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DOUBLING DOWN ON A LOSING STRATEGY:

More Income Tax Cuts Will Grow Budget Shortfalls, Not the Economy

BY ALEXANDRA F. SIROTA, DIRECTOR and CEDRIC JOHNSON, POLICY ANALYST

North Carolina policymakers have proposed another round of income tax cuts on top of those they passed in 2013. Senate Bill 526 would cost at least $1.4 billion by 2017, causing a new wave of cuts to services North Carolinians rely on each day and compounding the problems created by the tax cuts passed two years ago.[1]

Rather than repeating the failed strategy of 2013 and further damaging the state of North Carolina, lawmakers should revisit the 2013 tax plan. The 2013 plan made significant changes to the state's tax structure and shifted the tax responsibility to low- and middle-income taxpayers and away from wealthy individuals and profitable corporations. This new set of proposed income tax cuts would cause further harm to the state by reducing the availability of revenue to invest in the building blocks of a strong economy.

Senate Bill 526 would lower the personal income tax rate again and enact corporate tax changes that would further benefit profitable multi-state corporations. Key provisions of the proposal include the following:

Costly changes to the personal income tax

- Reduces the personal income tax rate to 5.5 percent from its current 5.75 percent by 2017.
- Replaces the existing standard deduction with a zero-percent tax bracket for non-itemizers. The amount of income included under the zero-percent tax bracket (up to $20,000 by 2017) would be higher than the existing standard deduction (up to $15,000).

Changes to the corporate income tax that benefit large multi-state corporations

- Makes the reductions to the corporate income tax rate in the 2013 tax plan permanent. That plan made any cuts in corporate income tax rates beyond 2015 contingent on state revenue collections reaching a certain level. This bill would eliminate that contingency. Further corporate tax cuts would take place regardless of revenue performance.
- Reduces the corporate income tax rate to 4 percent from the current 5 percent by 2017.
- Excludes payroll and property from the formula for determining a corporation's state income tax. Currently, North Carolina considers property, payroll (employees) and sales in determining the share of a

MEDIA CONTACT:

CEDRIC D. JOHNSON

919/856-3192
cedric@ncjustice.org

Budget & Tax Center

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north carolina
JUSTICE CENTER

P.O. Box 28068
Raleigh, NC 27611-8068

www.ncjustice.org

corporation's profits that is subject to tax.[2] The proposed bill would only consider the sales of a corporation under a new formula known as a Single Sales Factor (SSF) apportionment formula. This tax change would favor corporations whose presence in the state is based more on personnel or property ownership than sales.

- Cuts the corporate franchise tax rate by 10 percent by 2016. Corporations in North Carolina pay a franchise tax for the privilege of doing business in the state.

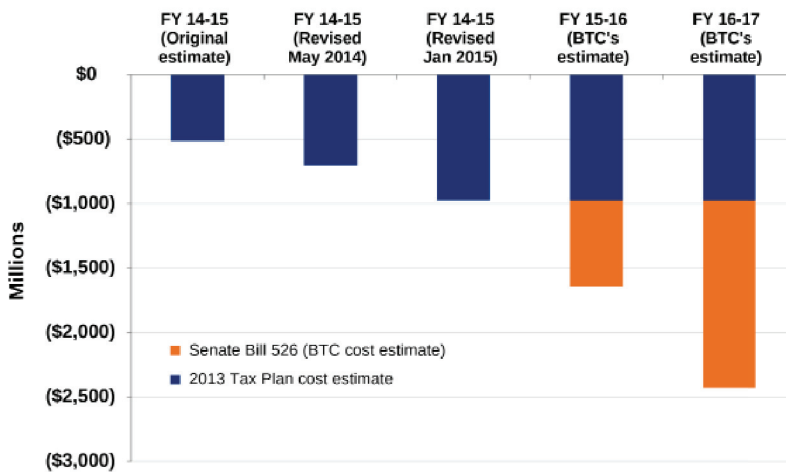
Neither the relevant research nor recent experiences in other states support the idea that tax cuts are a good strategy to achieve economic growth. In fact, tax cuts such as the ones included in this bill may lead to cuts in the very things that attract businesses and create jobs, such as a top-rated education system and safe roads and bridges. By focusing on providing tax cuts to corporations already doing well in today's economy, the proposed legislation fails to address North Carolina's immediate need for more good-paying jobs across the state.

