

NC Budget & Tax Center

A plan to raise revenues that improves the stability, fairness, and long-term adequacy of the state tax system

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Revenue Plan Goals

- Protect effective public investments by filling in a portion (30%) of the budget gap with new revenues
- Overall, any revenue package should improve long-term adequacy, stability and fairness



More than the Recession

- North Carolina has been hit hard by the global economic downturn.
- However, tax revenues are falling at a greater rate than the larger economy because of **the state's flawed and outdated tax system.**



The Problems with NC's Revenue System

- **It is regressive:** requires a greater tax contribution (as % of income) from low- and moderate-income taxpayers than from higher-income taxpayers
- **It is narrow:** major tax schedules (sales, income, and corporate profits) capture an inadequate and decreasing portion of the state's economic activity

As a result, revenue growth does not keep pace with growth in the economy over time



The importance of raising revenue to deal with the budget shortfall

Public spending is essential for economic growth.

- Severe cuts to public spending slow economic growth as jobs are cut and projects are put on hold.
- Public investments are necessary to ensure NC has a healthy, educated workforce and safe communities.



There is Room to Raise Revenues

North Carolina is not a high tax state.

- According to the most recent Census data, NC ranks 33rd in total state and local taxes per capita (\$3,384)
- NC would need to raise state and local taxes by \$5.5 billion (or \$617 per person) to match the national average of \$4,001

Sources: US Census Bureau; Bureau of Economic Analysis; Center on Budget and Policy Priorities.



There is Room to Raise Revenues

State spending has not kept up with population growth and inflation.

- North Carolina's population has grown by an estimated 1.3 million people, or 17%, since 2000
- General fund appropriations per capita decreased by \$19, from \$2,323 to \$2,304, between FY99-00 and FY08-09 after adjusting for inflation (pre-cuts)

Sources: North Carolina Office of State Budget and Management (OSBM) historical budget data (GF appropriation amounts), US Dept. of Labor Bureau of Labor Statistics Consumer Price Index (manual inflation adjustments), and NC OSBM population estimates.



How to raise revenue and improve stability, fairness, and long-term adequacy

Take steps to modernize the state's tax system:

- **Broaden the base** of the sales tax to capture a greater share of economic activity
- **Broaden the base** of the personal income tax and make it more progressive
- **Close corporate tax loopholes** and eliminate ineffective business incentives



Raising taxes on higher incomes best policy during downturns

- Higher-income taxpayers maintain spending (i.e. consumer demand) even if required to pay additional taxes
- Approximately 1/3 of any tax increase on higher incomes is offset by resulting lower federal tax bill
- Research by economists Joseph Stiglitz and Peter Orszag, found “if anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run.”
<http://www.cbpp.org/cms/?fa=view&id=1032>



Proposed Changes: Personal Income Tax

Broaden the Base by using adjusted gross income (AGI) instead of federal taxable income as the starting point for calculating state income taxes

Make it Fairer

- Adopt a more progressive rate structure
 - Move from 3 to 6 income brackets
 - Lower the bottom rate from 6% to 3.5%
- Increase personal exemption to \$4,000
- Increase the state EITC from 5% to 10%
- Add a refundable credit for charitable contributions
- Add a temporary top bracket for households earning more than \$350,000



Proposed income tax rate structure

MFJ	Single	HOH	MFS	Rate
\$0 to \$20,000	\$0 to \$10,000	\$0 to \$15,000	\$0 to \$12,500	3.5%
\$20,000 to \$40,000	\$10,000 to \$20,000	\$15,000 to \$30,000	\$12,500 to \$25,000	5.5%
\$40,000 to \$80,000	\$20,000 to \$40,000	\$30,000 to \$60,000	\$25,000 to \$50,000	6.75%
\$80,000 to \$130,000	\$40,000 to \$65,000	\$60,000 to \$97,500	\$50,000 to \$81,250	7.25%
\$130,000 to \$240,000	\$65,000 to \$120,000	\$97,500 to \$180,000	\$81,250 to \$150,000	7.5%
\$240,000 to \$350,000	\$120,000 to \$175,000	\$180,000 to \$262,500	\$150,000 to \$218,750	7.75%
\$350,000 and above	\$175,000 and above	\$262,500 and above	\$218,750 and above	8%

MFJ= Married Filing Jointly; HOH= Head of Household; MFS= Married Filing Separately



Impact of income tax changes

North Carolina Residents, 2007 (all ages)

