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THE CASE FOR NORTH CAROLINA'S PERSONAL INCOME TAX

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Executive Summary

- North Carolina's personal income tax represents half of the revenue collected by the state each year (an estimated $10 billion in 2011).
- Compared to every other tax in the state's revenue system, the personal income tax is most aligned with ability to pay and grows the most with the economy, which makes it key to ensuring the long-term adequacy of the state's revenue system.
- North Carolina should continue to rely primarily on the progressive income tax. However, the state's personal income has room for improvement to ensure adequate collections and an overall fairer state and local tax system. A strong first step toward reform would be broadening the personal income tax base to adjusted gross income (AGI) and creating an upper-income tax bracket.

Personal Income Tax is a Load-Bearing Pillar of the State's Revenue System

As Tax Day comes and goes in North Carolina and across the country, taxpayers are filing personal income tax returns with both the state and federal governments. In so doing, they are making vital contributions to their communities' well-being by helping to fund public schools, public safety agencies, public health programs, and infrastructure development.

North Carolina's personal income tax was established under state administration in 1921 as the state took on more financial responsibility for schools and roads. The personal income tax was viewed as the best way to ensure adequacy and equity in the state's tax system—a view that most economists and public-finance experts share to this day. The state personal income tax is a vital source of revenue that enables state policymakers to invest in a shared vision for a prosperous state.

The personal income tax is critical for bringing North Carolina's revenue system closer to fulfilling the three primary principles of a responsible, modern revenue system—equity, adequacy and stability. This BTC Report outlines the role of the personal income tax in the state's revenue system and reviews reform proposals that can improve the function of the personal income tax.

REVENUE MODERNIZATION PRINCIPLES

Equity

The services and investments that taxes make possible—from building the human capital necessary for a skilled, productive workforce to ensuring clean air and water in every community—benefit everyone, and it is important that everyone contributes according to their ability to pay.

Adequacy

North Carolina's revenue system must bring in enough revenue to adequately support investments in the public structures—schools, colleges, courts, and infrastructure—that pave the way to economic growth and prosperity.

Stability

State revenues, in combination with other fiscal tools like the Rainy Day Fund, should provide a stable base of resources for public investments and services even when the economy is weak.

North Carolina's Personal Income Tax

The personal income tax in North Carolina today is collected on wages, salaries, capital gains and other income with graduated rates that increase as income increases. As a result, the personal income tax is better aligned with taxpayers' ability to pay than any other tax in the state's revenue system.

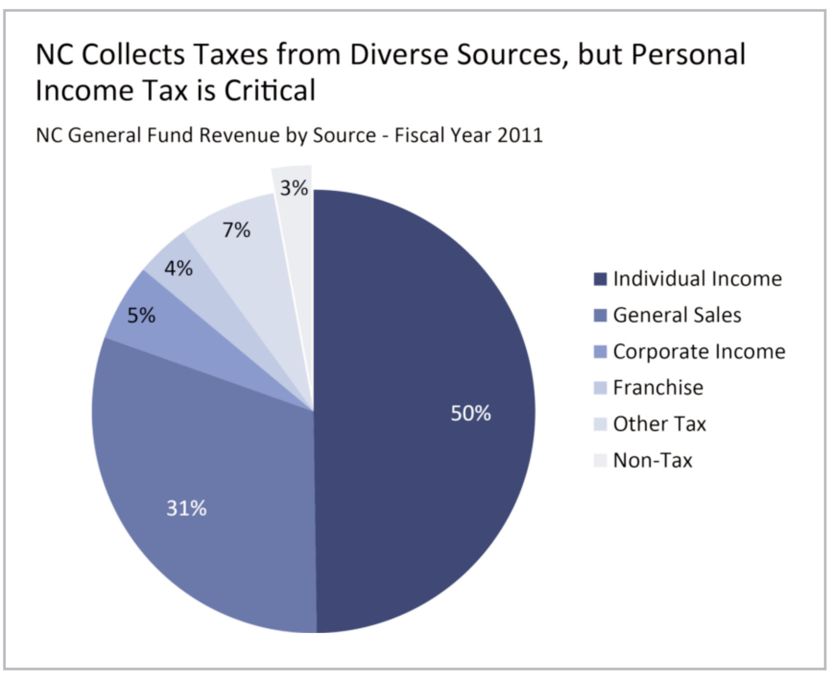
The state's personal income tax is based on federal taxable income, which takes into account deductions and exemptions such as mortgage interest, charitable contributions and major medical expenses. It is therefore a narrower base than adjusted gross income, which is a taxpayer's income before federal deductions and exemptions are accounted for and is what most states use.

