



The Future is Now:

A Plan to Modernize North Carolina's Revenue System

By Edwin McLenaghan
and Alexandra Forter Sirota

NC BUDGET & TAX CENTER

A project of the



NORTH CAROLINA JUSTICE CENTER

ABOUT THE JUSTICE CENTER

THE JUSTICE CENTER is a statewide, non-profit advocacy organization dedicated to securing economic justice for disadvantaged persons and communities. The mission of the Justice Center is to address poverty by ensuring that low-income individuals and communities have the resources and services they need to move from poverty to economic security. The work of the Justice Center is based on the belief that four objectives must be realized to enable disadvantaged individuals and communities to move from poverty to economic security. They include:

- **work that is safe**, pays a living wage and provides benefits that will enable a family to be self-sufficient;
- **government action** that supports and protects those able to work;
- **a safety net** of income and services that supports those unable to work;
- **equal opportunity** for low-income persons to achieve economic security free of discrimination.

To achieve its mission, the Justice Center works in collaboration with North Carolina's disadvantaged individuals and communities employing a multi-forum advocacy model in which the Center uses four primary strategies to fight poverty:

Litigation: Undertaking high-impact litigation to ensure that the rights of traditionally underrepresented populations are protected.

Research and Policy Development: Conducting and disseminating policy research and developing alternatives to existing policy on key issues facing traditionally disadvantaged populations.

Public Policy Advocacy: Working with traditionally underrepresented populations to define and shape the public policies that will most dramatically impact their communities.

Grassroots Empowerment/Community Capacity Building: Developing and implementing initiatives designed to enable low-income, working poor and minority individuals and community-based organizations to take the lead in solving the problems that they face.

JUSTICE CENTER PROJECTS

North Carolina Living Income Initiative
North Carolina Immigrants Legal Assistance Project
North Carolina Poverty Law Litigation Project
North Carolina Education and Law Project
North Carolina Budget and Tax Center
North Carolina Consumer Action Network
North Carolina Health Access Coalition
Grassroots and Community Empowerment Project

NORTH CAROLINA JUSTICE CENTER
224 S. Dawson Street • P.O. Box 28068 • Raleigh, NC 27611
919/856-2570 voice • 919/856-2175 fax • www.ncjustice.org • contact@ncjustice.org

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EXECUTIVE SUMMARY

The time is now to modernize the state's revenue system.

The purpose of the revenue system is to fund investments in the public structures—schools, courts, hospitals, colleges and universities, and infrastructure—that are critical to building and preserving a strong middle class and a 21st century economy, but North Carolina's revenue system is failing the people of the state.

While the Great Recession directly caused the collapse in state tax revenues, it is not the reason why now, with the state's economy growing once again, state revenues remain below pre-recession levels. Responding to the current fiscal crisis through a short-sighted, cuts-only approach—and ignoring the fundamental problems with the state's revenue system—will do nothing for the sound long-term fiscal stewardship of the state's public structures.



The state's current revenue system fails to meet the three key principles for responsible tax policy – **equity**, **adequacy and stability**. North Carolina's revenue system:

- Is inequitable because it asks more from those with the least ability to pay and asks the least from those with the greatest ability to pay,
- Is inadequate because state revenues are insufficient to meet the needs of the state's people and fail to grow with the economy except during boom times,
- Is unstable because numerous exemptions and loopholes make revenues more volatile in the face of ups and downs in the economy.

North Carolina's revenue system is outdated and narrow:

- North Carolina's revenue system was built for the economy of the 1930s and no longer fits our 21st century, service-based economy.
- North Carolina's tax code is riddled with tax exemptions, deductions and giveaways. The result of this "tax-code spending" is that while North Carolina's tax rates are typically near or slightly below the national average, state tax revenues are far below the national average.

Comprehensive revenue modernization entails reform of the four pillars of North Carolina’s revenue system: the personal income tax, the sales tax, business taxes, and “tax-code spending.”

