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IMPROVING THE SALES TAX:

A Critical Step to a Modern Revenue System

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EXECUTIVE SUMMARY

- The state sales tax in North Carolina represents nearly 30 percent of the state's total revenue each year. In 2011, the states sales tax generated $5.9 billion in state revenue.
- The sales tax is regressive, which means that it asks more from those with the least ability to pay. Lower-income families spend a greater share of their income on things subject to sales tax.
- North Carolina's sales tax is also narrow, outdated and unstable. The tax does not apply to the vast majority of transactions in the fastest-growing area of consumption—services.
- Some North Carolina legislators are considering a shift away from the personal income tax and toward a revenue system that primarily relies on consumption-based taxes which would require greater contributions from low- and moderate-income households in total taxes. Such a shift, if revenue-neutral, would raise the state sales tax rate to 13.88%.
- Broadening the base of the sales tax to services would align the sales tax with current consumption patterns and activity in the market

Introduction

North Carolina's revenue system faces three major hurdles: it is not aligned with the state's economy, it raises an inadequate amount of revenues, and it asks more from those with the least ability to pay. While the sales tax is exemplary of these problems with the revenue system, it is also a critical source of revenue for the state to invest in educating children, protecting communities, and attracting and growing businesses. Several legislative commissions have recommended reforms to the sales tax that could go a long way toward making the sales tax work better for all North Carolinians.

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This edition of BTC Reports *reviews the current structure of North Carolina's sales tax, outlines concerns with the sales tax, and offers recommendations for improving the sales tax in line with the principles of adequacy, equity and stability.*

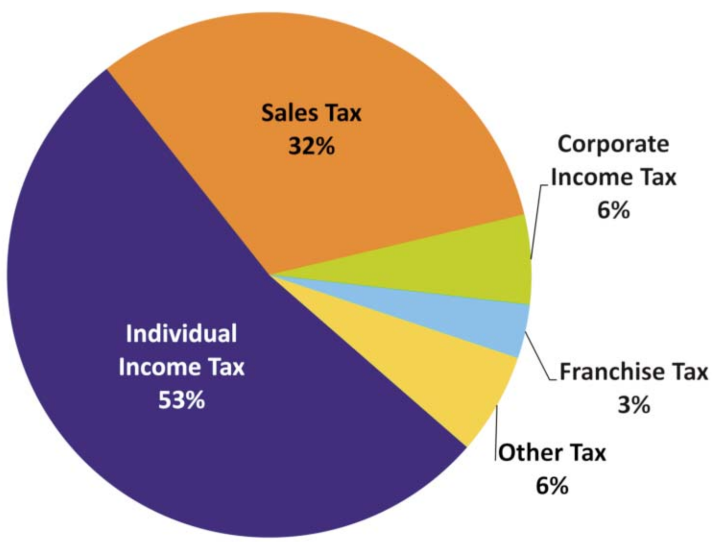
How the Sales Tax Works

The sales tax raises money for public structures by taxing many forms of transactions. The state and every county government levy sales taxes. The state sales tax rate is currently 4.75 percent, and most local governments levy an additional local option sales tax of 2 or 2.5 percent, for a combined state and local rate of 6.75 percent to 7.25 percent.

State sales tax collections provide nearly 30 percent of the state's total revenues each year and totaled $5.9 billion in 2011[1] (**Figure 1**). This dollar amount is roughly equivalent to combined state appropriations for the community college system ($990 million), the state's prisons ($1.66 billion), and Medicaid ($3.1 billion).

The sales tax rate is applied to the price paid for a good or service at retail sale,[2] and therefore the amount collected is closely tied to the base to which the rate is applied. In North Carolina, the base for the sales tax is narrow, with many services not taxed and numerous items exempted. The state sales tax base includes goods, such as a tube of toothpaste or a lawnmower. Several major consumer expenditure categories are exempt from the state sales tax, notably groceries and health care.

FIGURE 1: State Sales Tax Represents a Third of the State's Total Revenue Collected Each Year



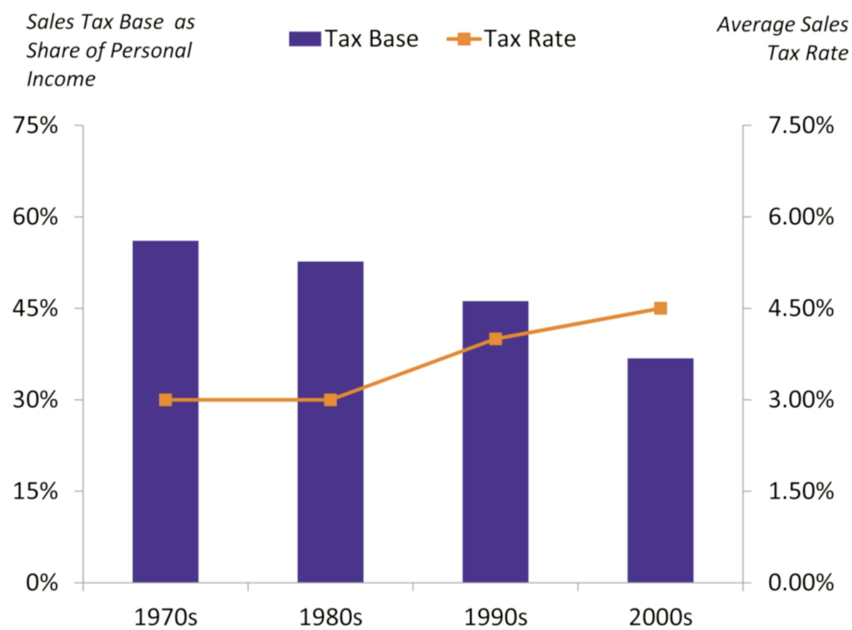
SOURCE: NC Department of Revenue, 2011.

