



# North Carolina Justice Center

*Opportunity and Prosperity for All*

## THE FUTURE IS NOW:

A Plan to Modernize North Carolina's Revenue System

February 2011



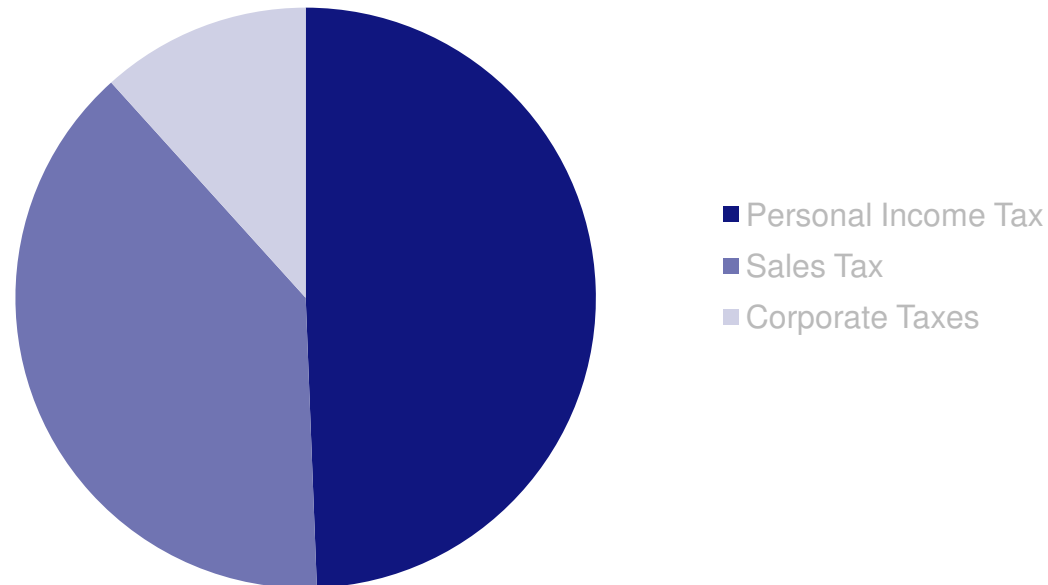
NC Justice Center

*Opportunity and prosperity for all*

## Revenue Plan Goals

Protect effective public investments  
with a modernized revenue system (and raise \$1.28 billion)

**Half of new revenue will come from modernizing the personal income tax.**





NC Justice Center

*Opportunity and prosperity for all*

## Revenue Plan Goals

A modern revenue system should improve long-term adequacy, minimize volatility and ensure equity so that the state can invest in North Carolina's shared prosperity.



NC Justice Center

*Opportunity and prosperity for all*

## 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However, tax revenues are falling at a greater rate than the larger economy because of **the state's flawed and outdated tax system.**



NC Justice Center

*Opportunity and prosperity for all*

# The Case for Revenue Reform

- There are problems with North Carolina's current revenue system that undermine the state's ability to fulfill its mission and support the economic recovery.
- Research shows that revenue reform can improve the economy's ability to grow and innovate in the long-term.
- Revenue reform can minimize the devastating impact of a cuts-only approach to the budget shortfall and set North Carolina on a path to economic recovery.