2007 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than	\$16,000 –	\$28,000 –	\$46,000 –	\$75,000 –	\$159,000 –	\$379,000 –
	\$16,000	\$28,000	\$46,000	\$75,000	\$159,000	\$379,000	Or More
Average Income in Group	\$10,000	\$22,000	\$36,000	\$59,000	\$104,000	\$231,000	\$1,131,000
Current system: % of income to NC income taxes	+0.6%	+2.0%	+2.9%	+3.4%	+4.4%	+5.1%	+5.5%
Tax Changes as % of Income	-0.5%	-0.7%	-0.3%	+0.2%	+0.3%	+0.4%	+0.4%
Avg \$ Tax Change	\$ -50	\$ -159	\$ -105	\$ 94	\$ 287	\$ 903	\$ 4,524
New System: % of income to NC income taxes	0.1%	1.3%	2.6%	3.6%	4.7%	5.4%	5.9%

Estimated Revenue Impact = \$338 M

Source: ITEP Microsimulation model



Alternative income tax proposal (assuming no switch to AGI)

- Add two new top brackets to current income tax structure
 - Impacts 2% of North Carolinians
 - 25% of increase offset by federal tax deduction

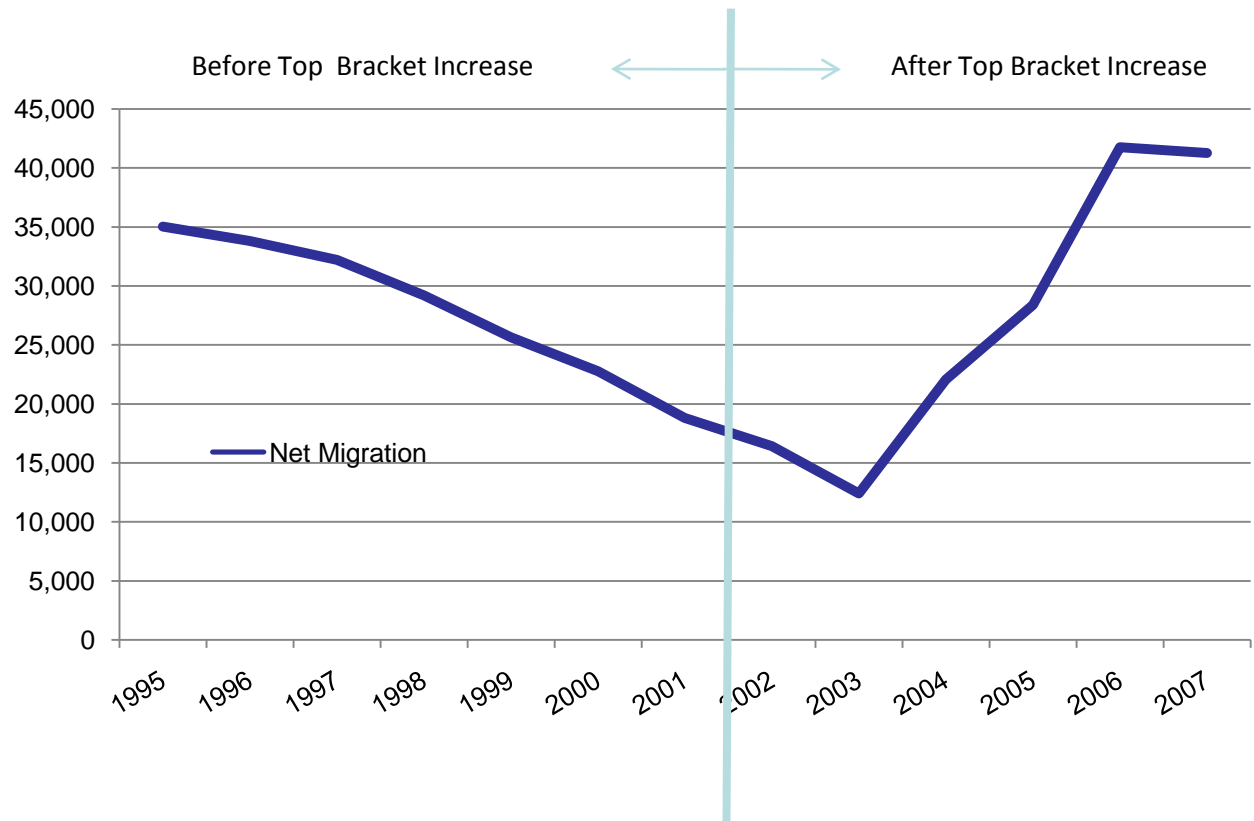
MFJ	Single	HOH	MFS	Rate
250K to 400K	125K to 200K	187.5K to 300K	125K to 150K	8%
400K and above	200K and above	300K and above	150K and above	8.25%