For several decades, North Carolina has experienced a national trend in which consumer purchasing patterns have shifted away from goods in favor of services – most of which are not subject to sales tax.[3] As a result, the sales tax is applied to a smaller percentage of household transactions each year. While the sales tax base in North Carolina has eroded, policymakers have had to raise the rate in an attempt to collect similar revenue levels.

This erosion is directly linked to the exclusion of services from the sales tax base (**See Figure 2**). In the 1970s, the sales tax base as a share of personal income was 56.1 percent and the rate was around 3 percent. But by the 2000s, the sales tax base had fallen to 36.8 percent of personal income and the rate had risen to 4.5 percent. Studies show that the erosion of the traditional state sales-tax base is a major contributing factor to the ongoing gap many states face between the cost of meeting public needs and the resources available.[4]

The state sales tax rate is also not uniformly applied to all goods and services. Lower (or preferential) rates are applied to the purchase of cars, boats, electricity, and various other goods and services. Higher rates are applied to purchases primarily made by tourists, such

FIGURE 2: NC Policymakers have Raised the Sales Tax Rate to Keep Up with Declining Taxable Base



SOURCE: NC Fiscal Research Division

as hotel rooms or rental cars, with the goal of "exporting" part of the sales tax to residents of other states.

North Carolina has an additional category of taxes on consumption known as selective or excise taxes. Excise taxes are imposed on the consumption of certain goods, such as alcoholic beverages, tobacco products, and petroleum products. Due to differences in tax bases and rates, direct comparisons between the sales tax and excise taxes are not possible. Excise tax rates vary considerably, and unlike the sales tax, excise tax rates are not always predicated on retail prices. Excise taxes for alcoholic beverages are assessed by volume, i.e., liters and gallons. Franchise taxes on piped natural gas are assessed per unit of consumption (therms) rather than market price per unit, and franchise taxes on electricity are assessed on gross receipts reported by the electric utility.

EXCISE TAXES ARE A CONSUMPTION TAX

Goods subject to excise taxation often possess one or more of the following characteristics:

- **Consumption of the good doesn't fall dramatically relative to increases in price**
- **Production and/or consumption of the good is regulated by government (i.e., sumptuary)**
- **The good is considered a "luxury good"[5]**
- **Consumption of the good is considered to have broad negative externalities[6]**

Although many excise taxes are not assessed against the price of a good, the total excise tax paid on a good relative to its price is usually greater than what would have been paid if the same good were subject to the retail sales tax.[7] Incorporating alcoholic beverages and tobacco products into the state sales tax and eliminating existing excise taxes on these products would likely result in a net revenue loss to the state as well as revenue losses for local governments (see "Sales Tax Implications for Local Governments"). Applying the state sales tax to electricity and piped natural gas in lieu of excise taxes on those items would likely result in some degree of cascading, which is undesirable (see "Taxation of Business Inputs").

SALES TAX IMPLICATIONS FOR LOCAL GOVERNMENTS

Local option sales taxes are a major source of revenue for cities and counties in North Carolina, as local-option-sales-tax collections are second only in magnitude to property-tax collections in many jurisdictions. Local option sales taxes are levied by counties, which must in turn share some of those revenues with cities within their borders. Cities and counties may choose to assess up to 2.5 percent in local option sales taxes, which are collected on top of the general state rate. All items included in the state sales tax base are

SALES TAX HOLIDAY

North Carolina is one of more than a dozen states to offer sales tax "holidays." These holidays are three days at the beginning of August, when many school supplies and computers are exempt from sales tax, and at the beginning of November, when energy-efficient appliances are tax-exempt. However, these holidays do little to address inequities in the state's sales tax because they benefit all taxpayers, even the wealthiest North Carolinians who have more flexibility in their budgeting and who can more easily time their purchases to take advantage of this time-limited offering.

North Carolina's sales tax holidays are estimated to result in the loss of $12 million in state revenue each year. Sales tax holidays undermine the adequacy of the state's revenue system, requiring spending cuts to make up for the lost revenue or shifting the cost to another revenue source. In addition, the administration of sales tax exemptions, including holidays, involves significant red tape, such as requiring retailers, revenue departments, and local governments to monitor and document the distinction of eligible and ineligible products.[12]

taxable by local governments. Additionally, local governments are allowed to tax the sale of food for home consumption (i.e., groceries).