NC Justice Center

*Opportunity and prosperity for all*

# 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

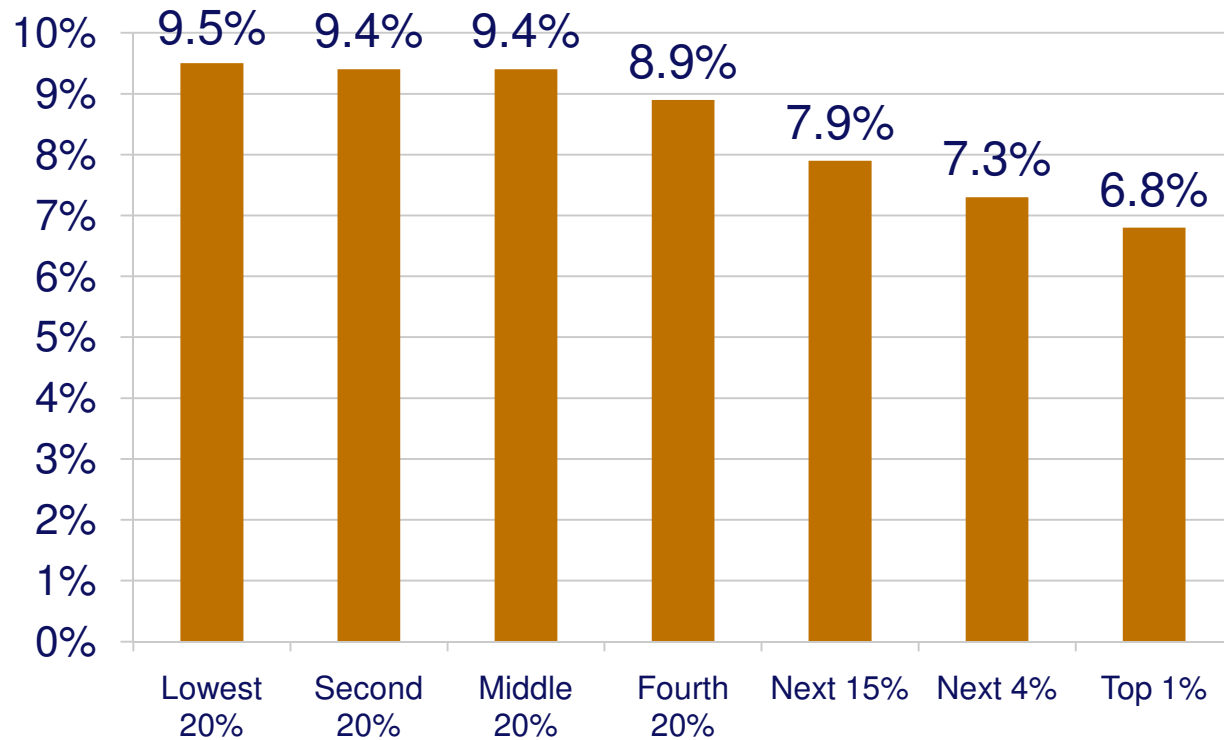
**It is narrow:** major tax schedules (sales, income, and corporate profits) capture an inadequate and decreasing portion of the state's economic activity

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



NC Justice Center  
*Opportunity and prosperity for all*

## North Carolina's Low-income Households Pay a Greater Share of Their Income in Taxes than High Income Households



### ■ State and Local Taxes Share of Income\*

**Source:** Institute on Taxation and Economic Policy, November 2009. Who Pays? 3<sup>rd</sup> Edition.

\* Includes "federal offset" for state and local taxes deducted from federal income taxes.

