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## WHO PAYS TAXES IN NORTH CAROLINA? (HINT - IT'S NOT WHO YOU THINK)

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### Executive Summary

- North Carolina lawmakers made several changes to state tax policy in 2007, including the creation of a 3.5% refundable earned income tax credit, the elimination of the top income-tax bracket, and the continuation of the state sales-tax rate at 4.25%.
- Taking the 2007 changes into account, North Carolina's state and local tax system remains regressive, meaning that it requires the poorest households to pay a greater share of their incomes in taxes than the wealthy.
- The poorest 20% of households, whose average annual income is \$10,000, pay 10.7% of their incomes to state and local taxes. In contrast, the wealthiest 1% of families, whose average annual income is \$970,000, pay only 7.1%.<sup>1</sup>
- The state income tax, which constitutes about a third of all state and local tax revenues, is moderately progressive by national standards. However, its progressivity is not sufficient to outweigh the regressive impact of North Carolina's sales, excise, and property taxes.
- One key reason the wealthiest taxpayers pay the smallest share of their incomes in state and local taxes is they benefit disproportionately from the ability to deduct what they pay in state income taxes and property taxes from their income for federal tax purposes.
- There are several policy changes that would make North Carolina's system fairer, such as increasing the amount of the state earned income tax credit, expanding the sales-tax base to include more personal services, and establishing a circuit-breaker credit to offset the property tax bills of low- and moderate-income homeowners.
- Currently in North Carolina, the incomes of wealthier residents are growing much faster than those of low- and moderate-income residents. Therefore, a tax structure that disproportionately targets lower-income residents, like North Carolina's, will not experience adequate revenue growth over time.

## Overview

*State and local taxes pay for many of the things that keep North Carolinians safe and enhance their quality of life. These include physical structures like roads, jails, and school buildings, as well as services like health care, education, and restaurant inspections.*

*Because these investments benefit everyone, it is imperative that each North Carolinian contribute an appropriate share of his or her income to pay for them. At the very least, it should be a common goal that all North Carolinians pay similar shares of their incomes in state and local taxes. In fact, a good case can be made that wealthier taxpayers should contribute a greater share of their incomes.*

*However, the situation in North Carolina is just the opposite. Wealthy North Carolinians pay a much smaller share of their incomes in state and local taxes than low- and moderate-income Tar Heels. In fact, the poorest 20% of North Carolina households pay a larger share of their family incomes in state and local taxes than any other income group. Not only is this unfair, but it also could have a serious impact on the state's ability to collect adequate revenues in the future.*

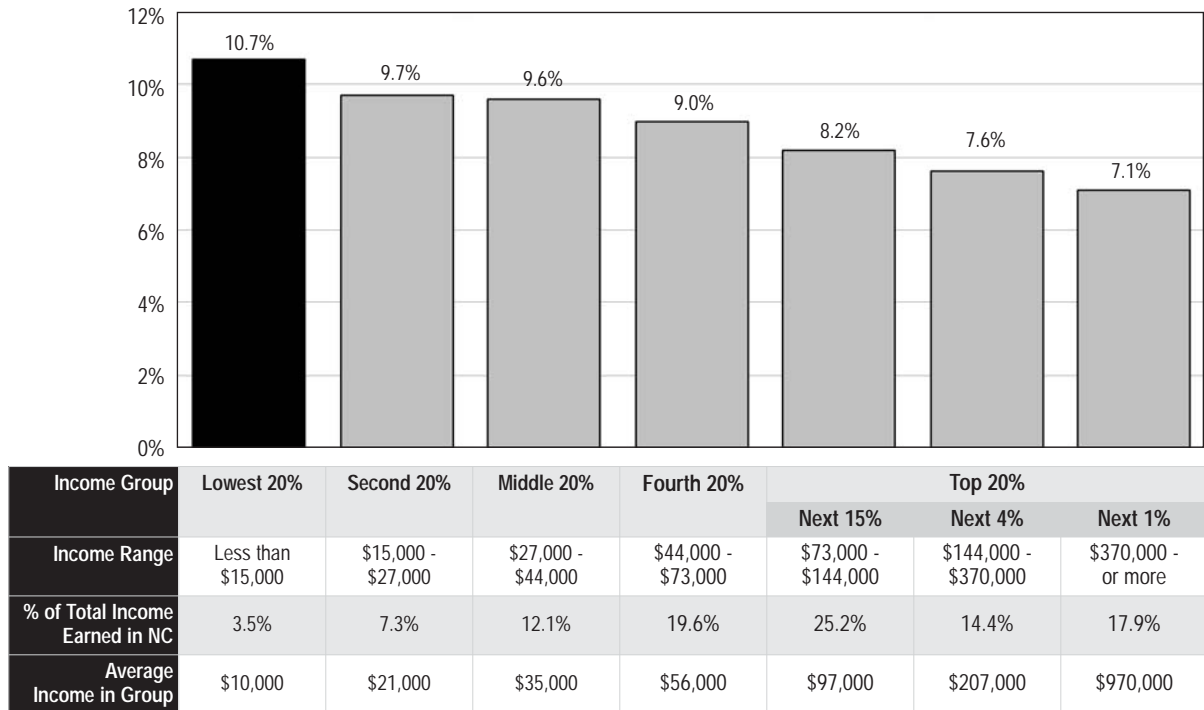
*This issue of BTC Reports analyzes who pays taxes in North Carolina, explains the impact the state's tax system has on low- and moderate-income households, and makes recommendations for policy changes that would make the system fairer*