- Broaden the personal income tax by using adjusted gross income instead of federal taxable income (improve stability and equity). Adopt a more progressive rate structure, convert deductions to credits, and double the value of the state Earned Income Tax Credit (improve adequacy and equity).
- Broaden the sales tax to include services taxed by any other state in the US; reduce the state and local sales tax rates (improve equity, adequacy, and stability).
- Level the playing field in business taxes by enacting mandatory combined reporting for corporate income taxes, treating Limited Liability Companies like other businesses, and eliminating ineffective business subsidies (improve adequacy and equity).
- Enhance accountability and transparency of tax-code spending (i.e. tax expenditures) by adopting a formal evaluation of existing tax-code spending and incorporating new tax-code spending proposals into the state budget (improve equity, adequacy, and stability).

Altogether, the components of the BTC Revenue Modernization Plan would raise more than \$1.3 billion in revenue in the next fiscal year, preserving many of the critical public investments threatened by inadequate state revenues next year and beyond.

If these proposals were adopted, North Carolina would have a 21st century tax structure that reflects the nature of today’s economy and produces the revenue required to meet the growing needs of a growing state, allowing continued investment on necessities that help promote prosperity and job creation.

BTC Plan Balances Distribution of State and Local Tax Responsibility							
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than \$17,000	\$17,000 – \$29,000	\$29,000 – \$48,000	\$48,000 – \$77,000	\$77,000 – \$158,000	\$158,000 – \$367,000	\$367,000 – Or More
Average Income in Group	\$11,000	\$23,000	\$38,000	\$62,000	\$105,000	\$223,000	\$929,000
Taxes Share of Income - Current	9.5%	9.4%	9.4%	8.9%	7.9%	7.3%	6.8%
Taxes Share of Income - BTC Plan	9.0%	9.1%	9.5%	9.2%	8.3%	7.9%	7.5%
Tax Change - BTC Plan	-0.5%	-0.3%	0.1%	0.3%	0.4%	0.6%	0.7%

SOURCE: Institute on Taxation and Economic Policy

*Includes impact of deducting state and local taxes from federal taxable income (i.e. federal offset)

These are hard times for North Carolina. As in just about every state, the worst economic crisis since the Great Depression triggered a collapse in state revenues just as public needs were rising. Though the revenue decline might be ending, policymakers face the challenge of closing another significant shortfall as they develop the state's next two-year budget.

State leaders must create a budget that meets the population's needs and allows them to make the investments that will prepare North Carolina for future prosperity. But these goals are made more difficult to achieve by the state's deteriorated revenue system, which even in the best of times cannot produce the resources required for education, public safety, health care, transportation and other necessities for a strong economy. It's not that taxes are too high or too low; the problem goes deeper than that. Whether one thinks North Carolina should spend more or less than it does today, the state needs a tax system that can raise adequate revenue and do it in a way that treats taxpayers equitably.

North Carolina's revenue system is no longer in line with the state's economy and asks more from those with the least ability to pay. As devastating as the Great Recession continues to be for North Carolina's economy and state revenues, comprehensive revenue reform along the lines of what is proposed in this report would have eliminated a substantial portion of this year's revenue shortfall while ensuring that North Carolina could continue to invest in the public structures that will help pave the way to economic recovery and prosperity.

Because North Carolina's revenue system is outdated, it has difficulty generating the resources needed to support the state's public structures and promote jobs and prosperity. That puts North Carolina at a disadvantage when mapping a path to economic recovery. Without building blocks like public structures—public schools, highways, courts and growing industries—North Carolina's economic growth will be bogged down.

Whether one thinks North Carolina should spend more or less than it does today, the state needs a tax system that can raise adequate revenue and do it in a way that treats taxpayers equitably.

The time is now to modernize the state's revenue system.