Does not include the temporary tax package passed in 2009

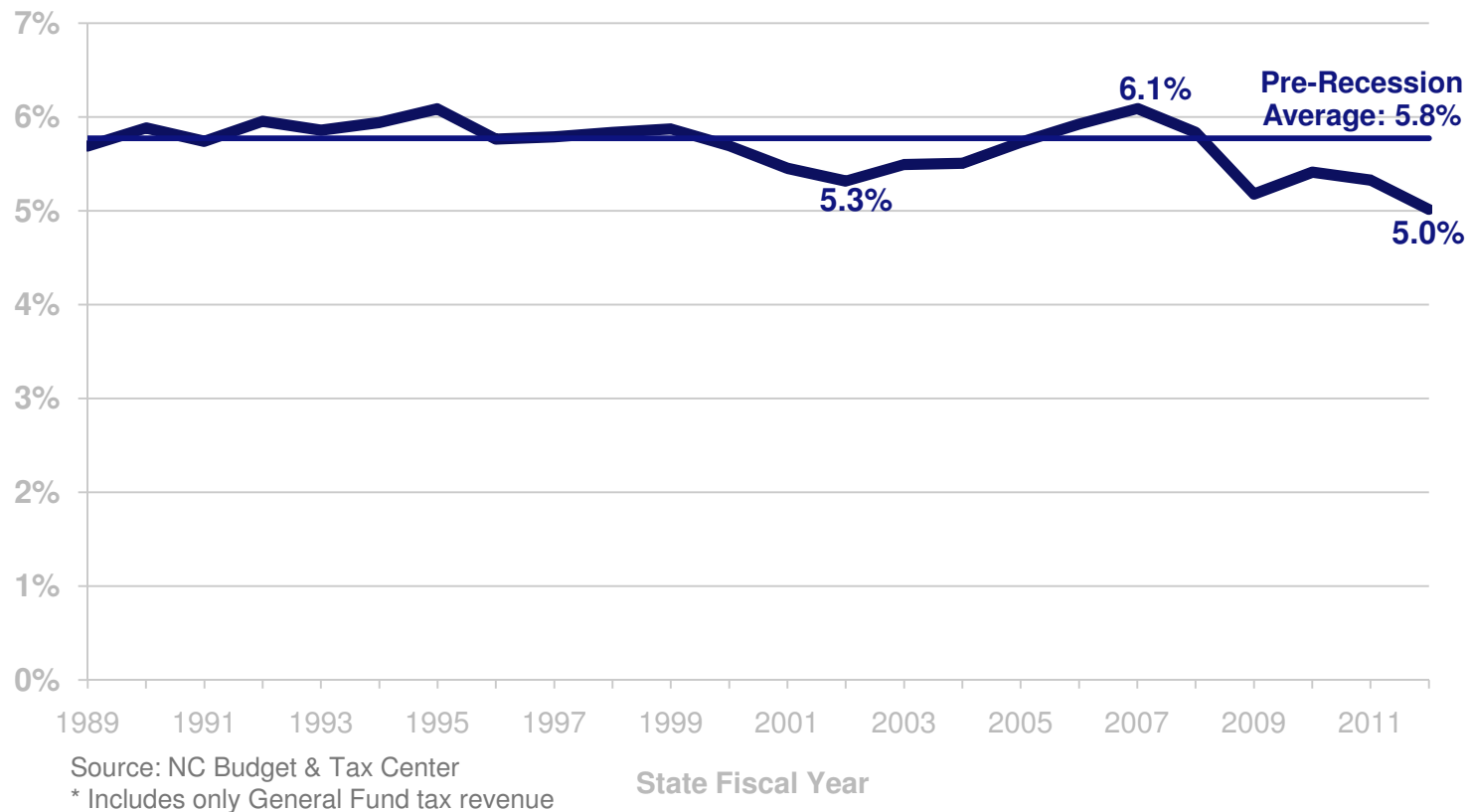


NC Justice Center

*Opportunity and prosperity for all*

# North Carolina tax revenues projected to reach historic lows

## State Tax Collections Will Dip to 5 percent of State Personal Income in FY 2012







NC Justice Center

*Opportunity and prosperity for all*

## Take Steps to Modernize the State's Tax System

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



NC Justice Center

*Opportunity and prosperity for all*

## Proposed Tax 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 state income tax better aligned to ability to pay**

- 1) Adopt a more progressive rate structure
  - Move from 3 to 6 income brackets
  - Reduce rates for income under \$200,000 (married couples)
- 2) Convert all deductions to credits
  - Disallow all itemized deductions other than mortgage interest, medical expenses, and charitable contributions
  - Increase value of standard deduction
  - Allow 3% credit for standard deduction or total of 3 allowed itemized deductions (whichever is higher)
- 3) Merge personal exemption and child tax credit into a per-person credit
- 4) Increase Earned Income Tax Credit (EITC) to 10%
- 5) Phase out credit for standard deduction and \$180 Per-Person Credit for top incomes



NC Justice Center

Opportunity and prosperity for all

# Proposed Tax Changes: Personal Income Tax

Households will pay lower tax rates on income under \$200,000 for married couples, under \$120,000 for single filers

Standard Deduction and Per-Person Credit phase out starting with 7.5% bracket; Itemized Deductions Capped

Current Personal Income Tax Brackets				
MFJ	Single	HOH	MFS	Rate
\$0	\$0	\$0	\$0	6.00%
\$ 21,250	\$ 12,750	\$ 17,000	\$ 10,625	7.00%
\$ 100,000	\$ 60,000	\$ 80,000	\$ 50,000	7.75%