## How Much Do North Carolinians Pay in Taxes?

Every North Carolina household pays taxes; however, low-income households pay the greatest share of their incomes in state and local taxes. In 2007, the bottom 20% of North Carolina households, with an average income of \$10,000, paid 10.7% of their incomes in state and local taxes. That same year, the top 1%, with an average income of \$970,000, paid only 7.1%. This means the responsibility of paying local and state taxes falls hardest on those with the least ability to pay.

In other words, North Carolina's state and local tax system on the whole is regressive. North Carolina relies primarily on income, property and sales taxes to fund state and local services. The fairest of these options, the income tax, is the largest of North Carolina's combined state and local revenue sources. This helps to lessen the overall regressivity of the state's tax system; however, it is not enough to offset the impact that the sales, excise and property taxes have on the poorest households. A fair tax system should be structured such that the combined impact of all tax sources results in households with higher incomes paying the greatest share of income in state and local taxes.

The Institute on Taxation and Economic Policy (ITEP) provided the Budget and Tax Center with an in-depth analysis of how the responsibility for paying state and local taxes is distributed in North Carolina. ITEP's analysis of who pays taxes divides North Carolina households into five quintiles by income, from the poorest 20% to the richest 20%, with the top quintile divided further into the top 15%, 4% and 1% of earners. **Figure 1** shows the average percentage of total household income paid in state and local taxes, the average incomes of households in each group, and the percentage of total state income earned in each group. Average incomes range from \$10,000 in the bottom 20% to \$970,000 in the top 1%.

**FIGURE 1****LOWEST-INCOME NORTH CAROLINIANS PAY THE LARGEST SHARE OF THEIR INCOMES IN STATE AND LOCAL TAXES**

SOURCE: The Institute on Taxation and Economic Policy (ITEP), October 2007. ITEP data reflects 2007 tax law changes, 2006 income levels and offset for federal deductibility