- Increase the state EITC to 10%
 - Impacts 20% of North Carolinians
- **Estimated Net Revenue Impact = \$40 M**
 - Est. Revenue Gain from Top Income Tax Brackets = \$120 M
 - Est. Revenue Loss from 10% EITC= (\$80 M)



The Impact of the Temporary Top Income Tax Bracket on In-Migration

During this period, on net, North Carolina gained households each year. The **average AGI** of in-migrants was higher than out-migrants. And, the **total taxable income** of in-migrants was higher than out-migrants.



Source: Analysis of IRS state-to-state migration flows compiled by US Census Bureau



Other income tax changes to consider

- Add a refundable credit for low-income older adults who may not be eligible for the EITC
- Index brackets for inflation to avoid regressive “bracket creep” effect



Proposed Changes: Sales Tax

Broaden the Base by including a significant number of services

- Add 43 services most frequently taxed in other states (NC currently taxes only 30 out of 168 services taxed in other states)
 - Examples: Landscaping services, auto repairs, tanning parlors, and pest control
- Apply sales tax to digital downloads (recommended by Revenue Laws Study Committee)

Make it Fairer by lowering the state sales tax rate as early as FY10-11

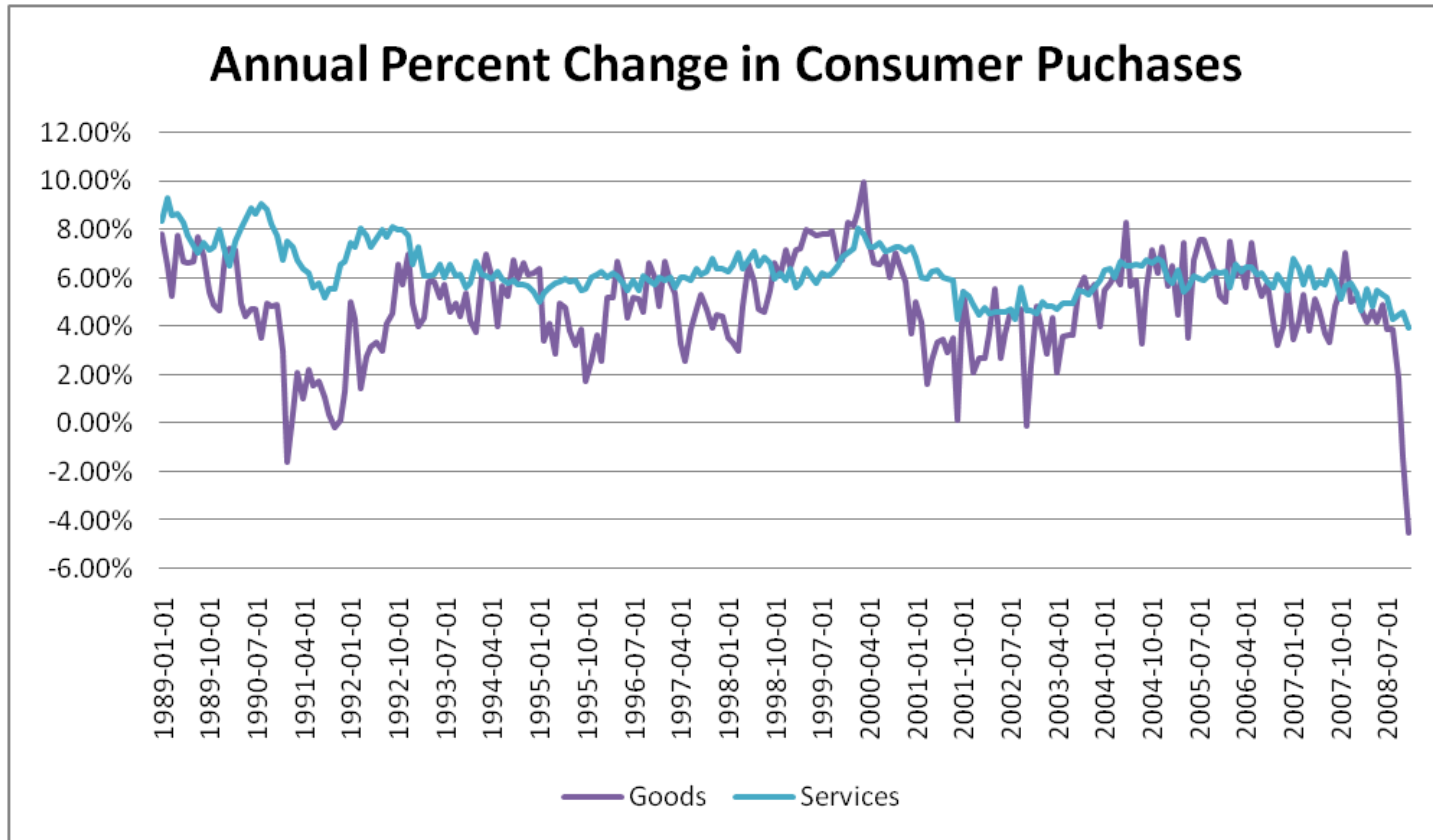


Why tax services?

- The economy is shifting from goods to services, but most services are not taxed in NC.
- Less than 1/3 of consumption in NC is taxed under the current sales tax structure. This share will continue to decline if services are not added to the sale tax base.
- Over time, revenue growth will not keep pace with growth in the economy thus exacerbating future budget gaps.
- During economic downturns, consumption of retail goods declines faster than consumption of services.



Purchases of services more stable than goods over time



Prepared by Karl Smith, UNC-Chapel Hill School of Government



Impact of sales tax changes

North Carolina Residents, 2007 (all ages)

07 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than	\$16,000 –	\$28,000 –	\$46,000 –	\$75,000 –	\$159,000 –	\$379,000 –
	\$16,000	\$28,000	\$46,000	\$75,000	\$159,000	\$379,000	Or More
Average Income in Group	\$10,000	\$22,000	\$36,000	\$59,000	\$104,000	\$231,000	\$1,131,000
Sales Tax Base Incidence	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%	0.05%
