has been made worse by cuts to the state's investments in educating its workforce, maintaining infrastructure such as roads and bridges, and teachers and public-sector layoffs that cancelled out gains in private-sector employment. Policymakers have responded by proposing to make significant changes in the state's tax code. Despite general agreement that North Carolina's revenue system is inadequate for making investments needed for a modern economy and in planning for downturns, proposals put forward so far have focused on a problem that doesn't exist – the claim that taxes are the main barrier to job creation and economic growth.

The Civitas Institute, a conservative policy organization, commissioned a study (the "Civitas/Laffer Plan") that purports to address this non-issue with a tax plan that is supported by North Carolina's Senate leadership. The study – conducted by a firm chaired by Arthur Laffer, whose economic theories have been discredited by many mainstream economists – claims that tax cuts for businesses and high-income individuals, along with other steps, will result in improved economic growth and hundreds of thousands of new jobs.

However, a Budget and Tax Center analysis finds that the plan fails in three key ways:

- It doesn't raise enough revenue to meet North Carolina's current and future needs.
- It is most generous to the wealthiest North Carolinians while raising taxes on middle-income households.
- Its structure threatens the state's ability to respond to changing economic conditions.

Tax Shift, Not Tax Reform

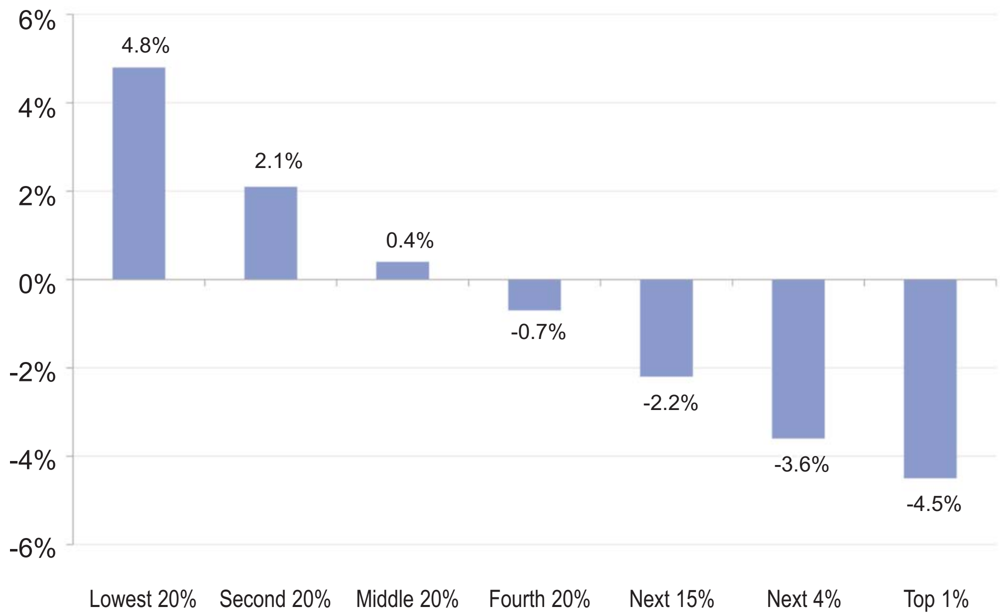
The Civitas /Laffer plan would radically change North Carolina's tax system by eliminating the personal income, corporate income and franchise tax, which represent a combined 65 percent of the state's revenue, and largely replacing this revenue with a higher sales tax that would apply to more goods and services. Specifically, the plan would:

- **Eliminate the personal income tax,** which generated $10.3 billion during FY2011-12.[1]
- **Eliminate the corporate income tax,** which generated $1.1 billion.[2]
- **Eliminate the business franchise tax,** which applies to businesses that are incorporated in North Carolina and generated $650 million.[3]
- **Raise the state sales tax** to 6.53 percent from 4.75 percent and expand it to include currently exempt goods, as well as services that are currently not taxed. The plan purports that the sales tax would generate an additional $7.6 billion.[4]
- **Create a real estate transaction fee** that would apply a 1 percent tax on the total value of commercial and real estate transactions when they are transferred, which would raise an estimated $390 million according to the plan.
- **Implement a business license fee** that would apply to businesses based on their earnings, assets and losses, with a minimum fee of $500, which would raise an estimated $4 billion.

Consequently, the plan would shift the tax load away from high-income individuals and to middle- and low income North Carolina taxpayers.