BTC Proposed Personal Income Tax Brackets				
MFJ	Single	HOH	MFS	Rate
\$0	\$0	\$0	\$0	5.00%
\$ 25,000	\$ 15,000	\$ 20,000	\$ 12,500	6.00%
\$ 50,000	\$ 30,000	\$ 40,000	\$ 25,000	7.00%
\$ 100,000	\$ 60,000	\$ 80,000	\$ 50,000	7.50%
\$ 200,000	\$ 120,000	\$ 160,000	\$ 100,000	8.00%
\$ 400,000	\$ 240,000	\$ 320,000	\$ 200,000	8.50%

New Standard Deduction			
MFJ	Single	HOH	MFS
\$ 10,000	\$ 6,000	\$ 8,000	\$ 5,000

Current Standard Deduction			
\$ 6,000	\$ 3,000	\$ 4,400	\$ 3,000

MFJ = Married, Filing Jointly

HOH = Head of Household

MFS = Married, Filing Separately



# Impact of Proposed Tax Changes: Personal Income Tax

## More than half of households receive a net income tax cut

*Even High-Income Households Still Receive Substantial Net Federal & State Tax Cut*

2011 Income	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income	Less than	\$17,000 –	\$29,000 –	\$48,000 –	\$77,000 –	\$158,000 –	\$367,000 –
Range	\$17,000	\$29,000	\$48,000	\$77,000	\$158,000	\$367,000	Or More
Average Income in Group	\$11,000	\$23,000	\$38,000	\$62,000	\$105,000	\$223,000	\$929,000

Personal Income Tax Changes							
Tax Change as % of Income	-0.8%	-0.6%	-0.1%	+0.2%	+0.3%	+0.6%	+0.8%
Average Tax Change	\$ -81	\$ -130	\$ -29	\$ +97	\$ +319	\$ +1,311	\$ +7,454
% with Income Tax Cut	+59%	+71%	+59%	+50%	+33%	+3%	—
% with Income Tax Increase	+1%	+9%	+31%	+44%	+64%	+96%	+99%

Revenue Change	
<b>\$ +634,000,000</b>	

Total Share w/ Tax Cut	52%
Total Share w/Tax Increase	31%

Net Tax Cut - Federal & State Combined	
Top 1%	\$ -42,533
Next 4%	\$ -7,786

Source: ITEP Microsimulation Model



NC Justice Center

*Opportunity and prosperity for all*

## The State Earned Income Tax Credit is critical to addressing the upside-down nature of the tax system.

**806,233** taxpayers in North Carolina filed for the state EITC.

**\$59.9 million** in state EITC dollars were received by taxpayers across the state.

The state EITC supplemented federal EITC dollars to bring an **average value of \$2,248** to eligible NC taxpayers



NC Justice Center

*Opportunity and prosperity for all*

## Proposed Tax Changes: Sales Tax

**Broaden the base** of the sales tax to include services taxed by any other state in the United States

- Exempt only food (from state), prescription drugs, business-to business services , health care and education

**Reduce state rate** from 4.75% to 3.75%



# Impact of Proposed Tax Changes: Sales Tax

**Broader Tax Base & Lower Rate Raises \$500 million**  
Would also stabilize revenues and help prevent future rate hikes

2011 Income	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income	Less than	\$17,000 –	\$29,000 –	\$48,000 –	\$77,000 –	\$158,000 –	\$367,000 –
Range	\$17,000	\$29,000	\$48,000	\$77,000	\$158,000	\$367,000	Or More
Average Income in Group	\$11,000	\$23,000	\$38,000	\$62,000	\$105,000	\$223,000	\$929,000

State Sales Tax Changes							
Tax Change as % of Income	<b>+0.3%</b>	<b>+0.3%</b>	<b>+0.2%</b>	<b>+0.2%</b>	<b>+0.1%</b>	<b>+0.1%</b>	—
Average Tax Change	\$ +34	\$ +61	\$ +75	\$ +93	\$ +107	\$ +132	\$ +398

Revenue Change
<b>\$ +500,000,000</b>

Source: ITEP Microsimulation Model



NC Justice Center

*Opportunity and prosperity for all*

## Why Tax Services?

- Services a growing share of North Carolina's economy
- Only one-third of household consumption subject to state sales tax
- Revenue to grow slower than economy and need for public investments
- Consumption of services more stable than goods





NC Justice Center

*Opportunity and prosperity for all*

## Proposed Tax Changes: Corporate Tax

- Eliminate unnecessary corporate income tax exemptions and ineffective corporate incentives
- Adopt mandatory combined reporting for multi-state corporations