While local option sales taxes comprise a major source of revenue for most North Carolina cities and counties, the state also shares portions of its own sales tax revenue with local governments. In most cases, counties and cities are required to use these shared sales tax revenues partially or entirely for specific purposes outlined in state law. Any changes to the state sales tax rate naturally impacts how much revenue goes to local governments and as such should receive careful consideration. Revenues from excise taxes on items like beer and wine, franchise taxes on the sale of utility services (electric and piped natural gas), and motor-fuel excise taxes are also shared with local governments.

Raising or lowering the state sales tax rate will commensurately raise or lower the total amount of state sales tax revenue shared with local governments. Broadening the sales tax base to include services will also broaden the base upon which local option sales taxes are collected.[8]

Concerns with the Sales Tax's Alignment with Key Revenue Principles

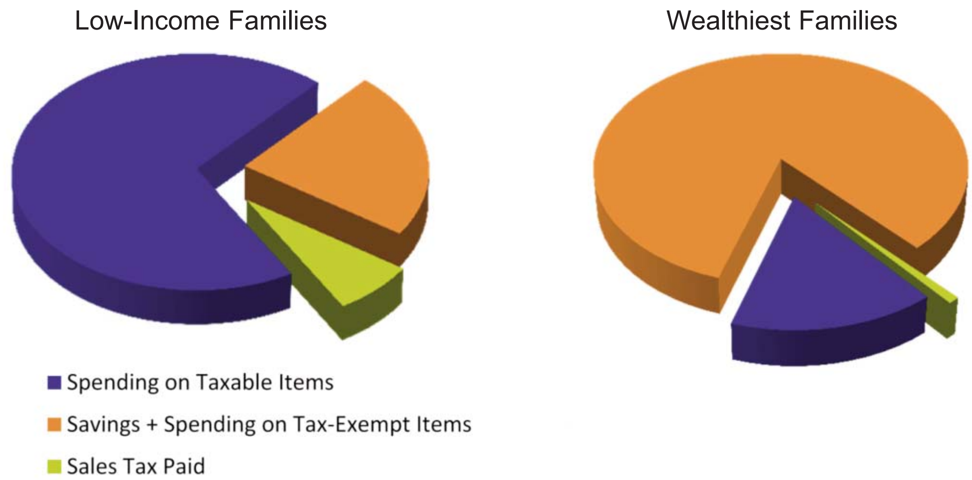
In addition to its narrow base, there are challenges with the sales tax that make its current function align poorly with key principles of sound revenue systems: equity, stability and adequacy. By its very nature, the sales tax asks more from those least able to pay, it is volatile in the face of economic shocks, and it struggles to achieve long-term adequacy without rate increases. It therefore is out of line with guiding principles for a sound state and local revenue system. As will be discussed in a later section, however, there are ways in which the sales tax can be improved to better align with these principles.

EQUITY

The sales tax contributes significantly to the regressivity of state and local tax codes. The lower a family's income, the greater the share of its income the family must dedicate to spending. The result is that low-income families pay a larger share of their incomes in sales tax than do wealthier families, who spend less of their incomes. Of the ten states with the most regressive tax systems, defined by the gap between the effective tax rates on the lowest-income 20 percent and the richest one percent of households, four rely heavily on a sales tax.[9]

The figure above right was produced by the Institute on Taxation and Economic Policy and is based on Consumer Expenditure Survey data. The left-hand pie chart shows that low-income families typically spend three-quarters of their incomes on things subject to sales tax, while the wealthiest families spend only about a sixth of their incomes on sales-taxable items.