Under current law, personal income tax rates range from 6 percent to 7.75 percent. The rate is applied according to the taxpayer's income as well as his filing status. The tax rates reported in the state's tax schedule are marginal tax rates, so only income earned in excess of each bracket is taxed at a higher rate. Therefore, if a taxpayer has income of $150,000, only the last $50,000 will be taxed at 7.75 percent in North Carolina. It is important to note that the effective tax rate paid by any given taxpayer will always be lower than the top marginal rate.

Personal income tax collections represents half of the state's revenue. In 2011, the latest year of actual data available, the personal income tax generated $10 billion **(see Figure 1).**

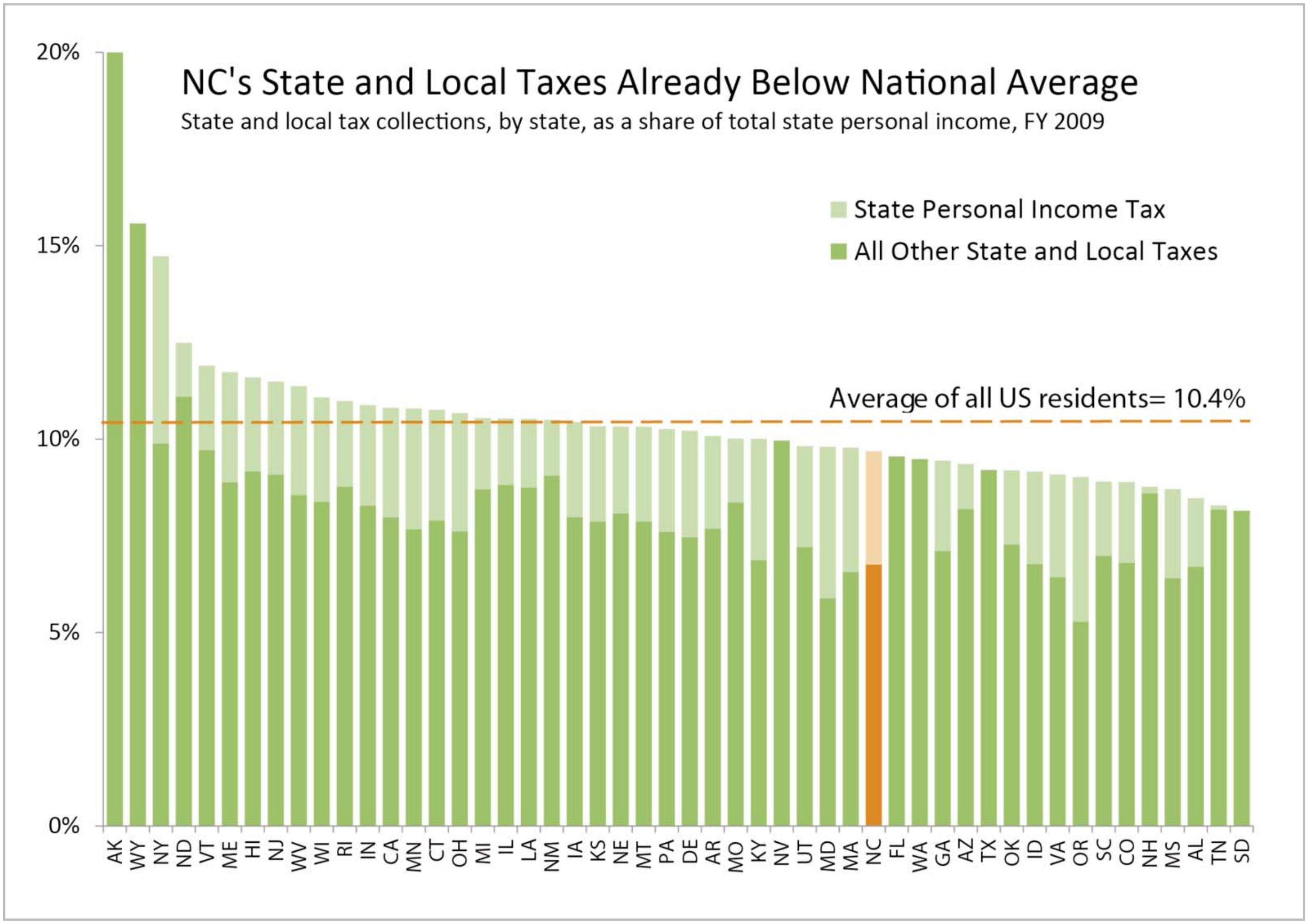
The relative importance of the personal income tax to the state's revenue system has increased over the years as North