Avg \$ Tax Change	\$ 43	\$ 62	\$ 83	\$ 109	\$ 131	\$ 167	\$ 526

Estimated Revenue Impact = \$522 M

Source: ITEP Microsimulation model



Proposed Changes: Corporate Income Taxes

- **Close corporate tax loopholes** by enacting Mandatory Combined Reporting
 - Estimated Revenue Impact = \$101 m
 - Majority of states with corporate income taxes have adopted this reform
 - Revenue gains can be used to lower the tax rate in the future
- **End ineffective business incentives** (Article 3J development tax credits, a.k.a. the Bill Lee Act credits)
 - Estimated Revenue Impact = \$49 m
 - Recent comprehensive study found these credits have not spurred job creation



NC is not a high tax state for businesses

- Ernst & Young and Council on State Taxation January 2009 study found:
 - In NC the share of state and local taxes paid by businesses is the lowest in the nation
 - State and local taxes paid by businesses represented 3.6% of Gross State Product in 2008, compared to US Average of 4.9%



Summary of BTC revenue plan impact

07 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than	\$16,000 –	\$28,000 –	\$46,000 –	\$75,000 –	\$159,000 –	\$379,000 –
	\$16,000	\$28,000	\$46,000	\$75,000	\$159,000	\$379,000	Or More
Average Income in Group	\$10,000	\$22,000	\$36,000	\$59,000	\$104,000	\$231,000	\$1,131,000
Income Tax Change as % of Income	-0.5%	-0.7%	-0.3%	+0.2%	+0.3%	+0.4%	+0.4%
Sales Tax Changes as % of Income	+0.4%	+0.3%	+0.2%	+0.2%	+0.1%	+0.1%	+0.0%
Corp Tax Changes as % of Income	+0.0%	+0.0%	+0.0%	+0.0%	+0.0%	+0.0%	+0.0%
Overall Incidence Change	-0.1%	-0.5%	-0.1%	+0.3%	+0.4%	+0.5%	+0.5%

Estimated Total Revenue Impact = \$1,010,000,000

Source: ITEP Microsimulation model



The Governor's Revenue Plan

Recommended Revenue Changes	FY09-10	FY10-11
Tobacco Tax Changes	\$343	\$457
Increase Cigarette Tax rate from \$.35 to \$1.35	\$311	\$415
Increase tax rate on other tobacco products from 10% to 28%	\$32	\$42
Alcohol Tax Changes (5% surcharge)	\$158	\$210
Improved Enforcement	\$50	\$75
Fees (Increase professional license fee from \$50 to \$200)	\$27	\$31
Disproportionate Share Allocation	\$25	
Increase state EITC to 6.5%		(\$21)
Small Business Tax Relief	(\$12)	(\$24)
IRC Update	(\$10)	(\$20)
Caregiver Tax Credit		(\$0.80)
Total Revenues	\$581	\$708
<i>all figures in millions of dollars</i>		