FIGURE 3: Low-Income Households Spend More of their Income on Taxable Items

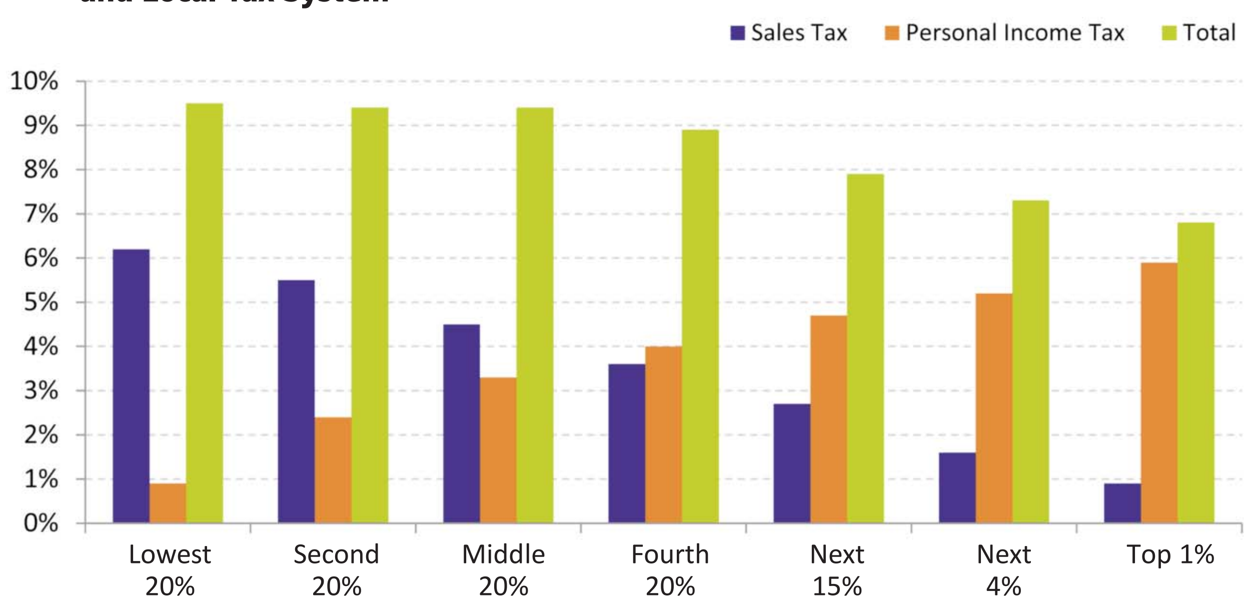


SOURCE: ITEP, 2011, Guide to Fair State and Local Taxes

Another way to think about the impact of such a tax on families is to consider what the sales tax rate would be equivalent to if translated into an income tax rate. In this scenario, a 6 percent sales tax is the equivalent of an income tax with a 4.5-percent rate for low-income families (that is three-quarters of the 6 percent sales tax rate) and a 1-percent income tax rate for the rich (one-sixth of 6 percent). This would not be a tax structure with broad public support or effective longevity. Because the sales tax's regressivity is hidden in a single rate and the amount families pay is hidden in many small purchases throughout the year, such a structure is tolerated.

The sales tax is the most significant contributor to the regressivity of the overall state and local tax system (**Figure 4**). Reliance on low-income families to raise adequate

FIGURE 4: Sales Tax Contributes Significantly to Overall Regressivity of the State and Local Tax System



SOURCE: ITEP, 2009, Who Pays? A Distributional Analysis of the Tax Systems of All Fifty States revenue for state investments is problematic for numerous reasons, not the least of which is that such a system forces households to choose between basic needs and taxes. In addition, these families have less long-term potential for income growth than wealthy families have, which means revenue growth is unlikely to keep pace with growth in the economy.[10] In North Carolina, as in the nation, the growth of income over time has been primarily in the top quintile of the distribution. Over the past three decades, the gap in wages between those in the top quintile and those in the bottom quintile has grown significantly and today stands at more than a $15 per hour.[11] The result is that long-term adequacy is difficult to achieve when the tax system relies heavily on those with stagnant or declining wages.

The state Earned Income Tax Credit is an important and effective tool for helping to alleviate the larger share of income low- and moderate-income North Carolinians pay in state and local taxes. In 2010, one in five North Carolina households (more than 880,000) received the EITC. A refundable EITC is particularly important to offset the regressivity of the sales tax. This tax credit reduces the total state and local tax contributions of low-income and working families even if their incomes are so low that they have no personal income tax liability. But it only partially offsets the greater contributions made by low-income families since they contribute a considerable amount of their income in the form of sales taxes.

THE SALES TAX FAIRNESS FALLACY

The sales tax is often mischaracterized as a "fair" tax in debates around tax policy.[13] Proponents argue that the sales tax affects everyone equally because the tax on an item is the same no matter who buys it. But actually, it is the very claim of "equality" upon which sales taxes fail the test of fairness. The cost and sales tax on a bottle of laundry detergent is the same for a high-income person and a low-income person. But the rich person has many times more income, and thus the amount of tax paid on the bottle of laundry detergent is much less significant an expense (i.e., a smaller share of their income) than it is for the middle- or low-income person.[14]

Furthermore, the sales tax is not levied on every single transaction that takes place in the economy. While the sale of many tangible goods is subject to tax, far fewer services are included. Low-income families are likely to spend a larger share of their incomes on tangible goods and taxable services than high-income families are, further reinforcing the disproportionate impact of sales taxation on low-income families and individuals.