FIGURE 1



SOURCE: NC Office of State Controller

FIGURE 2



SOURCE: Center on Budget and Policy Priorities tabulations of data from US Census Bureau and US Bureau of Economic Analysis

TAX RATE SCHEDULE FOR TAX YEAR 2011

Married Filing Jointly or qualifying widow or widower

Taxable Income	NC Taxes Owed
\$0 to \$21,250	6% of NC Taxable Income
\$21,250 to \$100,000	\$1,275 + 7% of amount over \$21,250
\$100,000 or greater	\$6,787.50 + 7.75% of the amount over \$100,000

Carolina has reduced its collection of corporate income taxes and use of other non-tax revenue to support the General Fund.

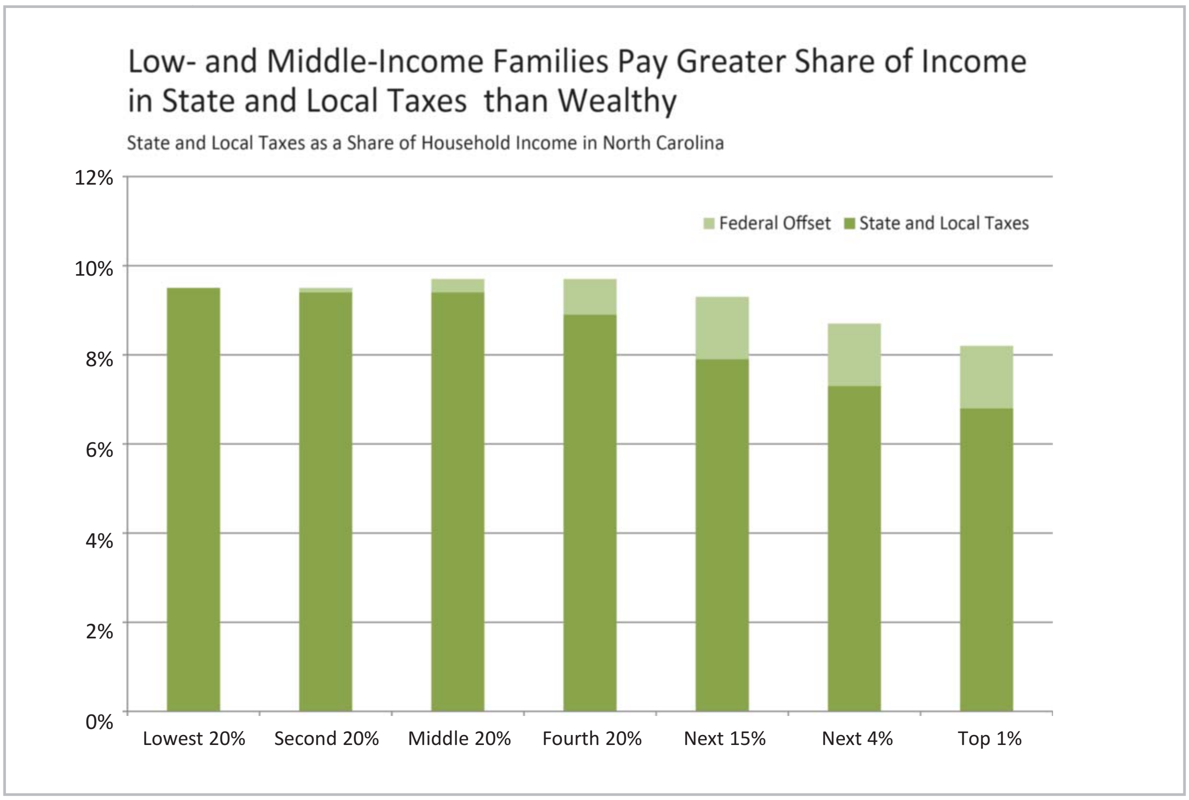
North Carolina's personal income tax collections as a share of the state's personal income (the total income received by state's residents from all sources) is 2.9%. North Carolina ranks 15th in the nation for lowest total state and local taxes. **(see Figure 2).**

