Legislative BULLETIN

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Why Both the House and the Senate are Right on Taxes

LAST WEEK, GOVERNOR BEVERLY PERDUE CALLED FOR REVENUE INCREASES TOTALING $1.5 BILLION. She has joined a chorus of citizens throughout the state who want the legislature to raise revenue to avoid devastating cuts to education and human services.

Leaders in both the state Senate and House also see the need to raise revenue. In fact, the tax proposals from each house, taken together, include all the elements necessary to create a revenue package that will enable North Carolina to make it through the recession without implementing the most devastating cuts. Plus, they could give the state a more stable and fair tax system for the future.

The Personal Income Tax

The Senate proposes broadening the income tax by changing the starting point for calculating state income taxes from federal taxable income (after deductions) to adjusted gross income (before deductions). They also want to 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).

The House has proposed creating two new upper-income tax brackets. This would make the state's outdated tax code more efficient because the incomes of the wealthy grow more quickly than those of low-income families. In addition, the wealthy can absorb modest tax increases in a recession; studies show they will save less but continue to spend. In fact, raising taxes on the wealthy has less of an impact on economic activity than cutting services and jobs.

So, let's consider a compromise of the two plans. Take the Senate plan, and then follow the House's lead and add one new upper-income tax bracket. These changes would generate an estimated $161 million in FY09-10 and more than $400 million in FY10-11 in income tax revenues.

The Sales Tax

The House recommended expanding the sales tax base to include warranties, installations and repairs; digital downloads; and converts the privilege tax on amusement to a sales tax. The Senate's base- broadening plan includes the House elements, but goes expands to more services, particularly in the areas of personal care, home and real property, and storage. There has also been talk at the General Assembly that the Senate is considering taxing electricity at the general state sales-tax rate, an increase from 3% to 6% once the Senate plan is fully implemented.

While the House plan included a 0.25 cent increase in the sales tax, the greater base broadening of the sales tax in the Senate plan allows them to lower the rate by as much as 0.75 cent.

The Senate plan to broaden the sales tax base is the better option. Doing so would have a lesser impact on low-income families than the House proposal to raise the rate and makes the sales tax more stable over time. Implementing the Senate's original proposal and adding the increase in the sales tax on electricity generate an estimated $500 million in the next fiscal year.

Business Taxes

The House called for the implementation of "combined reporting" for multi-state corporations, a move that will end the manipulations that enable large companies to avoid paying millions in taxes to North Carolina. Enacting this measure would demonstrate how much state legislators respect and support small businesses, which have been at a disadvantage when competing against these corporate tax avoiders. The House also recommended some smaller, but very important measures to improve the corporate income tax including closing the so-called "Nowhere Income" loophole ending a special tax break for banks.

The Senate wants to eliminate several business tax expenditures, including the Article 3J development credits, formerly known as the "Bill Lee Credits." A recent study showed that these credits have no demonstrated benefit to the state. The Senate plan also eliminates state and local privilege taxes, limits the farm sales tax exemption to small farms, and lowers the corporate income tax rate. There has also been some discussion of increasing the insurance gross premium tax.

Both the House and Senate expand the franchise tax to include limited liability business entities. Implementing the business tax plans from both the Senate and the House would raise additional revenue ($183 million in FY09-10 and $354 million the following year) and dramatically improve the fairness of the state's business taxes.

A Little Help for Low- and Moderate-Income Families

While these changes would raise needed revenue and modernize our tax system, the sales tax changes would disproportionately affect low and moderate-income families. The income tax changes could adversely affect fixed-income households. The legislature should consider two measures that would help to offset the increased taxes for those who are already struggling.

The state should increase the Earned Income Tax Credit. The state EITC will increase from 3.5% of the federal credit to 5% in the coming tax year. Increasing it more - to at least 10% of the federal credit - would cost approximately $70 million annually and would help more than 835,000 low- and moderate-income working families.

In addition, state leaders should consider establishing an alternative refundable credit that would benefit all low-income taxpayers regardless of work status, in order to offset the tax increases on older residents with fixed incomes or without families who do not benefit from the current state EITC.

Conclusion

The combination of the House and Senate budgets outlined here would raise more revenue than either chamber planned for- more than $1 billion in FY09-10 including an increased state EITC. Additional revenue will help prevent thousands of teachers and other workers from being laid off at a time when the state's unemployment rate is already hitting 12%. More revenue will avoid cuts to the Medicaid reimbursement rates for healthcare providers. Not doing this would make it harder for the state's poorest residents to find care as more doctors decide they will no longer take Medicaid.

The good news is state leaders are on the right track. If they make the right choices, North Carolina will be better able to recover from the recession, and they will ensure families throughout the state survive this difficult time without suffering financial setbacks from which they might never bounce back.

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