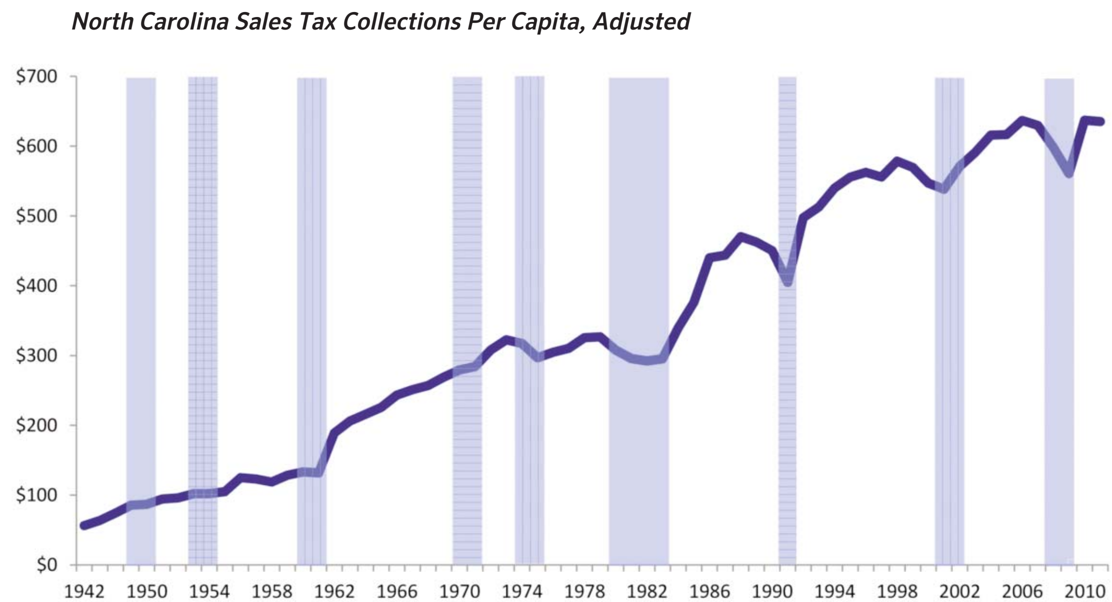
LONG-TERM ADEQUACY AND STABILITY

In 1933, when North Carolina first enacted a 3-percent state sales tax, household consumption consisted primarily of goods rather than services. There was no such thing back then as downloading music, for example; people bought music in the form of a good, on records or cassettes.

Over the last several decades, North Carolinians have seen purchasing patterns shift away from goods in favor of services, most of which are not subject to sales tax.[15] The result is that the sales tax is applied to a smaller percentage of household transactions each year. Therefore, state policymakers have had to increase the sales tax rate from 3 percent in 1990 to the current 4.75-percent rate just to keep revenues constant as a share of the state's economy.

The failure to include services in the base has the potential to create greater volatility and affect the long-term adequacy of revenue. Sales tax revenues experienced contractions in the Great Recession and prior downturns as a result of declines in consumer confidence and spending and the lack of services in the sales tax base (**Figure 5**). Sales taxes on services have greater stability because the consumption of services is more stable over

FIGURE 5: Historic State and Local Sales Tax and Recessions



NOTE: *As the U.S. economy and personal consumption expenditures have shifted away from taxable goods to largely-exempt services, the volatility of sales tax collections in response to economic downturns has increased significantly.*

SOURCES: U.S. Census Bureau, Annual Survey of State Government Tax Collections; U.S. Bureau of Labor Statistics, CPI-U for all items, less shelter; NBER, Business Cycle Dates

time than sales of big-ticket items, which make up a significant share of total sales tax revenues in North Carolina. While some have claimed that the sales tax can deliver greater stability than other revenue sources, it is important to note that research that demonstrates it is as volatile as the personal income tax.[16] Moreover, there is a tension between stability and long-term growth that must be balanced to effectively achieve long-term adequacy for the revenue system. The issue of volatility may be better addressed through such tools as Rainy Day Funds, which are contributed to in good times so that they can smooth revenue in downturns.[17]

It is difficult to achieve long-term adequacy with the sales tax when it excludes services, the fastest-growing area of consumption, in the base upon which the rate is applied. The continued expansion of preferential rates and existence of other sales tax exemptions further compromises the adequacy of the sales tax. Research has shown that the long-term growth of sales tax bases represent just half the growth in state income tax bases.[18]

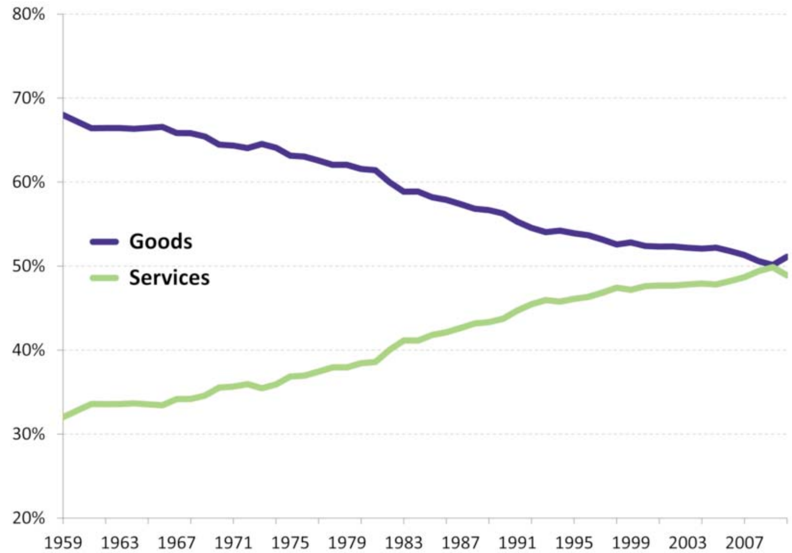
Improving NC's Sales Tax: Broaden the Base, Lower the Rate