Equity and the Personal Income Tax

Among North Carolina's three primary sources of state and local revenues, the personal income tax best aligns contributions from individual taxpayers with ability to pay. Taking account of all state and local taxes, low- and middle-income North Carolinians pay a greater share of their incomes in taxes than high-income households do **(see Figure 3)**. The primary reason that tax contributions rise as ability to pay falls in North Carolina is that state and local sales and excise taxes consume a much larger share of the budgets of low- and middle-income families than of the budgets of high-income families. The situation is the opposite in the case of North Carolina's personal income tax: low- and middle-income families pay less as a share of income than wealthier households do. Local property taxes consume a roughly equal share of the incomes of low-, middle-, and high-income families.

In addition to the progressive structure of its personal income tax, North Carolina has several tax credits that help increase the equity of the state's overall tax system. The refundable state Earned Income Tax Credit (EITC), representing 5 percent of the federal credit, offsets to some extent the greater total tax contributions for low-income families *(See breakout box)*. The child tax credit and child and dependent care tax credit, though not as targeted towards low-income families as the EITC, do provide greater benefits to

FIGURE 3



SOURCE: Institute on Taxation and Economic Policy - November 2009

Includes "federal offset" for reduced federal income taxes for state and local taxes deducted from federal taxable income

low-income households and further support the alignment of the state's overall tax system with the ability-to-pay principle.[1] These credits are directly subtracted from the amount of personal income tax owed and are used to ensure North Carolina's tax systems is better aligned with the ability-to-pay principle or to reduce specific tax contributions, for example in the case of property taxes.[2]

North Carolina's primary reliance on a progressive personal income tax at the state level

WORKING FAMILIES EARN IT

Some 883,000 North Carolinians received the state Earned Income Tax Credit in tax year 2010, the latest year for which data are available.[4] A conservative estimate would suggest that the state's credit reaches nearly 1 in 4 workers in the state.

The credit is calculated as 5 percent of the federal Earned Income Tax Credit and provides a boost to low-income working families so that they can make ends meet and provide for their families. For those earning low wages, the EITC has been proven to keep workers and their children out of poverty. In 2009, nearly 6.5 million Americans were kept out of poverty as a result of the federal EITC.[5]

Recent research has found that nearly half of all families with children in an 18-year period received the credit at least once. Sixty-one percent received the credit for one or two years at time, suggesting that the credit additionally plays an important role for families facing hard times.[6]

helps to partially offset the disproportionate impact of regressive state and local sales and excise taxes on low- and middle-income families' budgets. A progressive personal income tax also aligns with historical growth in incomes in North Carolina, which have not been evenly distributed for households at all income levels. In fact, since 1979, the top 5 percent of earners have seen 35-percent growth in their earnings while those with earnings in the bottom 20 percent have seen growth of 12 percent.[3]