And yet some policymakers claim the only option in the face of

an almost unprecedented budget shortfall is drastically cutting back on the public investments that lifted North Carolina from the dire widespread poverty of the early 20th century. Responding to the current fiscal crisis through a short-sighted, cuts-only approach will do nothing for the sound fiscal stewardship of the state's public structures.

Back in the Great Depression, Governors Gardner and Ehringhaus and state legislators responded to the fiscal crisis with a balanced, forward-thinking approach of efficiency measures and revenue reform to fund investments in public schools and infrastructure.¹ So too can today's policymakers work together to update the state's revenue system in ways that preserve the critical public investments that will enable prosperity to take hold again in North Carolina.

■ State Revenues Support Valued, Pro-Growth Public Structures

- Almost 90 percent of state funds support investments in education, health, public safety and transportation.
- These investments in the state's public structures improve the quality of life for all North Carolinians, create and support hundreds of thousands of public- and private-sector jobs, and pave the way for future economic growth and prosperity.

■ North Carolina's Broken Revenue System

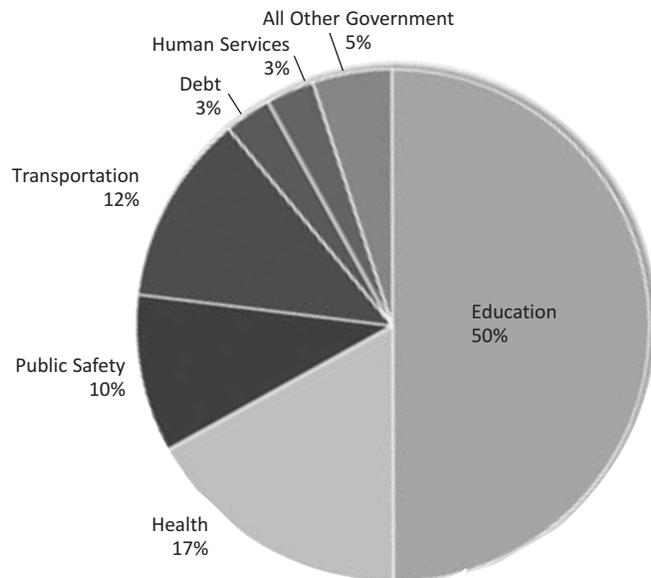
North Carolina's revenue system is failing the people of the state.

The purpose of the revenue system is to fund investments in the public structures—schools, courts, hospitals, colleges and universities, and infrastructure—that are critical to building and preserving a strong middle class and a 21st century economy in North Carolina. For the fourth year in a row, however, North Carolina's revenue system will fall far short of adequately funding the public structures that took generations to build.

Next year's state revenues will fall short by \$2.4 billion (more than 11 percent of the total state budget) of what the state needs to sustain current levels of investments in public structures, the Office of State Budget and Management estimates.⁵ Next year's shortfall comes on top of two years of state spending cuts, which total more than 10 percent of the budget and have already taken a major toll on the state's ability to fulfill its obligations to the people of North Carolina.

While the Great Recession directly caused the collapse in state tax revenues, it is not the reason why now, with the state's economy growing once again, the share of the economy collected in taxes is still far lower than before the recession. State tax revenues in the 2009 fiscal year constituted a smaller share of state residents' incomes than in any of the past 30 years. If state policymakers allow tax rates to fall back to 2009 levels in the next fiscal year, state tax revenues are likely to

FIGURE 1:
Vast Majority of State Appropriations Support Education, Health, Transportation and Public Safety