FIGURE 1: Civitas/Laffer Plan Increases Taxes for Middle- and Low- Income Taxpayers

Average Percent Change in Taxes as a Share of Income Based on Civitas/Laffer Plan



SOURCE: Special data analysis request to Institute on Taxation and Economic Policy (ITEP), December 2012.

Shifting the Load to the Poor, Middle Class

Under the Civitas/Laffer plan, the state's wealthiest residents would see a substantial tax cut while low- and middle-income North Carolinians would see their taxes increase. Because middle- and low-income families have less disposable income, a greater share of their income is spent on goods and services than the wealthiest households. Thus a higher, expanded sales tax would mean a much bigger contribution from the non-wealthy. Under the plan, a family earning $24,000 would see its taxes increase by $500, or by 2.1 percent of its income, while a household earning $1 million would get a $41,000 tax cut, representing 4.5 percent of its income (**See Figure 2 on page 4**).

This tax shift would come at a time when low- and middle-income households are still struggling to recover from the Great Recession, setting them, and the state's economy, back substantially. It would also further worsen the state's upside-down tax system that already requires the lowest income households to contribute more than wealthy households, as a percentage of income.[5]

The problems with an upside-down tax system are clear. Higher tax contributions from low- and middle-income households are required to raise the equivalent of what could be achieved with modestly higher contributions from wealthy households.

The over-reliance on contributions from lower-income households in North Carolina also makes it impossible to raise adequate revenue for the long-term. Because low- and moderate-income households have seen their wages and incomes stagnate and even decline in recent decades, while upper-income households have continued to see growth, maintaining revenue levels based on greater contributions by those least able to pay will be difficult.[6] Additionally,

FIGURE 2: Civitas/Laffer Plan Increases Taxes for Middle- and Low- Income Taxpayers

Combined Impact of Reform Civitas/Laffer Proposal							
2012 Income Groups	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Next 15%**	**Next 4%**	**Top 1%**
Income Range	**Less than $18,000**	**$18,000-$31,000**	**$31,000-$51,000**	**$51,000-$82,000**	**$82,000-$164,000**	**$164,000-$379,000**	**$379,00 or more**
Average Income in Group	**$11,000**	**$24,000**	**$40,000**	**$65,000**	**$110,000**	**$228,000**	**$902,000**
Tax Change as % of Income	4.8%	2.1%	0.4%	-0.7%	-2.2%	-3.6%	-4.5%
Average Tax Change	$544	$500	$174	($476)	($2,465)	($8,172)	($40,732)

SOURCE: Special data analysis request to ITEP, December 2012.

NOTE: The results are based on ITEP modeling of all aspects of the tax plan including the impact of the new business license fee under the assumption that the full amount would be borne by incorporated businesses paying the corporate income tax. Based on this assumption, the tax would pass through to corporate shareholders nationwide, of which only a small fraction lives in North Carolina.

low- and moderate-income households facing higher taxes on basic needs like food and medicine would have fewer dollars to spend on meeting other necessities.

Sales taxes could be even higher — and the tax shift even larger – than envisioned under the Civitas/Laffer plan if the business license and real estate transaction fees fail to raise the amount of revenue predicted because the difference will have to be made up somewhere. Because so little is known about the legal structure of the proposed business license tax, and because there is very little data available on active incorporated and unincorporated businesses in North Carolina, evaluating whether the proposed tax could actually raise $4 billion a year is difficult.

STABLE REVENUE, LONG-TERM CAPACITY NEEDED TO ADEQUATELY INVEST

The Civitas/Laffer plan would leave North Carolina largely dependent on one source of revenue – the sales tax. Supporters of eliminating all personal and corporate income taxes contend that doing so would result in a less volatile revenue system. However, research has found that all major revenue sources are vulnerable to short-term volatility from changes in the economy, and that the long-term growth in the personal income tax outweighs its short-term volatility.[7]

The General Assembly's Fiscal Research Division has tracked revenue changes caused by economic conditions since 1997 and found that the growth in personal income tax revenue has significantly outpaced growth in sales tax revenue in the long run.[8] Accordingly, reducing reliance on the personal income tax to resolve short-term volatility concerns would likely reduce the long-term growth of state revenue.[9] This will present significant budget challenges for future policymakers seeking to make investments in line with a growing economy.