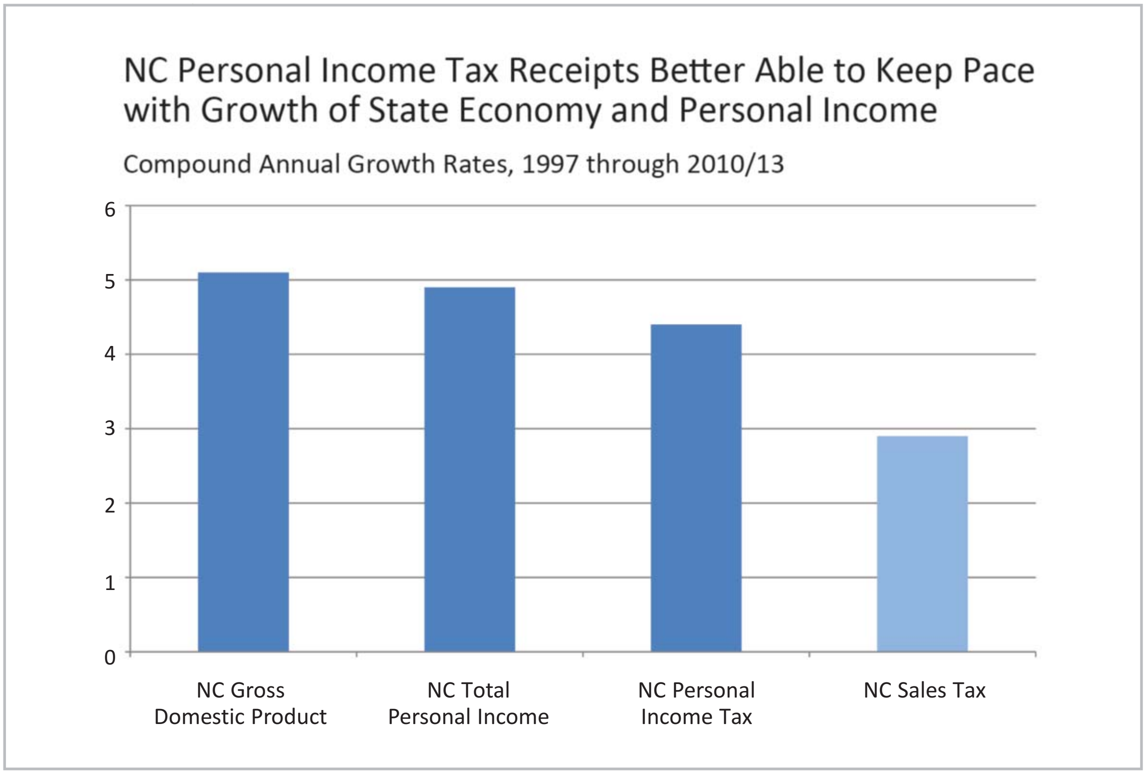
Adequacy, Stability and the Personal Income Tax

North Carolina's reliance on the personal income tax has yielded state revenues that have kept better pace with the long-run growth of the state's economy and residents' incomes. Personal income tax revenues have outperformed other, more volatile sources of revenue in growth and have enabled North Carolina to better meet fast-growing demand for public investments and services in the areas of public education, physical and mental health services, and public safety.

The General Assembly's Fiscal Research Division (FRD) has tracked economy-based revenue changes (excluding tax-law changes) since 1997. Although no single revenue source has fully kept pace with growth in the state's economy over that time, what stands out in FRD's analysis is that economy-based growth in personal income tax revenues has significantly outpaced growth in sales tax revenues in the long run, with economic growth lifting personal income tax receipts an average of 50 percent faster than sales tax receipts **(see Figure 4)**. Even accounting for incremental increases in the state sales tax rate since 1990 and other changes to sales tax law, sales tax receipts have failed to keep up with growth in personal income tax receipts.

This long-run growth in the personal income tax stands in contrast to the short-term volatility that is often a critique of the income tax. However, research has found that all major revenue sources are vulnerable to short-term volatility, and it is clear that reducing reliance on the personal income tax to resolve short-term volatility concerns would negatively impact the long-term growth rate of state revenue.[7]

FIGURE 4



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

Economy-based changes based on analysis by NC FIscal Research Division, which control for annual changes in tax law. Notes: All rates are compound annual growth rates. All rates except NC GDP for the period from FY 1997 through FY 2013 including projections by NC FIscal Research Dvision and the NC Office of State Budget and Management. NC GDP growth rates over the period from CY 1997 through CY 2010.