This *BTC Report* provides an overview of the proposed legislation and highlights the immediate and long-term impact on the state's finances, the likely economic impact and who benefits.

Available Revenue Would Be Reduced

By 2017, Senate Bill 526 would reduce available revenue by at least $1.4 billion due to personal and corporate income tax rate cuts and other changes to tax law for profitable multi-state corporations. That's on top of the $1 billion price tag of the 2013 tax cuts (see Figure 1).

FIGURE 1: **Proposed Tax Plan Would Increase Revenue Loss**



SOURCE: Original, FN for HB 998; Revised, Consensus Forecast; ITEP, Using Up-to-Date Taxpayer Data; and Reported Tax Collections for the First Five Months of FY15; ITEP analysis of Senate Bill 526 (combined PIT changes only).

Revenue loss would further reduce North Carolina's ability to fund core investments

Fiscal responsibility means having the resources on hand to deliver the important public services that drive a strong state economy. Tax cuts enacted in 2013 have already undermined that goal by reducing available revenue and causing a $271 million shortfall in the current fiscal year.[3] In the upcoming two-year budget cycle, these cuts will reduce revenue by as much as $1 billion annually.

The Senate proposal would make the current revenue loss significantly larger and more damaging for the state. Over the next two years, the cost of the personal income tax changes alone (that is, excluding other tax changes proposed in the Senate bill) in conjunction with income tax cuts in the 2013 tax plan would reduce revenue for North Carolina schools and other services by around $2.3 billion annually.[4]

Notably, these revenue reductions are roughly equivalent to revenue growth that the state would naturally experience with a growing economy. Accordingly, the proposed legislation essentially locks in current spending levels and prevents the state from making investments in line with its growing population, business activity, and the changing needs for the economy.

People and businesses in North Carolina get critical support from public investments each day, and recent research has found an overall positive relationship between state spending and economic growth.[5] Having a more skilled and better educated workforce, made possible in part through adequate investments in public schools and higher education, is connected to higher wages.[6] The greatest driver of income growth is the stock of educated workers and research institutions, according to analysis of data from 1904 to 2004 by the Federal Reserve Bank of Chicago.[7] Infrastructure investments, early childhood education and public health care are among other public investments that boost economies.

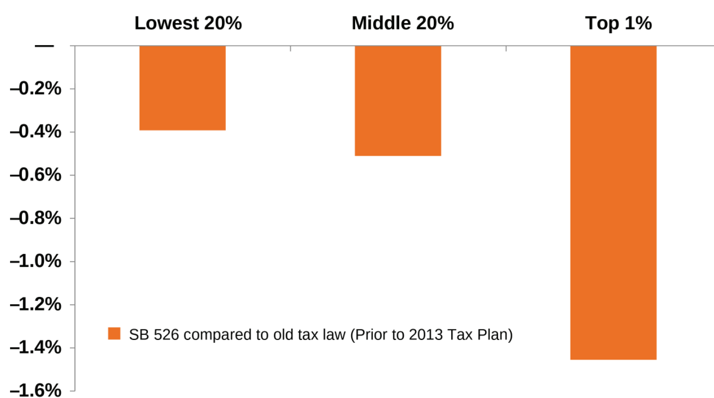
Experiences of other states show that income tax cuts will not boost the economy

Recent tax cut experiments in other states provide clear evidence that such tax cuts do not result in an economic boost. Job growth in four of the five states that have recently cut income taxes—Kansas, Maine, North Carolina, Ohio, Wisconsin—has been slower than the national average since the cuts went into effect. In Kansas, despite promises that income tax cuts would provide a "shot of adrenaline to the heart of the Kansas economy," the median income of Kansans has grown more slowly than the national average.