SOURCE: 2010 Joint Conference Committee Report

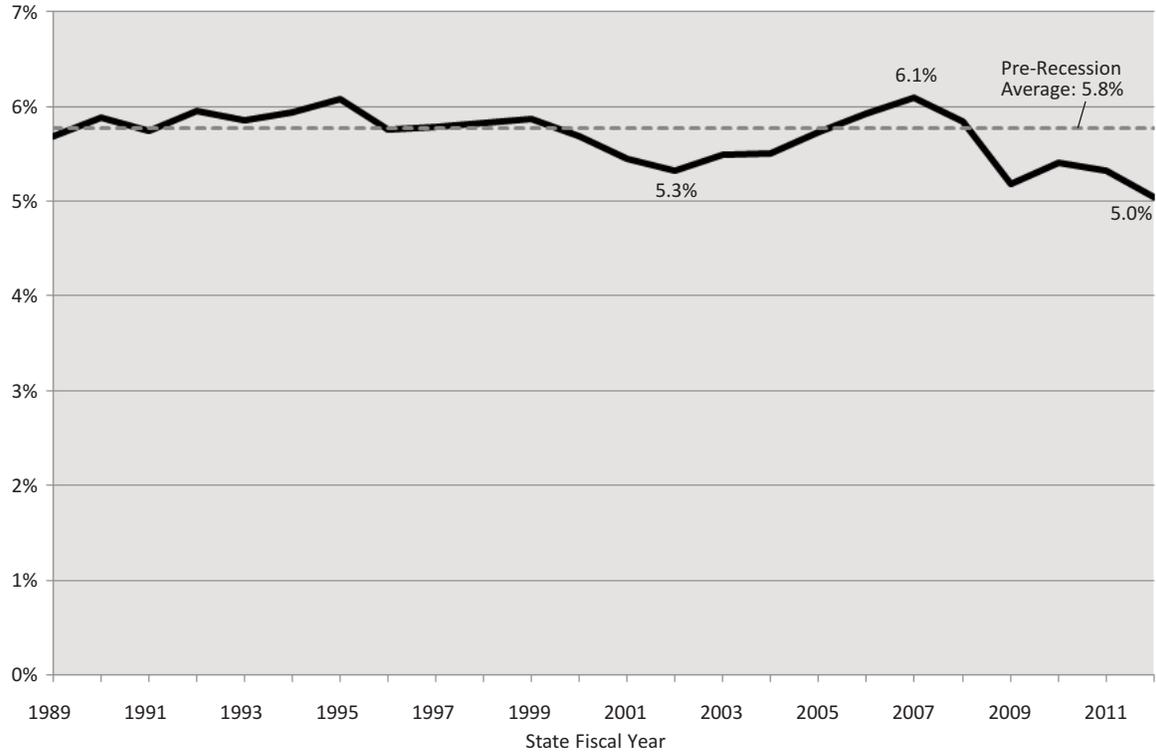
Public investments deliver returns to the entire state

- For every \$1 invested in early childhood education, \$7 is returned to the broader economy.²
- The total annual economic benefit to North Carolina from its UNC campuses is greater than \$10 billion, compared to \$2.7 billion annual state appropriation.³
- Eliminating state Medicaid and refunding dollars to taxpayers would cause employment to fall by 67,400 jobs and make adequate health care unattainable for one in six North Carolinians.⁴

FIGURE 2:

North Carolina Tax Revenues Projected to Reach Historic Lows

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



SOURCE: State Personal Income Data – Bureau of Economic Analysis; State Tax Collections Data – NC Department of Revenue; FY2011 & FY 2012 State Personal Income calculated based on national-level projections from the Congressional Budget Office (CBO); FY2011 State Tax Collections from Consensus Revenue Estimates by NC OSBM and NC Fiscal Research; FY2012 State Tax Collections calculated using CBO forecast for national-level growth in tax base (salary & wages, domestic profits.)

reach a new low relative to state residents’ income (see Figure 2).⁶ North Carolina’s current fiscal challenges stem not from excessive growth in state spending but from the inability of state revenues to keep up with the needs of the people of North Carolina.

■ Why North Carolina Needs Revenue Reform

Since the early 1990s, seven commissions, public and private, have convened to study revenue modernization for North Carolina. They recommended numerous changes, but state lawmakers have failed to take comprehensive action.