The "basket" of goods and services subject to the state sales tax is narrow relative to personal consumption expenditures in the economy as a whole. The Federation of Tax Administrators lists 168 services that states could tax. North Carolina's sales tax currently applies to 30 of them. The most recent research shows that 32 states apply their sales tax to more services than North Carolina,[19] and many states are strongly considering broadening their sales taxes to include more services.[20]

In addition to exempting personal consumption on such items as food, health care and housing, there are multiple exemptions and refunds for the purchase of certain goods or the purchase of goods and services by certain types of consumers. There are also preferential – i.e., lower – sales tax rates for transactions involving certain items. As part of broadening the

FIGURE 6: Growth of Services Erodes Goods-Based Sales Tax

Personal Consumption Expenditures, Share of Goods and Services (excludes health care, education, professional services, and housing)



SOURCE: US Department of Commerce, Bureau of Economic Analysis, National Economic Accounts

sales tax base, policymakers should review and evaluate the costs and benefits of existing exceptions to general sales taxation of specific goods or services. The inclusion or exclusion of certain items in the sales tax base should be predicated on the principles of equity, stability, and adequacy, with the default position being one of inclusion in the sales tax base unless sales taxation of the good or service will result in negative economic effects, such as cascading (see "Taxation of Business Inputs" below), or greater inequity in the tax system.

Furthermore, personal consumption of services is now far greater than consumption of goods (**Figure 6**). As of 2011, 62.2 percent of national personal consumption expenditures were on services and 33.7 percent were on durable and non-durable goods.[21] Many of the largest categories within services in terms of total personal consumption expenditure are not subject to North Carolina's sales taxation, particularly housing[22] and health care, which represented 18 percent and 16.3 percent of total consumption expenditure in 2011, respectively. Housing is generally subject to property taxation, either directly in the case of homeowners or indirectly in the case of renters. For the most part, the consumption of health care services is not taxed.

Because services comprise such a large and growing share of consumption, state policymakers have long discussed extending the state sales tax to certain currently untaxed services. However, services that are most often shortlisted for inclusion in the sales tax base—such as lawn care, tattooing, and certain repair and maintenance services—have tended to account for a relatively small share of state personal consumption. Expanding the list of taxable items as broadly as possible would restore the long-term adequacy of North Carolina's sales tax. It would remove state government from the current process of "picking winners" among consumers and producers of services based on consumption patterns. Such discrepancies not only cost the state needed revenue, they also raise issues of fairness because households that rely more on services—and therefore avoid taxes—tend to me more affluent.

Finally, the revenue raised from broadening the base would allow North Carolina to lower the overall rate, going some way toward reducing the overall tax contributions from all households.

TAXATION OF BUSINESS INPUTS

Any discussion of broadening the sales tax base naturally raises the question of whether to tax business inputs, also called business-to-business (B2B) transactions. For the most part, the state sales tax is not applied to transactions conducted primarily between businesses, such as legal, accounting and engineering services. While including these services in the sales tax base could dramatically increase state sales tax collections, doing so would have negative economic consequences for both businesses and consumers that are better avoided.

The state sales tax is intended to tax only the final sales transaction of a good or service. As such, the rate set is intended to capture the total amount of revenue in one transaction. In theory this is simple, but in practice it can be difficult. When goods or services are subject to the sales tax at multiple stages between production and final sale, the tax owed is assessed on both the base price of the good or service and the tax already paid on the same good or service, resulting in a phenomenon called "cascading." Cascading distorts the relative prices of goods and services and causes the effective tax rate to be different from the statutory rate. This increases capital costs to producers and places financial strain on consumers.

It is particularly important to consider the possibility of cascading when extending the sales tax to certain types of services. For example, a business that pays taxes on its accounting and legal fees will likely pass those costs on to the consumers who purchase their final products—products that may be subject to sales tax again at the final transaction. Some research suggests this "hidden" sales tax on business inputs falls particularly hard on low-income families because it often ends up increasing the price of basic necessities like food and utilities.[23] In addition, large businesses that can afford in-house lawyers, accountants and engineers would be able to legally avoid paying sales tax on business inputs because these services would be provided by their own employees. Therefore, applying the sales tax to business inputs would put smaller businesses at a competitive disadvantage.

Potential Damage from Increasing Reliance on Consumption Taxes

A number of North Carolina policymakers have expressed interest in eliminating the personal income tax as part of the broader revenue modernization effort the NC General Assembly plans to undertake in 2013. Doing so would require all but the highest-income North Carolinians to pay a higher effective tax rate and would undermine the state's economic growth in both the short and long terms.