While North Carolina's job growth since December 2013 (3.1 percent) has been slightly stronger than the nation's overall job growth (2.7 percent), there's little evidence to believe that tax cuts are responsible. In fact, more recent economic data suggest that North Carolina's economy is falling behind the national average:

- Between February 2014 and February of this year, North Carolina's job growth fell below the national average by 4 percentage points.
- North Carolina's state personal income growth in 2014 was 3.5 percent, compared to the national average of 3.9 percent, according to the Bureau of Economic Analysis.[8]
- North Carolina's nominal hourly wage growth over the year actually fell by 0.5 percent, which is below the national average of 2.0 percent. The target range of 3.5 to 4 percent is generally considered the growth rate needed to deliver broad benefits to North Carolina's workers.[9]

FIGURE 2: Overall benefits from income tax cuts still largely flow to state's highest income earners



SOURCE: Data request to ITEP, March 2015.
NOTE: ITEP compares all personal income tax changes from 2013 tax plan (fully phased in) along with Senate Bill 526 to pre-2013 tax law.

Tax cuts have overwhelmingly gone to North Carolina's richest households

The 2013 tax changes delivered the greatest benefit to the wealthiest income earners in the state, not average people. Nearly two-thirds, 65 percent, of the total net tax cut went to the top 1 percent of income earners, whose average income was nearly $1 million in 2013. The income tax cuts in the Senate proposal would reduce income taxes, on average, for taxpayers across the entire income distribution. However, the state tax code after the combined changes of the 2013 tax plan and Senate Bill 526 would overwhelmingly benefit the state's most well-to-do (see Figure 2).

The further reduction of the personal income tax rate to 5.5 percent by 2017 would give

the top 1 percent of income earners in the state (whose average income is now at least $1 million) an additional average income tax cut of around $2,000—16 times the average income tax cut of $113 for the bottom 20 percent of income earners in the state.

Given that the proposal keeps in place a low, flat tax rate, the state's wealthiest taxpayers will continue to receive the greatest benefit from the tax changes made in the state since 2013. Moreover, because a zero tax bracket is poorly targeted to address the greater total tax load carried by low- and moderate income taxpayers, it would not address the loss of the state EITC for nearly 1 million North Carolinians. If lawmakers propose an expansion of the sales tax to include more goods and services in order to pay for these income tax cuts, low- and moderate- income North Carolinians may end up paying more taxes overall.

The cost of more tax breaks for big profitable corporations

Preliminary estimates of the cost of the proposed changes show that corporations will contribute less to public investments that help drive the state forward. These reductions are on top of the existing reductions to their corporate income tax rate, which has moved from 6.9 to 5 percent in two years. Here is a rough breakdown of the costs associated with specific proposed changes in the Senate bill:

- Corporate Income Tax rate reduction to 4 percent = $165 million
- Adoption of Single Sales Factor = between $50 million and $90 million
- Expanded investments in corporate subsidies (namely the JDIG program) = $30 million
- Corporate Franchise Tax rate reduced by 10 percent = $66 million

Taken together, these tax changes for businesses would add an additional $245 to $285 million to bring the total cost of the tax plan to at least $1.4 billion.

Changes to corporate taxation would benefit large, profitable, multi-state corporations

Because of changes to the corporate income tax and the Single Sales Factor formula, the Senate bill would deliver an additional $245 million in tax cuts to corporations, which have seen record profits during the current economic recovery.[10] Productivity has steadily increased, yet wages for workers have stagnated since the end of the recession, an indication that workers are not sharing in the economic benefits.[11] Meanwhile, corporate profits have more than doubled from their trough level in 2008.[12]

Tax cuts for large, profitable corporations are unlikely to boost economic growth or result in more jobs being created in North Carolina. This is in part because a portion of the corporate income tax cuts will flow to out-of-state shareholders. Furthermore, state and local taxes represent a small share of businesses' total expenses, typically 3 to 4 percent.[13] Accordingly, there is little reason to believe that further cuts to the corporate income tax rate will result in substantial investment or relocation of headquarters to the state.[14]

The Senate bill also would change the way corporations with business operations in multiple states apportion their income for income tax purposes. Most states, including North Carolina, consider property, payroll (employees) and sales in determining the share of a corporation's profits that is subject to tax.[15] The proposed bill would replace the current formula with a new formula known as a Single Sales Factor (SSF) apportionment formula. Under this formula, only sales would be considered—with property and payroll no longer being accounted for—in determining the amount of income tax corporations pay.