NORTH CAROLINA’S REVENUE SYSTEM FAILS TO MEET KEY PRINCIPLES

North Carolina needs a revenue system that supports adequate investments in public structures and does so by not asking more from those with the least ability to pay. The state’s current revenue system fails to meet the three key principles for responsible tax policy – equity, adequacy and stability.

Equity

The services and investments that taxes make possible—from building the human capital necessary for a skilled, productive workforce to ensuring clean air and water in every community—benefit everyone, and it is important that everyone pays according to their ability. North Carolina's current revenue system violates this principle because it asks more from those with the least ability to pay and asks the least from those with the greatest ability to pay (see Figure 3). For example, families whose earnings put them in the bottom fifth of

average of \$930,000 per year).⁷ In addition, because the state's tax code is full of tax breaks and loopholes, it asks taxpayers—both households and businesses—of similar means to pay very different amounts in taxes.

Adequacy

North Carolina's revenue system must bring in enough revenue to adequately support investments in the public structures—schools, colleges, courts, and

the needs of the state's people and fail to grow with the economy except during boom times. That North Carolina's revenue system is both inadequate and inequitable is no coincidence: asking the poor to pay more of their income in taxes will consistently yield less revenue than having the wealthy and profitable corporations pay their fair share.

Stability

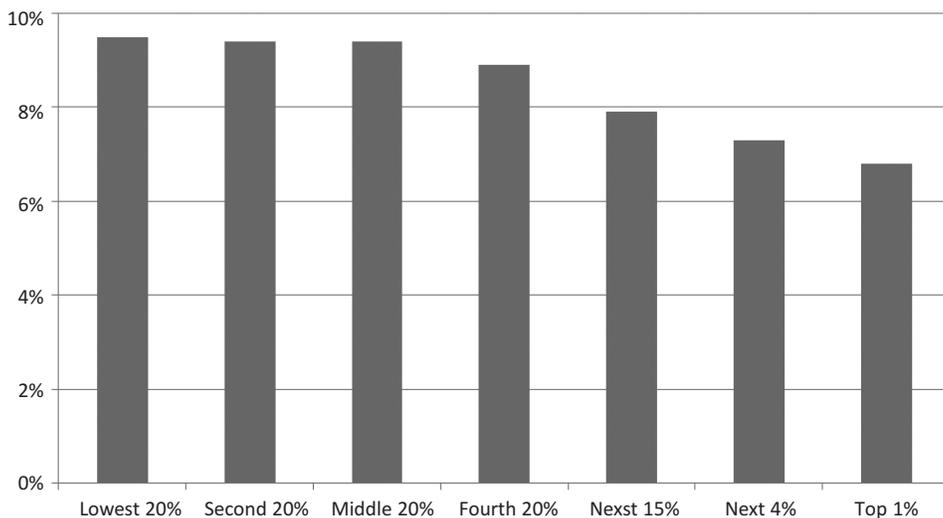
Although less critical than overall adequacy and equity, state revenues should also be stable enough to make planning and managing public services as straightforward as possible. North Carolina's loophole-ridden tax system creates substantial instability in revenues. When policymakers and public managers must spend time figuring out how to allocate ever-changing levels of resources, they have less time to focus on delivering high-quality public services to the people of North Carolina. In addition to implementing reforms that enhance revenue stability, state

policymakers can mitigate the revenue impact of ups and downs in the economy by implementing sound fiscal management practices such as having a robust, meaningful rainy day fund.⁸

FIGURE 3:

Low- and Middle-Income Families Pay Greater Share of Income in State and Local Taxes than Wealthy

State and Local Taxes as a Share of Household Income in North Carolina



SOURCE: Institute on Taxation and Economic Policy - November 2009
Includes "federal offset" for reduced federal income taxes for state and local taxes deducted from federal taxable income

all North Carolina households (making an average of \$11,000 per year) pay 9.5 percent of their income in state and local taxes, compared to only 6.8 percent for households with earnings in the top one percent (who make an

infrastructure—that pave the way to economic growth and prosperity. Yet North Carolina is facing its fourth straight year of revenue shortfalls because state revenues are inadequate to meet

■ North Carolina's Revenue System is Outdated and Narrow

OUTDATED

North Carolina's revenue system was built for the economy of the 1930s and no longer fits our 21st century, service-based economy.