RAINY DAY FUND A TOOL FOR ADDRESSING VOLATILITY IN REVENUE

Fortunately, lawmakers can counter the inevitable short-term volatility of state revenues, including the personal income tax, by investing in the state's Rainy Day Fund. Officially called the Savings Reserve Account, the state's Rainy Day Fund is funded through contributions in good times so that the state can maintain investments during downturns. Current law calls on the state legislature to make contributions to the fund at the end of the fiscal year based on the allocation of one-quarter of unreserved balance. The result of these rules is that North Carolina has only once hit its target for Rainy Day Fund levels in the past 20 years.[8] By setting the Rainy Day Fund target to a higher proportion of the state's operating budget and moving savings to the front of the budget cycle, it is possible to improve the effectiveness of the Rainy Day Fund to minimize the negative impact of business cycles on the state's investments.

Setting the Record Straight on the Personal Income Tax in North Carolina

Given the pivotal role of the personal income tax in the state's revenue system, discussions of revenue modernization have necessarily included proposals to reform this tax. State policymakers have recently suggested eliminating the personal income tax or replacing the current progressive income tax with a flat personal income tax rate. Both proposals have been put forward with separate yet similar economic justifications. The proposal to eliminate the personal income tax is based on the claim that personal income taxes have a negative impact on economic growth and individuals' behaviors *vis a vis* work and where they live. The proposal to move North Carolina to a flat personal income tax is based on similar claims regarding the impact on individual behavior, particularly savings and investment decisions.

■ Personal income tax and economic growth

One concern expressed by policymakers is that too great a reliance on the personal income tax could impede economic growth or encourage wealthier residents to move to states with lower income taxes. Recent research on both issues should put those concerns to rest. A landmark 2004 study by economist Howard Chernick found no statistical relationship between a state's reliance on progressive taxes and several measures of economic growth.[9] More recent research by the Institute on Taxation and Economic Policy comparing the nine states with "high" income tax rates and the nine states without a personal income tax finds that those states with "high" rates are experiencing economic conditions as good as or in some cases better than those in states without a personal income tax.[10]

Additional analysis of longer-term trends has found that of the nine states adopting a personal income tax since the 1950s, six have seen higher income growth than the national average.[11] Moreover, analysts at the Federal Reserve Bank of Cleveland found after analyzing data from 1904 to 2004 that the greatest driver of per capita income growth is the stock of educated workers, research institutions and other knowledge assets supported by public investment.[12]

■ Personal income tax and individual decisions about work, home and investment

Research into the personal income tax as a driver of individual decisions about how much to work, where to live and how much to save and invest attempt to better understand the relationship between tax policy and the behaviors of households. Such research demonstrates the complexity of the effort to single out taxes and assign a value to the magnitude of their impact on decisions. A review of some of the most relevant research is provided below.

Economic theory suggests that taxes can impact an individual's decision to work in two ways. One way, called the income effect, could occur if by reducing the average tax rates, the after-tax income of a worker is increased and therefore a worker can work fewer hours and maintain their standard of living. Moving in the opposite direction is the substitution effect, which could occur after a reduction in the marginal tax rate of the worker resulting in increased hours of work. A review of available research finds that the statistical evidence to support the economic theory that would suggest tax cuts impact labor supply is not conclusive.[13] More recent research by the Congressional Budget Office in 2007 of various tax changes found that the impacts vary across the income distribution: some of the greatest impacts from reductions in marginal rates, for example, would be for low-income workers and secondary wage earners.[14] This is because low-income workers are much more sensitive to changes in their after-tax income.

Research has found that taxes play a minor to non-existent role in decisions about where to locate. Several recent studies on interstate migration have found that income taxes do not drive decisions by households about where to locate.[15] This new research confirms North Carolina's experience: the Budget and Tax Center found that net in-migration of wealthy households into North Carolina increased significantly after the state added a new top income-tax bracket in 2001.[16]

Finally, there is additional research to suggest that the personal income tax does not significantly affect job-creation decisions. This is primarily because relatively few personal income tax filers, whether they are individuals or businesses, are in a position to create jobs. Nearly half of the businesses filing personal income taxes are sole proprietors and 9 out 10 of those do not have any employees.[17] Moreover, research has found that more than 14 percent of filers with small-business income claim the EITC for

RECENT PERSONAL INCOME TAX PROPOSALS WILL NOT MODERNIZE THE STATE'S REVENUE SYSTEM

Recent personal income tax proposals, including the elimination of the personal income tax and a move to a flat rate, are not evidence-based and undermine core principles of a sound revenue system. Outright elimination of the personal income tax would be counter to the consensus goal of making North Carolina's revenue system less volatile and more adequate, while moving to a flat income tax would require greater contributions from low-income households.