This change would create winners and losers. Large manufacturers with a lot of physical capital and payroll in the state may see a large reduction in taxes. Meanwhile, businesses that do a disproportionate amount of sales in the state but have a relatively little physical presence—smaller, homegrown North Carolina businesses, for example—would lose as a result of this tax change. Furthermore, like corporate income tax cuts, an SSF formula is unlikely to spur job creation or boost

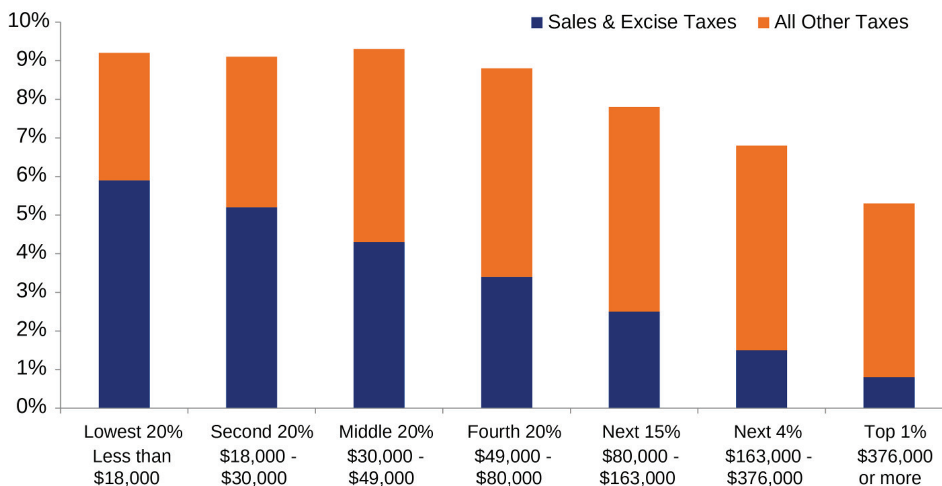
the state's economy. Of the eight states that had an SSF formula in effect from 2003 through 2012, six were below the average of all states in retaining manufacturing jobs; only two were above the average.[16] Cutting the corporate Franchise Tax rate and capping the amount of franchise taxes paid by corporations is not the best policy tool for helping create jobs either. The cap on the Franchise Tax would limit the total amount of franchise taxes paid by any corporation to no more than $150,000. Such a tax cut would disproportionately benefit the largest corporations, rather than large and small corporations equally, and is more costly than a targeted policy aimed at small businesses.

How would North Carolina pay for these costly tax cuts?

North Carolina's constitution requires state policymakers to pass a balanced budget, which means that every dollar in tax cuts must be made up with a dollar from somewhere else or a cut to the existing state budget. Reducing state revenue by an additional $1.4 billion (equivalent to nearly 6 percent of the state's total General Fund revenue) on top of the nearly $1 billion in annual revenue loss caused by the 2013 tax package (equivalent to around 5 percent of total General Fund revenue at the time of passage) would only increase the state's budget woes.

FIGURE 3: North Carolina State and Local Taxes

Share of Family Income for Non-Elderly Taxpayers



SOURCE: "Who Pays?", Institute on Taxation & Economic Policy, January 2015.

In recent years, lawmakers have paid for tax cuts overwhelmingly with cuts to the state budget. This compounded problems from the recession, when state lawmakers made damaging cuts to public schools, higher education, and healthcare services for the elderly. Now, as the economy slowly recovers, many states are starting to reinvest in these important priorities, while North Carolina continues to make cuts as a result of the costly 2013 tax package.

Alternatively, lawmakers may choose to pay for the income tax cuts by expanding the sales tax base to include a broader range of goods and services—such as lawn care services, car washing services, and cosmetology services, for example. However, low- and middle-income taxpayers pay a much larger share of their incomes toward sales taxes than wealthy taxpayers do (see Figure 3). Accordingly, expanding the sales tax to include more goods and services without a strong state Earned Income Tax Credit could further shift the tax responsibility to lower-income North Carolinians and away from higher-income households and profitable corporations.