Furthermore, since the plan is designed to neither lower nor increase the total amount of revenue the state currently takes in and eliminates the personal income tax, it would lock in historically low revenue collections (**See Box on page 4**). This plan would severely crimp the state's ability to invest in educating its workforce for good-paying jobs, build and maintain a modern transportation system, provide health care to needy children, and a host of other services that make for a strong economic base into the future.

A Plan Based on Flawed Economic Theory

The Civitas/Laffer plan is based on the flawed theory of supply-side economics and the Laffer Curve, which hold that reducing taxes actually increases revenue and boosts economic growth. The evidence is overwhelming that this theory does not yield the economic growth.

There is no evidence of a direct relationship between top tax rates and economic or job growth, according to a 2012 study by the Congressional Research Service.[10] Moreover, states that Laffer himself has termed "high income tax states" turn out to have economic conditions comparable to, if not better than, states that do not have a personal income tax, according to the Institute on Taxation and Economic Policy.[11]

In fact, states with low income tax rates actually have lower employment growth and lower median household income than Laffer's designated high-tax states according to a recent study by Good Jobs First and the Iowa Policy Project.[12] Furthermore, the industry composition in a state has a greater impact on a state's economic performance. Similarly, an educated workforce, the presence of research centers like major universities and other knowledge factors boost per capita income growth. Accordingly, states will likely suffer in the long run because they lack the resources needed to invest in education and other building blocks of economic growth.[13]

A Better Way Forward

A sound tax system is one that allows North Carolina to invest in schools, roads, public safety and other assets that form a strong foundation for economic growth and opportunity. Such a tax system is able to raise adequate revenue in a way that is fair to all North Carolina taxpayers and is stable in the face of changing economic conditions.

The Civitas/Laffer plan does the opposite. It would mostly benefit high-income individuals while increasing taxes for 60 percent of North Carolinians, primarily middle- and low-income taxpayers. It would lock in a revenue level that is at a historic low, and fail to meet the state's needs now and in the future. A much better option than the Civitas/Laffer plan would be true tax reform that helps promote a brighter future for *all* North Carolinians.

1 "General Fund Revenue Report & Economic Outlook," Barry Boardman, Fiscal Research Division, North Carolina General Assembly; September 2012. Archived presentation last assessed on January 15, 2013.

2 *Ibid.*

3 "Where Does the Money Come From? North Carolina FY 2011-12 Budget," Fiscal Research Division, North Carolina General Assembly; August 2011. NOTE: The existing business franchise tax applies to incorporated businesses – C Corporations and S Corporations.

4 The Civitas/Laffer plan estimates $12.9 billion in total revenue from the state sales tax. For FY 2012, the state sales tax raised $5.3 billion, meaning the plan would raise an additional $7.6 billion from the state sales taxes.

5 Sirota, Alexandra, September 2012. *Who Pays Taxes? The Rich, The Poor and Everyone in Between*. BTC Brief: NC Justice Center, Raleigh, NC.

6 Mitchell, Tazra, June 2012, *Economic Mobility and the American Dream: How is the Deck Stacked in North Carolina?* BTC Brief: NC Justice Center, Raleigh, NC and Mitchell, Tazra, September 2012, *High Poverty Levels Resistant to Economic Recovery: Families Still Reeling from the Great Recession*. BTC Brief: NC Justice Center, Raleigh, NC.

7 Alexandra F. Sirota, "The Case For North Carolina's Personal Income Tax," NC Budget and Tax Center. April 2012.

8 *Ibid.*

9 Donald Bruce, William Fox and MH Tuttle, "In It for the Long Haul: Why Concerns over the Personal Income Tax 'Volatility' Are Overblown," Institute on Taxation and Economic Policy. March 31, 2011.

10 Thomas L. Hungerford , "Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945," Congressional Research

Service. September 14, 2012.

11 "High Rate" Income Tax States Are Outperforming No-Tax States: Don't Be Fooled by Junk Economics, Institute of Taxation and Economic Policy. February 2012.

12 Peter Fisher, Greg LeRoy and Philip Mattera, "Selling Snake Oil to the States: The American Legislative Exchange Council's Flawed Prescriptions for Prosperity," Good Jobs First and The Iowa Policy Project. November 2012.

13 Bauer, Paul W., Mark E. Schweitzer, and Scott Shane, 2006. *State Growth Empirics: The Long Run Determinants of State Income Growth*. Federal Reserve Bank of Chicago.

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