Corporate Income Tax Breaks	2010 Revenue Estimate (millions)
Disallow net capital losses not deductible from federal taxable income	\$15
Eliminate ineffective Article 3J tax credits	\$17
Eliminate corporate deduction for contributions made to non-NC charities	\$3.5
Adopt throwback rule for corporate "Nowhere Income"	\$12.5
Adopt Mandatory Combined Reporting for multi-state corporations	\$101
<b>TOTAL</b>	<b>\$149 million</b>



NC Justice Center

*Opportunity and prosperity for all*

## North Carolina is a Low-cost State for Business

- Annual report by pro-business *Council on State Taxation* put North Carolina as being tied for the lowest business-tax state in the country in FY2009
- *Forbes* recently ranked North Carolina as having the third-lowest business costs of any state



NC Justice Center

*Opportunity and prosperity for all*

# Proposed Tax Changes: Tax-Code Spending

## What is Tax-Code Spending?

- **Tax-code spending** includes special tax credits, deductions, exemptions, and preferential rates that:
  - ...represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.\**
- **In fiscal year 2009-10**, tax-code spending in North Carolina totaled over \$5.8 billion\*\*

\* Stanley Surrey, Assistant Treasury Secretary, 1961-1969

\*\* 2010 Biennial Tax Expenditure Report – NC Department of Revenue



NC Justice Center

*Opportunity and prosperity for all*

# Proposed Tax Changes: Tax-Code Spending

## Treat Tax-Code Spending Like Other Spending

- In 2007, NC General Assembly commenced “Continuation Reviews” to evaluate cost-effectiveness of selected programs supported by state appropriations
- The General Assembly should implement a process similar to continuation reviews to evaluate \$5.8 billion in tax-code spending starting in 2011-12
- As in the State of Washington\*, NC General Assembly could establish a Citizens’ Tax-Code Spending Review Commission to review and make recommendations on whether to preserve or terminate reviewed tax-code spending

\* Citizen Commission for Performance Measurement of Tax Preferences - <http://www.citizentaxpref.wa.gov/>



# Governor's Budget on Revenue is not Reform-Minded

## Governor Perdue's budget incorporated some new revenue to protect public investments, but the General Assembly should consider alternatives

- Preserving three-quarters of 1-percent sales tax increase raises over \$800 million per year but hits low- and middle-income families hardest
- Reducing corporate income tax rate without broader base reduces revenue with little evidence of potential job boost
- Governor's revenue changes do not address long-term problems with North Carolina's revenue system

Impact of Keeping 0.75-Cent Sales Tax							
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % of Income	+0.5%	+0.4%	+0.3%	+0.2%	+0.2%	+0.1%	+0.1%
Average Tax Change	+54	+82	+117	+148	+198	+290	+866

Source: ITEP Microsimulation Model – Preliminary Results



NC Justice Center  
*Opportunity and prosperity for all*

# Summary of Revenue Modernization Plan

## Revenue Target Breakdown - \$1.28 billion in FY2012

- Personal Income (\$634 Million)
- Sales Tax (\$500 Million)
- Corporate Tax (\$149 Million)

## Modernized Revenue System Replaces Revenues of Temporary Tax Package, But Based on Ability to Pay

Tax Change as % of Income								
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	Total Revenue
<b>BTC Revenue Modernization Plan</b>	-0.5%	-0.3%	0.1%	0.4%	0.4%	0.7%	0.8%	\$1.13 Billion
<b>Temporary Tax Package</b>	0.7%	0.5%	0.4%	0.3%	0.3%	0.3%	0.3%	\$1.12 Billion

Source: ITEP Microsimulation Model



NC Justice Center

*Opportunity and prosperity for all*

## Contact Information:

**Alexandra Forter-Sirota**

Director, NC Budget & Tax Center

[alexandra@ncjustice.org](mailto:alexandra@ncjustice.org)

919-861-1468

Edwin McLenaghan

Policy Analyst

[edwin@ncjustice.org](mailto:edwin@ncjustice.org)

919-856-3192

Brenna Burch

Policy Analyst

[brenna@ncjustice.org](mailto:brenna@ncjustice.org)

919-856-2176