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BTC Brief

NC BUDGET & TAX CENTER

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Timely, accessible, and credible analysis of state and local budget and tax issues

EQUAL MEASURE: The estimated impact of the Senate's proposed tax modernization plan and recommendations for improvement

Key Findings: The Senate Finance Committee's proposed tax modernization plan would require an additional **0.3% of income** ($32 average annually) from the lowest-income earners, **0.1% of income** ($32 average annually) from middle-income taxpayers and **0.1% of income** ($958 average annually) from the highest 1% of income-earners. The plan would improve stability and long-term revenue adequacy, but additional measures should be taken to improve fairness.

Introduction

In April, the North Carolina Senate's Finance Committee released its proposed Tax Modernization and Simplification Plan. It proposed broadening the bases of the personal-income, corporate-income, and sales taxes and lowering the state's nominal tax rates. The plan would raise $544 million in fiscal year 2009-10 and $733 million in fiscal year 2010-11, filling in 15% and 22% of the respective budget gaps for those years.

Since the draft plan was released, no additional hearings have been held or votes taken. In addition, the state's budget picture has deteriorated since then, and the budget shortfall for the next fiscal year now stands at $4.6 billion, or approximately 20% of the budget.

As stated by Senate Finance Co-chair Dan Clodfelter during his presentation to the committee, the plan is trying to achieve various objectives, including:

- Generate the revenue required to balance the budget (the Senate's revenue target was $544 million for fiscal year 2009-10)
- Reform the tax system to better match today's service- and technology-based economy, rather than simply raising some rates or making temporary changes
- Ensure that the state's tax structure is competitive to peers
- Make the system more progressive and fairer; in particular, level the tax treatment of similarly situated taxpayers and ensure that all types of taxpayers are responsible for appropriate shares of state revenue
- Disentangle state revenues from local revenues

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The Senate's Plan in Summary:

Personal Income Tax Changes:

- Switch from federal taxable income (after deductions) to adjusted gross income (before deductions) as the starting point for calculating state personal income taxes, and establish credits for mortgage interest, health care expenses and charitable contributions
- Create a new zero-percent tax bracket for first $10,000 of adjusted gross income for married couples filing jointly ($5,000 for single filers)
- Lower all income-tax rates (reduce current rates of 6%,7% and7.5% to 5.25%, 6.75%. and 7.5%); the top income tax rate of 7.5% would begin at an adjusted gross income of $100,000 for married couples filing jointly (versus the current starting point of $100,000 of federal taxable income)

Sales and excise tax changes:

- Broaden the sales tax base to include more services, particularly in the areas of entertainment, personal care, home and real property, and repairs and warranties
- Add digital downloads to the sales tax base
- Lower the state sales tax rate from 4.75% to 4%
- Limit sales tax refunds for nonprofit organizations to $5,000,000
- Increase the tax on cigarettes by 15 cents per pack, the tax on tobacco products to 3%, and taxes on alcohol products by an unspecified percentage

Business tax changes:

- Broaden the base of the corporate income tax by eliminating several tax expenditures, including the Article 3J development credits, formerly known as the "Bill Lee Credits"
- Broaden the franchise tax to limited liability corporations and eliminate state and local privilege taxes on businesses
- Limit sales-tax breaks for equipment to purchases of depreciable equipment (as opposed to supplies)
- Limit the farm sales tax exemption to small farms (100% exemption for farms with gross receipts under $1 million and 50% exemption for farms with gross receipts between $1 million and $2.5 million)

The plan's impact on North Carolina taxpayers

The proposed plan raises revenue from the state's three major tax categories – personal income, sales, and business taxes. By doing so, the Senate's plan distributes the additional tax responsibility relatively equally.

At the behest of the NC Budget & Tax Center, analysts with the Institute on Taxation and

FIGURE 1: **IMPACT OF SENATE'S PROPOSED TAX CHANGES***

North Carolina Residents, 2008							
2008 INCOME GROUP	LOWEST 20%	SECOND 20%	MIDDLE 20%	FOURTH 20%	NEXT 15%	NEXT 4%	TOP 1%
Income Range	Less Than $16,000	$16,000 - $28,000	$28,000 - $47,000	$47,000 - $77,000	$77,000 - $159,000	$159,000 - $372,000	$372,000 - Or More
Average Income in Group	$10,000	$22,000	$37,000	$60,000	$105,000	$227,000	$1,011,000
Income Tax Changes (as % of income)	-0.11%	-0.18%	-0.13%	0.17%	0.17%	0.28%	0.06%
Sales Tax Changes (as % of income)	0.27%	0.18%	0.14%	0.12%	0.08%	0.05%	0.03%
Excise Tax Changes (as % of income)	0.16%	0.11%	0.07%	0.05%	0.03%	0.02%	0.00%
Total Tax Change (as % of Income)	0.32%	0.10%	0.09%	0.33%	0.28%	0.34%	0.09%
Total Tax Change in Dollars	$32.32	$22.36	$31.86	$199.70	$290.96	$770.72	$958.06

*SOURCE: Institute on Taxation and Economic Policy, May 2008. Does not include proposed business tax changes.