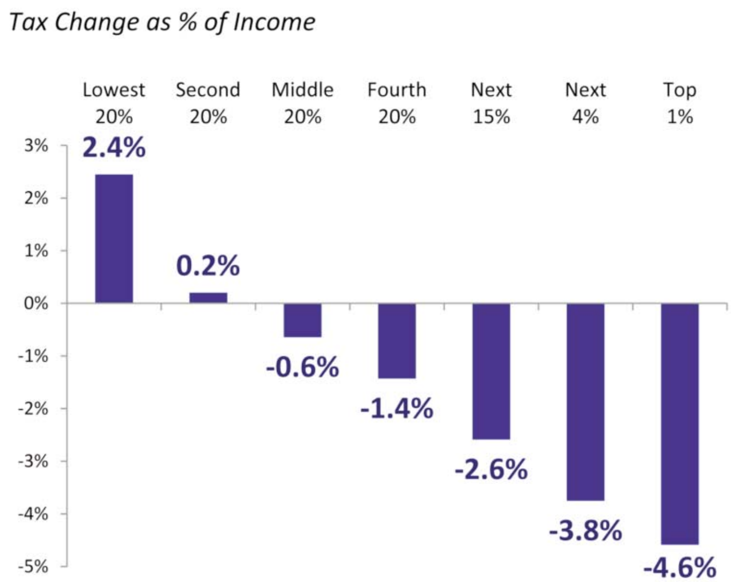
Reducing reliance on other major state revenue sources, particularly the personal income tax and the corporate income tax, would necessitate a shift toward reliance to the sales tax as a means of collecting revenue. State revenue collections from the personal income tax represent half of total General Fund revenues in any given year—approximately $10 billion. This amount is equivalent to the combined state budget for both K-12 and postsecondary education. Given the economic necessity, legality, and popularity of continuing to invest in public structures like education, reducing state revenues by such a significant margin is fundamentally impossible.[24] To suggest drastic reductions in personal-income-tax or corporate-income-tax collections is to imply a shift toward significantly higher consumption taxes, most likely in the form of higher sales taxes but also perhaps inclusive of higher excise taxes, franchise taxes, and user fees.

WHO PAYS IN THE GREAT TAX SWAP?

There are various scenarios under which policymakers could implement a tax swap for the elimination of the personal income tax. These scenarios are dependent upon the percentage of revenue lost from the personal-income-tax elimination that policymakers would seek to replace with revenue from other sources. Each scenario presents different impacts on taxpayers at different places in the income distribution.

The greater effort to replace the personal income tax revenue from other sources—that is, the higher the percentage to be replaced—the larger the number of North Carolinians who would experience an increase in their contributions in taxes as a share of their income. Assuming the state legislature increased the sales tax rate enough to replace 75 percent or more of the revenue lost from the personal-income-tax elimination, people in the bottom 60 percent of North Carolina's income distribution would see a net increase in their state and local taxes. To replace 50 percent would require a net increase in tax contributions from those in the bottom 40 percent of the state's income distribution, or those earning less than $31,000 (**Figure 7**).

FIGURE 7: Replacing 50 percent of Revenue Loss from Income Tax Repeal with Sales Tax will Require Greater Contributions from those earning less than $31,000.



SOURCE: Institute on Taxation and Economic Policy, Special Request June 2012

Notably, the tax swap would provide a significant tax cut to those in the highest end of the income distribution. Under the 50-percent-replacement scenario, the top 1 percent of North Carolinians would see a net reduction in their contributions of 4.6 percent, the result of which would further exacerbate the state's upside-down revenue system. With this shift, for every $100 earned, a millionaire would pay $2.20 in total state and local taxes, while someone earning $24,000 would pay $10.70.[25]

At the same time that the tax contributions would shift down the income distribution, the sales tax rate would need to increase over the current base. To replace 50 percent of the personal income tax revenue lost, the new state sales tax rate would have to be 9.32 percent, an increase of more than 4 percentage points over the

REVENUE NEUTRAL SHIFT TO CONSUMPTION BASED SYSTEM

Much of the discussion of revenue modernization proposals has been focused on revenue neutrality, the idea that changes to the tax code should not have a net negative or positive affect on the level of taxes collected. A change to a consumption-based system that is revenue-neutral that is makes up the entire loss in revenue from the elimination of the personal income tax or $10 billion would require a 9.13 percent increase in the state sales tax rate to 13.88 percent. This would result in a tax increase by 5.6% on the lowest-income North Carolinians while cutting taxes for the top 1% by 4 percent. Even if the base of the state sales tax was expanded to include all those services in the Budget and Tax Center's plan, the sales tax rate would still need to increase to 12.51 percent to maintain revenue neutrality.