**Income Taxes**

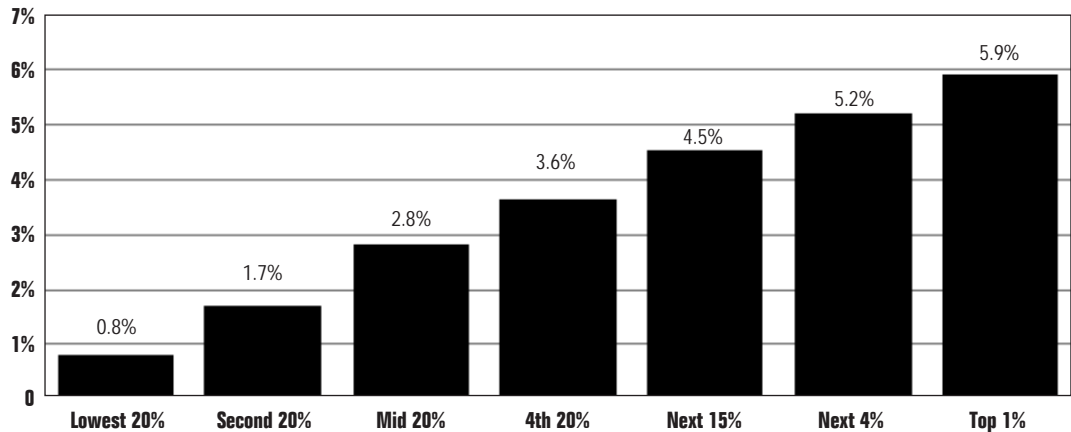
North Carolina's personal income tax is the fairest of all major state and local tax sources. On its own, it requires those who earn the most to pay the largest share of their incomes, while those who earn the least pay the smallest share. **Figure 2** shows the percentage of income the average household pays in income taxes in each income quintile. As a percent of income, the average top 1% household pays upward of seven times more than the poorest households. As income grows, the percentage of that income paid in personal income taxes increases.

In 2007, state lawmakers made some significant tax policy changes. First and foremost, working families will benefit from a new 3.5% state earned income tax credit (EITC). The state EITC is a targeted tax reduction that will help more than 800,000 low- and moderate-income families in the first, second and middle income quintiles. It is a refundable credit, so it will not only offset income taxes owed, but it will also help to offset the disproportionately negative impact of sales and property taxes on the lowest-paid workers. While North Carolina's state EITC will not go into effect until tax year 2008, its impact is reflected in ITEP's analysis.

State lawmakers also gave a tax break to the wealthiest 2% of taxpayers by allowing the top personal-income-tax bracket to expire. As a result, North Carolina has only three income-tax brackets, with the highest rate being 7.75% for taxable income over \$100,000 for married couples. This change is also reflected in ITEP's analysis and helped to lower the percentage of income the wealthiest households pay in state personal income taxes.

**FIGURE 2**

**INCOME TAXES (% of income paid by income groups)**



SOURCE: The Institute on Taxation and Economic Policy (ITEP), October 2007. ITEP data reflects 2007 tax law changes, 2006 income levels and offset for federal deductibility.

In addition to helping to counterbalance the impact of less fair taxes on low- and moderate-income taxpayers, North Carolina's reliance on the personal income tax makes the state's revenue flow more stable and less vulnerable to economic downturns. This is because over the long run, personal income tax collections will grow faster than personal income.

The personal income tax accounted for 30% of all state and local tax revenues in 2005. North Carolina should maintain and strengthen the progressive income tax and continue to rely on it as the cornerstone of the state's revenue system.

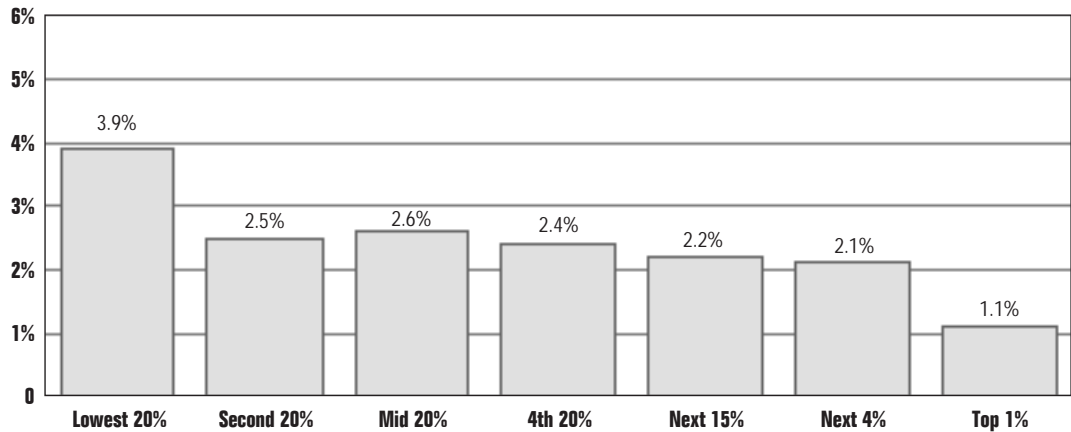
**FEATURES OF NC'S PERSONAL INCOME TAX THAT AFFECT FAIRNESS**

- + MULTIPLE BRACKETS (AS OPPOSED TO ONE FLAT RATE)
- + REFUNDABLE STATE EITC (BEGINNING TAX YEAR 2008)
- + CHILD AND DEPENDENT CARE CREDITS (NON-REFUNDABLE)