For example, the sales tax, which accounts for more than one-third of all state and local revenue in North Carolina, is levied almost solely on tangible goods.⁹ However, services, as a share of household expenditures, have increased from 32 percent in 1959 to nearly 50 percent in 2010.¹⁰

The state franchise tax, one of two major business taxes in North Carolina, was designed in 1849 and has changed little since 1933. Underlying changes in the state's economy—particularly changes in how business entities form in North Carolina—have created substantial inequities in how the state tax code treats different types of businesses.

Other tax code relics, including the state's privilege tax on amusements and entertainment and the 1%/\$80 cap on taxes for certain classes of business equipment, are simply no longer relevant for today's economy.

NARROW

North Carolina's tax code is riddled with tax exemptions, deductions and giveaways. The result of this "tax-code spending" is that while North Carolina's tax rates are typically near or slightly below the national average, state tax revenues are far below the national average.

Since the early 1990s, North Carolina lawmakers have inserted hundreds of tax preferences into

The purpose of the revenue system is to fund investments in the public structures—schools, courts, hospitals, colleges and universities, and infrastructure—that are critical to building and preserving a strong middle class and a 21st century economy in North Carolina.

the tax code that benefit certain businesses and individuals. For example, tobacco companies and alcohol distributors get a 2-percent discount on tax payments for filing and paying their taxes on time. The film industry has successfully lobbied to receive refundable tax credits valued at up to one-quarter of their expenses for productions in the state. Even "artisan bakeries" got a state sales-tax exemption not granted to other types of dining establishments.¹¹

North Carolina enacted...

- A state administered personal income tax and corporate income tax in 1921
- A permanent sales tax in 1939
- A motor fuel tax rate change in 1986
- Myriad exemptions, credits and incentives from 1995 to the present

Other States Moving Forward on Revenue Modernization

A wide variety of efforts are taking place as states recognize the need for revenue systems that can help rebuild a strong economy.

- New Jersey broadened its sales tax to include a dozen services. Vermont, Georgia, Rhode Island and Connecticut are seriously considering proposals to include more services.
- North Carolina, Colorado, New York and Illinois have encouraged sales tax collection from on-line and remote catalogue retailers.
- Vermont, Wisconsin, Rhode Island and Colorado scaled back or ended preferential treatment of capital gains.
- Numerous states are reducing or eliminating certain tax credits. Rhode Island repealed itemized deductions, New York capped charitable contributions, Oregon marginally pared back its federal income tax deduction, New Mexico ended its state income tax deduction, Vermont scaled back its state income tax deduction, and Utah converted deductions and personal exemption to a credit and limited it.
- A number of states have modernized or temporarily put in place bracket or rate changes to their personal income tax. In New York, Maryland and New Jersey a millionaire's brackets was put in place. Delaware also has temporary higher rates and changes to the brackets and rates in Oregon through 2012. Wisconsin added a new top rate and changed its brackets while Hawaii added a top rate. Rhode Island restructured brackets and lowered rates as part of its plan to expand the base of the personal income tax. Illinois increased its flat rate this year.
- A number of states have put in place refundable credits for low-income households. Kansas indexed food sales tax credit and slightly increased it. Arkansas added a Low-Income Credit. The Earned Income Tax Credit (EITC) has also been addressed in a number of states including an increase in Nebraska, Indiana, Iowa, and Maryland and DC. Washington introduced EITC legislation, New Mexico just enacted one and the Connecticut Governor proposed a new refundable state EITC.
- There have also been changes enacted in a number of states around corporate taxes and tax expenditures. Massachusetts, Wisconsin and West Virginia implemented combined reporting in order to increase tax collections from multi-state corporations. Oregon modernized its corporate minimum tax to increase contributions from businesses located in the state. New Jersey and Iowa suspended film credits in 2010.