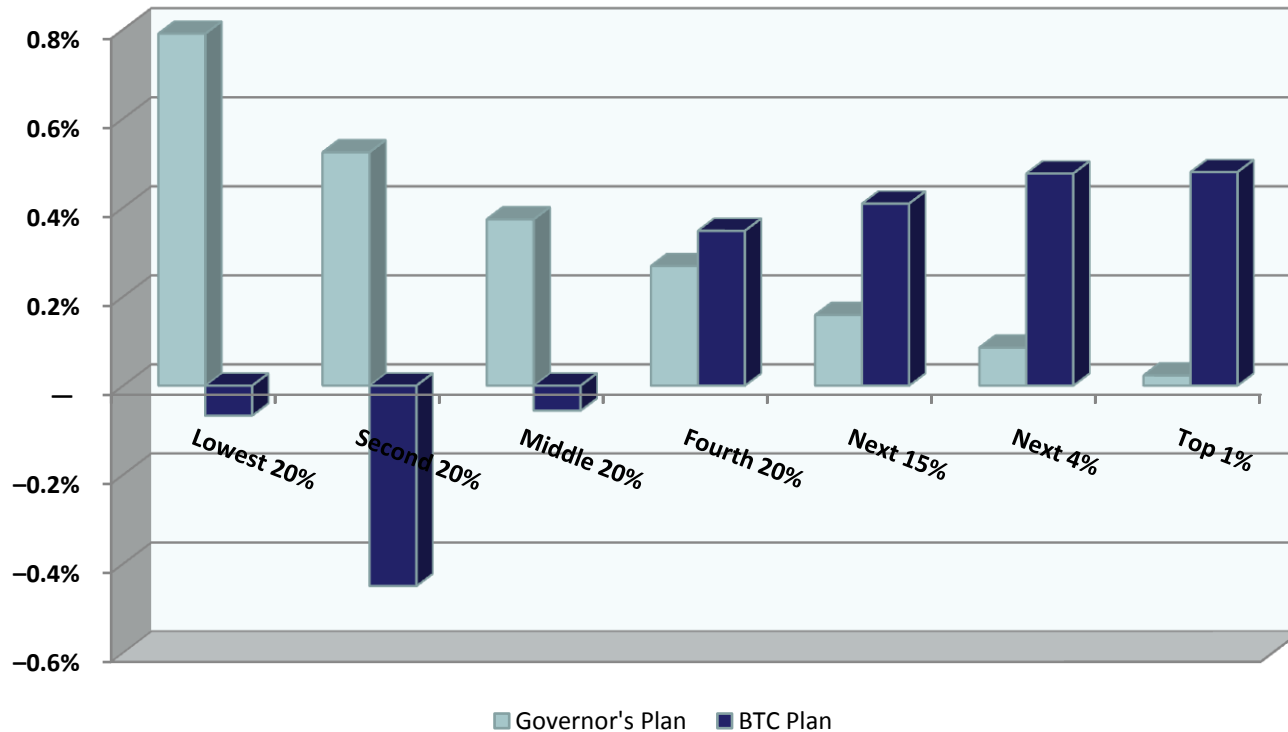
What about tobacco tax increases?

- Tobacco tax increases of at least 50 cents per pack are sound health policy
- Because tobacco taxes are regressive and the revenue declines over time lawmakers should:
 - Use a portion of the revenue generated to increase the state EITC
 - Ensure that any additional tax increases are progressive so that responsibility of the overall plan is fairly distributed



Impact of BTC plan vs. governor's plan on North Carolinians

(as a % of income)



Source: ITEP Microsimulation model



BTC plan compared to governor's revenue plan

- BTC plan closes a higher percentage of the budget gap (30%) than the governor's plan (17%).*
- BTC plan lowers taxes on the bottom 60% of income-earners. Governor's plan increases taxes for all income categories, with the largest increases on low-income taxpayers.
- BTC plan will improve long-term revenue stability and adequacy over time.

**Based on Governor's Shortfall Estimate*



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