It is important to note that this analysis includes corporate income tax revenues, which currently represent 5% of all state and local tax revenues in North Carolina. This adds to the overall progressivity of the income tax data shown in Figure 1. While technically paid by corporations, this tax is usually passed on in the form of lower profits for shareholders. Because stock ownership is heavily concentrated at the top of the income scale, the corporate income tax is one of the most progressive taxes that a state can levy. Another important feature of the state's corporate income tax is that a significant portion of the tax is paid by non-residents who are shareholders of corporations that do business in North Carolina.

**FIGURE 3**

**PROPERTY TAXES (% of income paid by income groups)**



SOURCE: The Institute on Taxation and Economic Policy (ITEP), October 2007. ITEP data reflects 2007 tax law changes, 2006 income levels and offset for federal deductibility.

## Property Taxes

All households pay property taxes, either directly as homeowners or indirectly as renters. With the exception of the poorest and wealthiest households, the property tax is mostly flat, or proportional, across income categories. This is because home values tend to increase in proportion to income. At the very top of the income distribution, however, wealthy residents' homes are usually worth smaller shares of their incomes. For example, middle-income families often own homes valued at two or three times their annual income, but wealthier families are less likely to own homes worth as much relative to their incomes.

The property tax is strictly a local revenue source in North Carolina, but it accounted for 24% of all state and local revenues in 2005. Rates vary by county and municipality, and property values are currently reassessed at a minimum of every 8 years. The property tax also applies to other tangible property including land and motor vehicles.

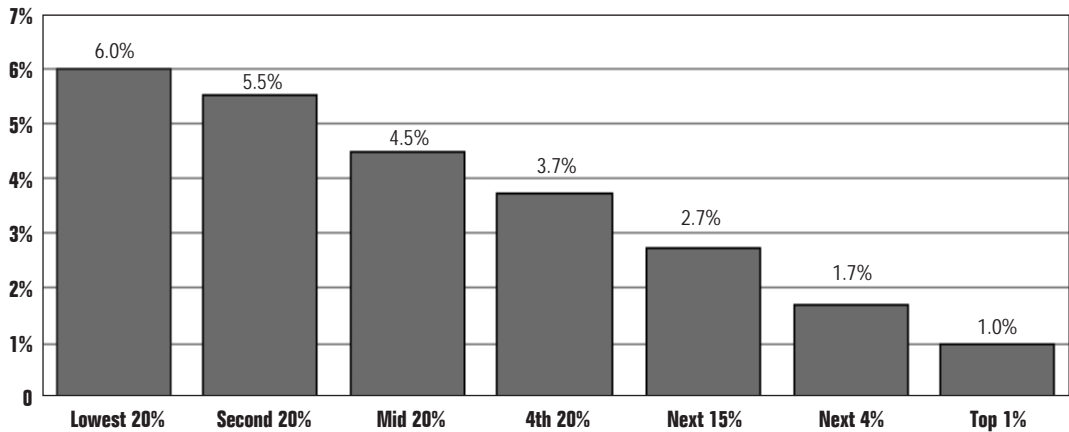
Figure 3 shows the bottom 20% of households pay the highest percentage of their incomes in property taxes, on average 3.9%. Most of those taxes are passed on to renters from landlords through rent prices. The wealthiest households pay the smallest share of their incomes in property taxes, on average just 1.1%.

### FEATURES OF NC'S PROPERTY TAX THAT AFFECT FAIRNESS

- + HOMESTEAD EXEMPTION AND TAX DEFERRAL PROGRAMS TO HELP HOMEOWNERS WHO ARE 65 OR OLDER OR DISABLED
- INFREQUENT REASSESSMENTS

**FIGURE 4**

**SALES AND EXCISE TAXES (% of income paid by income groups)**



SOURCE: The Institute on Taxation and Economic Policy (ITEP), October 2007. ITEP data reflects 2007 tax law changes, 2006 income levels and offset for federal deductibility.