A Better Path Forward

More income tax cuts in North Carolina are a risky bet. Research and the experiences of other states tell us more cuts will reduce the state's ability to invest in public services that North Carolinians rely on every day and is unlikely to generate economic returns. As North Carolina recovers from the Great Recession, now is the time to begin to replace the worst of the cuts made during the downturn and lay the foundation for future economic growth by making smart investments in our people, infrastructure and communities.

1. This cost estimate accounts for changes to the Personal Income Tax, the Corporate Income Tax, and the state's major economic development incentives program, the Jobs Development Investment Grant Program (JDIP), within Senate Bill 526. Senate Bill 526 also includes proposed changes to corporate Franchise Tax; however, a cost estimate is not available for the proposed tax change and thus not included in the total estimated cost of Senate Bill 526.
2. "Corporate Income Tax Apportionment and the 'Single Sales Factor'," Policy Brief, Institute on Taxation and Economic Policy, Washington, DC, August 2012.
3. Cedric D. Johnson, "A Whole Lot of Numbers Converging on One Truth," blog post, Progressive Pulse, NC Policy Watch, February 2015.
4. This cost estimate does not include a state Earned Income Tax Credit (EITC) as part of tax law prior to the passage of the 2013 tax plan.
5. Arwiphawee Srithongrung and Kenneth A. Kriz, "The Impact of Subnational Fiscal Policies on Economic Growth: A Dynamic Analysis Approach," Journal of Policy Analysis and Management, Volume 33, Issue 4, Pages 912-928, Fall 2014.
6. Noah Berger and Peter Fisher, "A Well-Educated Workforce is Key to State Prosperity," Economic Policy Institute, Washington, DC, August 2013. http://www.epi.org/publication/states-education-productivity-growth-foundations/
7. Paul W. Bauer, Mark E. Schweitzer, and Scott Shane, "State Growth Empirics: The Long-run Determinants of State Income Growth," Federal Reserve Bank of Cleveland, Working Paper 06-06, May 2006. file:///C:/Users/cjohnson.NCJUSTICE/Downloads/wp0606-state-growth-empirics-the-long-run-determinants-of-state-income-growth.pdf
8. State Personal Income 2014, Bureau of Economic Analysis, U.S. Department of Commerce, Media release, March 25, 2015. http://www.bea.gov/newsreleases/regional/spi/spi_newsrelease.htm
9. Analysis of Bureau of Labor Statistic Quarterly Census of Employment and Wages for Third Quarter of 2014 and 2013.
10. BTC estimates that each one percent of the state corporate income tax equates to around $160 million in revenue raised. In 2014 the Fiscal Research Division of the NC General Assembly estimated that a move to a Single Sales Factor apportionment formula would reduce state revenue by approximately $90 million.
11. Federal Reserve Bank of St. Louis, Economic Data, see "Nonfarm Business Sector: Real Output Per Hour of All Persons" and "Average Hourly Earnings of Production and Nonsupervisory Employees: Total Private" https://research.stlouisfed.org/fred2/series/OPHNFB https://research.stlouisfed.org/fred2/series/AHETPI/
12. Federal Reserve Bank of St. Louis, Economic Data, Corporate Profits After Tax (without IVA and CCAdj) https://research.stlouisfed.org/fred2/series/CP/
13. Senate Bill 526 also reduces the corporate franchise tax by 10 percent. BTC does not have a cost estimate for this corporate tax cut.
14. Cedric D. Johnson, "Cutting Corporate Income Taxes Won't Be an Economic Boon for North Carolina," BTC Brief, NC Budget & Tax Center, Raleigh, NC, April 2013.
15. Peter S. Fisher, "Corporate Taxes and State Economic Growth," Iowa Fiscal Partnership, Revised February 2012.
16. "Corporate Income Tax Apportionment and the "Single Sales Factor," Policy Brief, Institute on Taxation and Economic Policy, Washington, DC, August 2012.
17. Cedric D. Johnson, "Tax Change for Multistate Corporations: A Measure That Would Harm Critical State Investments and Fail to Help Economy," BTC Brief, NC Budget & Tax Center, Raleigh, NC, March 2014.

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