SOURCE: Data request from ITEP

In 1986, Republicans and Democrats in Congress came together with President Reagan to reform the federal tax system, recognizing that the existing loophole-riddled system was unsustainable. Members of the General Assembly and Governor Perdue need to do the same for North Carolina's outdated tax system. But in addition to eliminating existing loopholes, they need to put in place measures to prevent lobbyists from reinserting loopholes and giveaways into the tax code.

■ The Right Revenue System for North Carolina

The reform plan presented here would eliminate more than half of the state's projected revenue shortfall over the next two-year budget cycle. It would accomplish this by strengthening the capacity of North Carolina's three major state revenue streams: the personal income tax, the sales tax, and corporate/business taxes.

The plan also would better align North Carolina's tax system with people's ability to pay by improving the state Earned Income Tax Credit (EITC) and converting income tax deductions to credits.

PERSONAL INCOME TAX

The personal income tax is the most equitable of all major state and local revenue sources in North Carolina because, unlike the sales tax and the property tax, what people pay in a year is based solely on how much money they make. The share of a household’s income paid in personal income tax increases as household income increases; wealthy households pay a higher share of their income in personal income taxes than low-income households. This is not the case with

sales and excise taxes, where the lower one’s income is the greater percentage of it one pays in taxes.

But there is room for improving the income tax. Currently, the poorest fifth of all households pay more of their income in state income taxes in North Carolina than in all but six other states.¹² Ideally the state income tax would both raise adequate revenue and help offset for lower-income households the higher share of their incomes that goes to sales, excise and property taxes.

TABLE 1:

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%

Current Standard Deduction			
MFJ	Single	HOH	MFS
\$6,000	\$3,000	\$4,400	\$3,000

A good way to do this is to adjust the rate structure and increase the number of brackets in the income tax. Today, after accounting for exemptions, deductions and credits, a married couple

TABLE 2:

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%

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

filing jointly pays 6 percent of their annual income in state income taxes up to \$21,250. Couples making over \$21,150 in taxable income pay 7 percent on income above that threshold and 7.75 percent on income above \$100,000 (see Table 1 for details).

The proposed structure would have six brackets, with rates

ranging from 5 percent up to \$25,000 in household income to 8.5 percent on income over \$400,000. Less than two percent of North Carolina households would fall into the top two brackets. The standard deduction would increase significantly, to \$10,000 from the current \$6,000

for married couples and to \$6,000 from the current \$3,000 for single filers (see Table 2 for details).

MFJ – Married Filing Jointly
 HOH – Head of Household
 MFS – Married Filing Separately

A second major change in the income tax system would be to revise the way taxable income is calculated. For the past two decades, North Carolina has levied the income tax based on a household’s federal taxable income. This takes into account numerous deductions and increases the likelihood that two households with roughly the same gross income will pay different amounts of tax. Instead the state should base the income tax on something closer to adjusted gross income. State taxpayers would be allowed credits for the three principal itemized

deductions—mortgage interest, medical expenses and charitable contributions—but most other credits and deductions would no longer be allowed.

In addition to reducing the number of allowable federal itemized deductions, the proposed tax changes would allow households to take a 3 percent credit of either the standard deduction or the sum total of the three allowable itemized

deductions, whichever is greater. Whereas the tax benefit of deductions rises with income, the value of credits remains the same regardless of income.

Under the current system of deductions, a high-

income household would receive a tax benefit of \$8.50 for each \$100 in annual mortgage interest while a low-income household would only receive \$5 in tax benefit. A 3 percent credit would provide taxpayers of all income levels with the same \$3 in tax benefit for each \$100 in itemized deductions.