The elimination of the personal income tax would result in the loss of nearly half of the state's revenue in a given year. A state revenue loss of this magnitude would be unsustainable in either the short or long term. Given that fact, shifting to consumption-based taxes in lieu of the income tax would likewise constitute a major shock to both the North Carolina economy and individual taxpayers. Under our current sales tax, the rate would have to triple in order to replace the amount of revenue lost from the income tax, and even then it may not prove sufficient. Increasing the sales tax so steeply would dampen consumer spending on many key goods and services beyond those necessary for subsistence. This major tax shift would also disproportionately impact low- and moderate-income households, who already spend a greater share of their incomes on goods and services subject to sales tax.

Moving to a flat personal income tax would likewise constitute a significant expense to low- and moderate-income taxpayers, many of whom already pay a higher effective tax rate than the wealthiest residents of this state. Moreover, some of the recent proposals in the state around flat taxes also consider further narrowing the base by excluding saved income, thereby cutting into the ability of the tax to achieve adequacy without also requiring higher rates.

low-income workers.[18] Research has also found that the impact of tax cuts on business investment would not only be small but require years to fully take effect. Evidence has generally found that a 10 percent reduction in total state and local taxes paid by businesses is likely to boost economic output and jobs by only about 2 percent.[19] Additionally, as emerging research is beginning to show many small businesses are not in a position to significantly grow their businesses due to the nature of their industry and their own motivations for owning a small business.[20]

Ultimately an additional body of research should be consulted when considering the impacts of tax changes on individual decisions and broader economic growth. This research documents how what taxes pay for can contribute to greater economic opportunity and generate higher educational attainment and expansion and attraction of businesses for example.[21]

Conclusion

North Carolina's reliance on the personal income tax as its primary source of state revenues provides multiple important benefits to state residents. It ensures that state revenues are better able to keep pace with growth in the state's economy and demand for public investments, and it better aligns North Carolinians' state and local tax contributions with families' ability to pay.

Reforms to the personal income tax are certainly needed, but they should be done in a way that supports the consensus principles of comprehensive revenue modernization and, in so doing, ensure that North Carolina is positioned to invest in economic opportunity for all.

MODERNIZING THE PERSONAL INCOME TAX: The Budget and Tax Center's Proposal

▶ Broaden the Base

North Carolina's personal income tax has performed ably in its role as the primary source of state tax revenue since the state's last major income-tax reform effort in 1989. By adopting federal taxable income as the starting point for calculating state income taxes, however, North Carolina has experienced a gradual erosion of its income tax base caused by federal tax policy changes, especially growth in some income tax deductions and exemptions.

Further de-linking North Carolina's personal income tax from some federal deductions and converting the remaining deductions to credits would generate several important benefits for state residents. Narrowing the allowable federal deductions to mortgage interest on a primary residence, eligible health care expenditures, and charitable contributions and converting them and the personal exemption into a flat-rate credit would make North Carolina's personal income tax revenues less volatile while also raising additional revenue at the same, or even slightly lower, tax rates.

- **Broaden the income-tax base to Adjusted Gross Income (AGI).**
- **Replace itemized deductions and the personal exemption with comparable tax credits.**
- **Phase out some deductions/credits at higher income levels.**

▶ Make the Rate Structure More Progressive

Even with North Carolina's current reliance on the personal income tax as its primary source of state revenue, low- and middle-income families still pay a greater share of their incomes in state and local taxes than high-income North Carolinians do. Adding one or more new top income-tax brackets to a broader income tax base, while also increasing the value of the state's Earned Income Tax Credit (EITC), would help to tip North Carolina's current regressive tax system closer to a more proportional tax system, where families at different income levels would contribute a similar share of their annual incomes in state and local taxes. And because state income taxes are deductible on federal income taxes, much of the additional revenue from increasing the progressivity of North Carolina's personal income tax would be offset by the reduction in many households' federal income tax payments.

- **Add a new top income-tax bracket to better align overall tax contributions with ability to pay.**
- **Strengthen the state EITC.**

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