**Sales and Excise Taxes**

North Carolina's sales and excise taxes are the most regressive of all state and local revenue sources. Low- and moderate-income households spend most of their incomes on necessities, most of which are taxed. Wealthier households tend to spend more of their incomes on services, most of which are exempt from taxation in North Carolina, or put money in savings and investments. Sales taxes comprised 23% of total state and local revenues in 2005.

As Figure 4 shows, North Carolina's sales and excise taxes require the poorest households to pay on average six times more as a share of their incomes in these taxes as do the wealthiest. Middle-income households pay more than four times the rate of the wealthy. Unlike the personal income tax, as income rises, the share of income paid in sales and excise taxes decreases considerably.

**FEATURES OF NC'S SALES TAX THAT AFFECT FAIRNESS**

- + FOOD TAXED ONLY AT 2% COMPARED TO 6.75% GENERAL RATE
- MOST SERVICES ARE NOT TAXED

Lawmakers agreed to maintain the state's portion of the sales tax rate at 4.25% in 2007. For the most part, county sales taxes are 2.5%, making North Carolina's combined state and local sales-tax rate 6.75%. North Carolina taxes food purchased for home consumption at only 2%, which helps to lessen the regressivity of the sales tax; however, the exemption of most services and North Carolina's moderately high rate make the tax extremely unfair.

In addition to the state's general sales tax on purchases of goods and a few services, the state imposes several excise taxes on specific goods. Excise taxes are typically a set amount rather than a percentage of the sale price, and their costs are not always itemized on receipts, making them a form of hidden tax. Excise taxes make up around 12% of all state and local tax revenues in North Carolina. The two excise taxes that raise the most revenue are the state gas tax and the taxes on alcohol. Like sales taxes,

## Federal taxes impact fairness in North Carolina

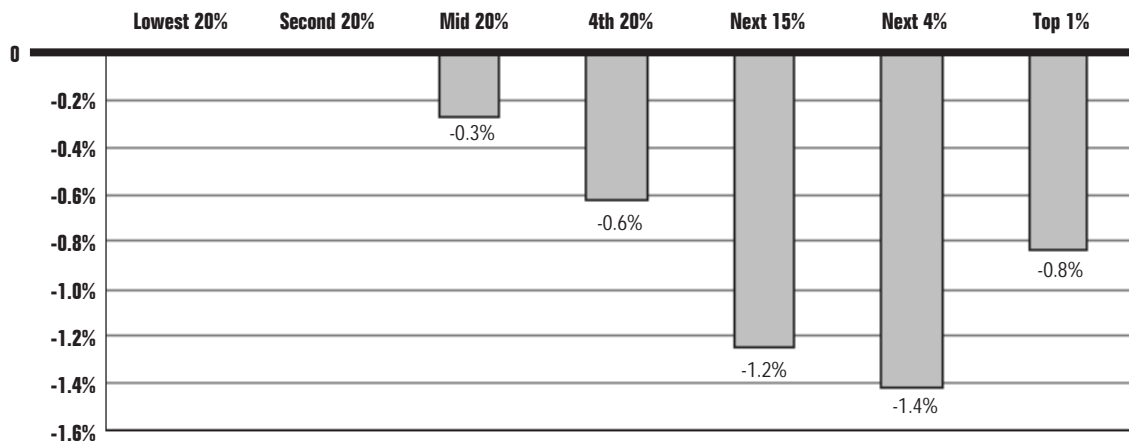
excise taxes are regressive because lower-income taxpayers spend a higher share of their incomes on these products than wealthier taxpayers. The impact is even more dramatic for purchases of products that are consumed more heavily by low-income taxpayers.

North Carolinians who pay state income tax get a federal tax break because they can deduct what they paid in state income tax from their income for federal tax purposes. This benefit, however, only applies to those who have enough additional expenses that they choose to itemize rather than take the standard deduction on their federal income taxes. Most low- and moderate-income taxpayers do not itemize and therefore do not see any additional benefits from federal deductibility.