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 – $81,000	$81,000 – $163,000	$163,000 – $387,000	$387,000 – Or More
Average Income in Group	$11,000	$24,000	$40,000	$65,000	$111,000	$232,000	$1,021,000
Tax Change as % of Income	+5.6%	+2.3%	+1.3%	+0.1%	-1.3%	-3.0%	-4.0%

Source: ITEP, Special Data Request, June 2012

CHASING AMAZON: SALES TAXATION OF ONLINE COMMERCE

States and localities lose more than $7 billion a year in uncollected sales taxes because of a 1992 U.S. Supreme Court decision that allows Internet and catalog sellers to avoid charging the tax to a customer if the company does not have a "physical presence" in the customer's state. Internet retailer Amazon.com has argued that the company obtains no meaningful benefits from states in which it maintains no facilities and therefore should not have to collect taxes for those states, and that collecting sales taxes would pose an undue administrative burden.[29]

While there is ample evidence to counter both of these assertions—and to suggest that Amazon.com enjoys a significant competitive price advantage over brick-and-mortar retailers by virtue of not assessing and collecting sales taxes—the magnitude of state revenues foregone due to the non-taxation of internet sales is clear. A 2009 study by researchers at the University of Tennessee estimated that, under a baseline scenario, total state and local sales and use taxes due on e-commerce in North Carolina in 2012 would be $858.1 million.[30] That amount is equivalent to 15 percent of the state's $5.9 billion in total sales tax collections in fiscal year 2011-12. The study assumed that business-to-business transactions accounted for 93 percent of total e-commerce and subsequently excluded that share of total e-commerce consumption in generating sales tax collection estimates by state, resulting in a conservative final estimate of foregone sales tax revenue collections from of e-commerce.

North Carolina has been an active participant in the Streamlined Sales Tax Initiative, which a cooperative effort of 44 states, the District of Columbia, local governments and the business community to simplify sales and use tax collection and administration by retailers and states.[31] A key goal of the initiative is to encourage "remote sellers" to collect taxes on sales to customers living in participating states. North Carolina is one of 24 states to have passed legislation conforming to the agreement, but the U.S. Supreme Court has ruled that, until Congress acts, states cannot require sellers to collect and remit sales tax unless the seller has a physical presence in the state.

current rate. Even if the legislature broadened the sales tax base to nearly all services taxed by other states, the state sales tax rate would need to increase to 8.39 percent, and the state would still experience a loss of $5 billion in revenue. Moreover, either of these scenarios would make North Carolina's state sales tax rate the highest in the country.[26] States without an income tax have sales taxes 18 percent to 21 percent higher than the national average.[27]

The combination of higher sales tax rates and potential decline in revenue for critical public investments would harm the state's economic competitiveness and long-term growth. Higher sales tax rates in the state could create disincentives to purchase from retail establishments in North Carolina and further push consumption online or out of state. Additionally, research has found that tax-supported public investments in educating the workforce and maintaining and enhancing infrastructure contribute to the economic development of a state.[28]

Conclusion

As North Carolina considers how to modernize the state's revenue system, it will be critical to tackle the problems with the sales tax to ensure that the system as a whole is fair and adequate. Such steps should include broadening the base of the sales tax, strengthening the Earned Income Tax Credit, and ensuring that the sales tax does not become the primary source of revenue for the state. And while it will be important to maintain the sales tax as a source of overall revenue for the state, over-reliance on the sales tax could make even more problematic the state's revenue system.

SALES TAX MODERNIZATION: CONCRETE STEPS TO A STRONGER, FAIRER SALES TAX

- **Broaden the base of the sales tax by including all consumer services except health care, education and housing (158 of 168 categories of services, as defined by the Federation of Tax Administrators)**
- **Combined state and local rates would drop from 6.75 percent to 5.25 percent**

1 NC Department of Revenue, September 2012, Revenue Collections by Type in 2011.

2 Institute on Taxation and Economic Policy, 2011. Guide to Fair State and Local Tax Policy.

3 Mazerov, Michael, 2009. Expanding Sales Taxation of Services: Options and Issues. Center on Budget and Policy Priorities: Washington, D.C.

4 Brookings Mountain West & Morrison Institute of Public Policy. January 2011. "Structurally Unbalanced: Cyclical and Structural Deficits in California and the Intermountain West." Available at http://www.brookings.edu/~/media/Files/rc/papers/2011/0105_state_budgets/0105_state_budgets.pdf

5 Technically this is true for any good with income elasticity greater than unity – namely, goods that are not necessities. While energy and petroleum products are not in this category, most "sin tax" goods are included, such as alcohol and tobacco products.

6 McCarten, William J., and Stotsky, Janet, 1995. Tax Policy Handbook. Chapter on Excise Taxes. Fiscal Affairs Department, International Monetary Fund: Washington, D.C.

7 Ibid.

8 Local option sales taxes may be assessed and collected on the sale of food for home consumption – an item that is currently excluded from the state sales tax base. However, statute provides that all items taxable under the state sales tax are taxable by local option, so broadening the state sales tax base will automatically broaden the local base as well.

9 ITEP, 2009.

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