Economic Policy ran the proposed tax changes through their microsimulation model for estimating tax impacts on taxpayers of various income levels. ITEP's analysis found the personal income, sales, and excise tax changes would have the following estimated impacts:

Ideas for improving the plan

While the proposed tax plan would require similar additional tax contributions from taxpayers of varying incomes, it is important to recognize that the current tax system already places a much heavier tax responsibility on low- and moderate-income taxpayers than on higher-income taxpayers. According to a recent analysis by the NC Budget & Tax Center and the Institute on Taxation and Economic Policy, the current state and local tax system exacts 10.7% of the income of the bottom quintile of income-earners, 9.0% of the income of the middle fifth of income-earners, and 7.1% of the incomes of the top 1% of income-earners.

In order to make the state's tax system fairer, raise the funds necessary to preserve vital state services and programs, and increase the system's stability so it will perform better during future economic downturns, the NC Budget & Tax Center recommends the following improvements to the Senate's plan:

- **Add two top personal income tax rates,** which would achieve several policy objectives. First, doing so would raise additional revenue. Second, it would improve the long-term adequacy of the tax system by capturing a greater share of wealthier taxpayers' incomes, which typically grow more rapidly than the incomes of low- and middle-income taxpayers. Third, it would make the tax system fairer by requiring wealthy taxpayers to contribute a share of their incomes that is closer to what low- and middle-income families pay. Adding two additional income tax brackets would generate approximately $140 million annually in additional tax revenues (one bracket applying to household income between $200,000 and $300,000 at a rate of 7.75%, and a second bracket applying to household income above $300,000 at a rate of 8%).
- **Increase the state Earned Income Tax Credit and/or consider adding a refundable low-income credit.** The current tax system places too high a tax responsibility on the lowest-income taxpayers, and the Senate's plan on the whole would increase taxes on them. The state EITC is set to be increased from 3.5% of the federal credit to 5% in the coming tax year. Increasing it even more would help more than 800,000 low- and moderate-income working families. In addition, state leaders should consider establishing a refundable credit that would benefit all low-income taxpayers regardless of work status, in order to offset the tax increases on residents with fixed incomes or without families who do not benefit significantly from the current state EITC. Increasing the state EITC from 5% to 10% would cost approximately $85 million annually. The following table describes the changes in tax liability from the additional tax brackets and EITC increase.

FIGURE 2: **IMPACT OF SENATE TAX CHANGES INCLUDING BTC'S RECOMMENDATIONS**

North Carolina Residents, 2008							
2008 INCOME GROUP	LOWEST 20%	SECOND 20%	MIDDLE 20%	FOURTH 20%	NEXT 15%	NEXT 4%	TOP 1%
Income Range	Less Than $16,000	$16,000 - $28,000	$28,000 - $47,000	$47,000 - $77,000	$77,000 - $159,000	$159,000 - $372,000	$372,000 - Or More
Average Income in Group	$10,000	$22,000	$37,000	$60,000	$105,000	$227,000	$1,011,000
Tax Change (as % of Income)	-0.04%	-0.12%	0.05%	0.33%	0.28%	0.38%	0.39%
Tax Change (in Dollars)	-$4.32	-$26.24	$17.64	$198.59	$292.20	$865.92	$3,894.49

*SOURCE: Institute on Taxation and Economic Policy, May 2009.

- **Close corporate tax loopholes by requiring mandatory combined reporting.** This change would require multi-state corporations to combine the business activity of all related entities into one report so the Department of Revenue can more accurately assess the share of corporations' profits that are attributable to doing business in North Carolina. This effective loophole-closing technique is the law in the majority of states that levy a corporate income tax, and if implemented, it would generate approximately $100 million annually in additional tax revenue. The Senate's business-tax changes generate revenue primarily by requiring more types of businesses to pay state franchise taxes and by no longer contributing a share of corporate income tax revenues to the school building capital fund. However, the plan would use these additional funds primarily to lower the tax rate paid on corporate profits.

Conclusion

The Senate's plan, if enacted, would significantly improve North Carolina's tax system by making it simpler and more reliable over time. The plan builds on the strengths of North Carolina's current tax system, leaving in place the major tax elements (personal income, sales and corporate income) and making each one fairer. Moreover, the Senate's proposed overhaul would place reasonably similar additional tax responsibility on taxpayers of various income levels. Before adoption, however, Senate leaders should work to improve the fairness of the overall plan and consider requiring large, profitable multi-state corporations to share the additional tax responsibility.

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i A summary of the plan was released at a meeting of the Senate Finance Committee. Complete details will not be available until the legislation is written and released publicly.

ii A detailed description of the microsimulation model used for this analysis can be accessed on ITEP's website at http://www.itepnet.org/modelmenu.htm.

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