According to the Institute on Taxation and Economic Policy (ITEP), on average every dollar that a state collects in income taxes only ends up costing taxpayers about 80 cents. This is because roughly 20% of the state tax imposed is offset by federal tax cuts for those who itemize, primarily wealthier taxpayers. This impact is even greater for the top 1% of taxpayers who get back about one third of every dollar they pay in state taxes through cuts in federal taxes owed. This is why income tax cuts at the state level are a bad deal for both the state's revenue needs and its taxpayers.

**FIGURE 5**

### IMPACT OF FEDERAL DEDUCTION OFFSET



SOURCE: The Institute on Taxation and Economic Policy (ITEP), October 2007. ITEP data reflects 2007 tax law changes, 2006 income levels and offset for federal deductibility.

Figure 5 shows the impact the federal offset has on the total percentage of income paid toward state and local taxes. The bottom 40% of taxpayers receive no benefit from the offset while the top quintiles are able to reduce their share of income paid in taxes by more than 1 percentage point. Before accounting for the federal offset, the top 1% of households pay on average 8% of their incomes in state and local taxes. After the offset, the total is reduced to just 7.1%, resulting in an average tax break of \$8,730.

## Unfair Taxes Means Slower Revenue Growth

The growing income and wealth gap exacerbates the inequity in North Carolina's tax system. North Carolina is not requiring those with the most money and fastest-growing incomes to pay their fair share. In fact, responsibility for paying for state needs continues to shift to low- and moderate-income taxpayers who have seen their wages stagnate and who have the least to give.

A tax system that relies on raising money from the people who have the least of it has direct implications on North Carolina's ability to raise adequate revenues. The simple reason is that the top 20% of North Carolina households earned close to 60% of the state's income in 2006, compared to just 3.5% earned by the bottom 20%. Over time, this trend will worsen because the incomes of the top 1% are growing at a much faster rate than any other income category. Between 1979 and 2005, incomes of the top 1% increased on average by 228% compared to only a 6% increase for the bottom 20%.<sup>2</sup>

STRATEGIES FOR IMPROVING TAX FAIRNESS IN NC		
TAX CATEGORY	STRATEGIES	DO OTHER STATES EMPLOY THIS STRATEGY?
Income tax	Increase number of brackets	yes
	Index brackets and deduction for inflation	yes
	Increase refundable EITC	yes
Sales Taxes	Eliminate food from local sales tax base; or create refundable food tax credit	yes
	Expand base to include more personal services (and use revenue gains to lower overall rate)	yes
Property Taxes	Create a refundable circuit-breaker credit for low-income homeowners and renters that would allow them to claim a refundable credit against their state income tax, offsetting their property taxes.	yes
All Categories	Require distributional analysis of proposed tax policy changes before they can be considered	yes

According to ITEP, if North Carolina lawmakers changed the state and local tax system to require the wealthiest 1% of households to pay as much of their income as the poorest 20% do, the revenue yield would have been \$589 million in 2006. Extending that same condition on the top 20% would have yielded \$1.6 billion.

A tax system that values fairness can offset the growing income gap and help North Carolina raise revenue to pay for core services and unaddressed needs. Changes to the tax system that would require wealthy households—those with the most money and fastest-growing incomes—to pay their fair share are essential.

## Conclusion

Increasingly, state and local leaders recognize the need to modernize North Carolina's state and local tax system. In addition to fairness, there are concerns of efficiency, long-term adequacy, and economic competitiveness.

The legislative-appointed Commission to Modernize State and Local Finances is working to develop a tax reform plan for the state, and it is considering dozens of major policy changes. Many of these changes would exacerbate the already regressive



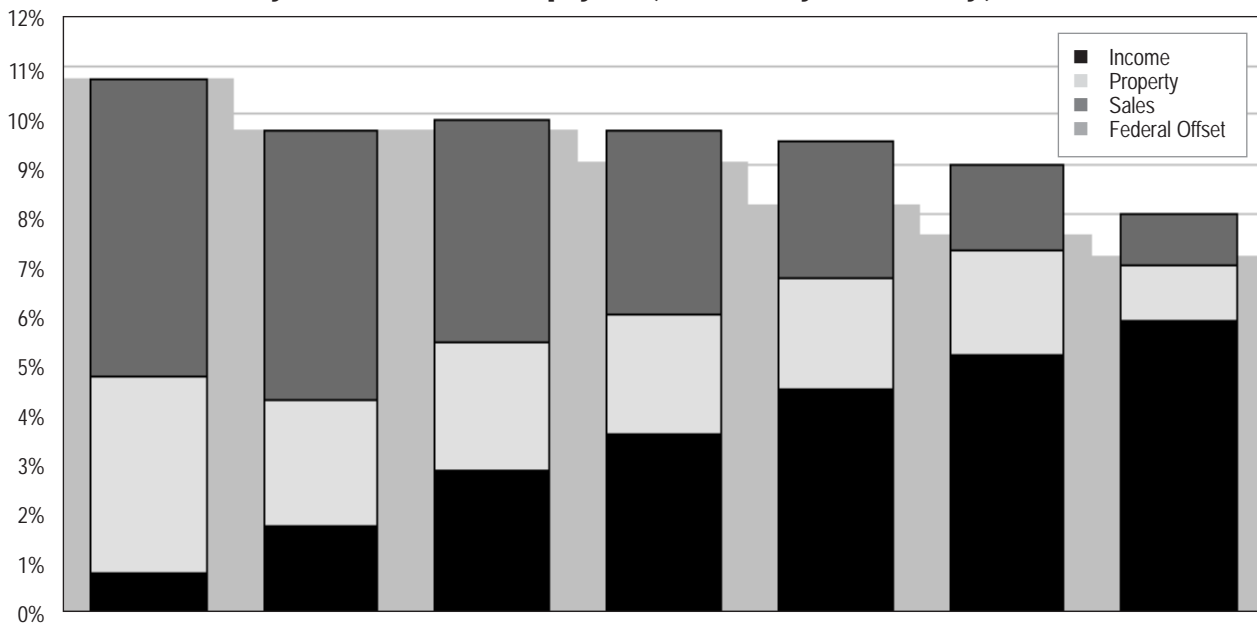
nature of the state and local tax system. Such changes include decreasing reliance on the progressive state income tax by relying more heavily on sales taxes and eliminating the state corporate income tax. Not only would these types of changes make the system less fair, they would also negatively affect revenue adequacy in the long run.

An overhaul of the tax system should make the system fairer and should provide for revenue growth that matches economic growth without rate changes. These two objectives can be achieved without jeopardizing the state's economic competitiveness or making the system overly burdensome from an administrative standpoint.

- 1 Tax incidence analysis conducted by the Institute on Taxation and Economic Policy (ITEP), October 2007. ITEP data reflects 2007 North Carolina tax policy changes, 2006 income levels and offset for federal deductibility.
- 2 Sherman, Arloc. "Income Inequality Hits Record Levels, New CBO Data Show: Incomes Rose \$180,000 for Top 1 Percent in 2005 But Just \$400 for Middle-Income Households." Center on Budget and Policy Priorities, December 14, 2007. <http://www.cbpp.org/12-14-07inc.htm>

## Appendix

### NORTH CAROLINA STATE & LOCAL TAXES IN 2007 Shares of family income for all taxpayers (non-elderly and elderly)



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Next 1%
Sales & Excise Taxes	6.0%	5.5%	4.5%	3.7%	2.7%	1.7%	1.0%
Property Taxes	3.9%	2.5%	2.6%	2.4%	2.2%	2.1%	1.1%
Income Taxes	0.8%	1.7%	2.8%	3.6%	4.5%	5.2%	5.9%
<b>Total Taxes</b>	<b>10.7%</b>	<b>9.7%</b>	<b>9.9%</b>	<b>9.7%</b>	<b>9.4%</b>	<b>9.0%</b>	<b>8.0%</b>
Federal Deduction Offset	-	-0.0%	-0.3%	-0.6%	-1.2%	-1.4%	-0.8%
<b>Total After Offset</b>	<b>10.7%</b>	<b>9.7%</b>	<b>9.6%</b>	<b>9.0%</b>	<b>8.2%</b>	<b>7.6%</b>	<b>7.1%</b>

SOURCE: The Institute on Taxation and Economic Policy (ITEP), October 2007

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