That North Carolina's revenue system is both inadequate and inequitable is no coincidence: asking the poor to pay more of their income in taxes will consistently yield less revenue than having the wealthy and profitable corporations pay their fair share.

The last major set of improvements to the state income tax includes doubling the state Earned Income Tax Credit (EITC) from 5 percent to 10 percent of the federal credit and merging the current personal exemption and the child tax credit. Doubling the state EITC would be an

TABLE 3:

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	-0.77%	-0.58%	-0.09%	+0.15%	+0.33%	+0.57%	+0.80%
Federal Offset	—	—	-0.02%	-0.04%	-0.07%	-0.07%	-0.1%
Net Tax Change	-0.77%	-0.58%	-0.11%	0.11%	0.26%	0.50%	0.71%
Average Tax Change	-82	-132	-34	+94	+348	+1,279	+7,414
% with Income Tax Cut	+59%	+71%	+60%	+49%	+31%	+5%	+0%
% with Income Tax Increase	+1%	+9%	+30%	+45%	+66%	+94%	+99%

Federal Offset %	State Tax Change (\$1000)	Federal Tax Change (\$1000)	Net Tax Change (\$1000)
23%	+\$635,000	-\$145,000	+\$490,000

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

Proposed Personal Income Tax Changes

- Broaden the base by using adjusted gross income instead of federal taxable income as the starting point for calculating state income taxes
- Adopt a more progressive rate structure
 - Move from 3 to 6 income brackets
 - Reduce rates for income under \$200,000 (married couples)
- 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 larger)
- Merge personal exemption and child tax credit into a \$180 per-person credit
- Increase Earned Income Tax Credit to 10% of the federal credit
- Gradually reduce credit for both standard deduction and \$180 per-person credit for top incomes

important step toward fixing the “upside-down” nature of North Carolina’s tax system because doing so would lower the share of income paid in state and local taxes by low-income working families with children. As with converting the standard deduction and itemized deductions into credits, merging the personal exemption and child tax credit into a per-person credit of \$180 would ensure that tax benefits aimed at families would vary with family size, not with income.

The net impact of these changes would be dramatic. The state income tax would bring in about \$634 million more next year to be used to fund public services. More than half of all households would see a net income tax cut under this proposal, and less than one-third of all households would see an increase in their state income taxes. Even among the households that would see a net state income tax increase, nearly one quarter of this increase would be offset by lower federal income tax bills. This “federal offset” means that while North Carolina annual revenues would increase by \$635 million, tax payments by residents would increase by less than \$500 million (see federal offset in Table 3). Limiting the number of allowable itemized deductions and converting deductions to credits effectively reduces the amount of income exempt from the state income tax, which research shows is likely to improve the overall stability of the personal income tax.¹³

Table 3 on page 11 illustrates how the proposed changes would affect households of different income levels. On average, households making under \$48,000 a year – representing 60 percent of all North Carolina households – would see their net income taxes decline. Increases would amount to about \$94 a year for a household making \$62,000, \$319 for those making more than \$105,000 and \$7,454 for the top 1 percent of households, whose average income is about \$929,000 a year.

■ Sales Tax

The sales tax raises money for public services by adding a charge to many forms of transactions. Today in North Carolina the state sales tax rate is 4.75 percent, with most local governments levying an additional local rate of 2 percent.¹⁴

The shortcoming of the current state sales tax as a revenue source is that it hasn't kept up with significant changes in the economy. In 1933, when North Carolina first enacted a 3-percent state sales tax,¹⁵ household consumption consisted primarily of goods rather than services. There was no such thing back then as downloading music, for example; people bought records.

Over the last several decades, North Carolinians have been part of a national trend that has seen purchasing patterns shift away from goods in favor of services, most of which are not subject to sales tax (see Figure 4). The result is that the sales tax is applied to a smaller percentage of household transactions each year. Therefore, state policymakers have had to increase the sales tax rate from 3% in 1990 to 4.75% just to keep revenues constant as a share of the state's economy.¹⁶

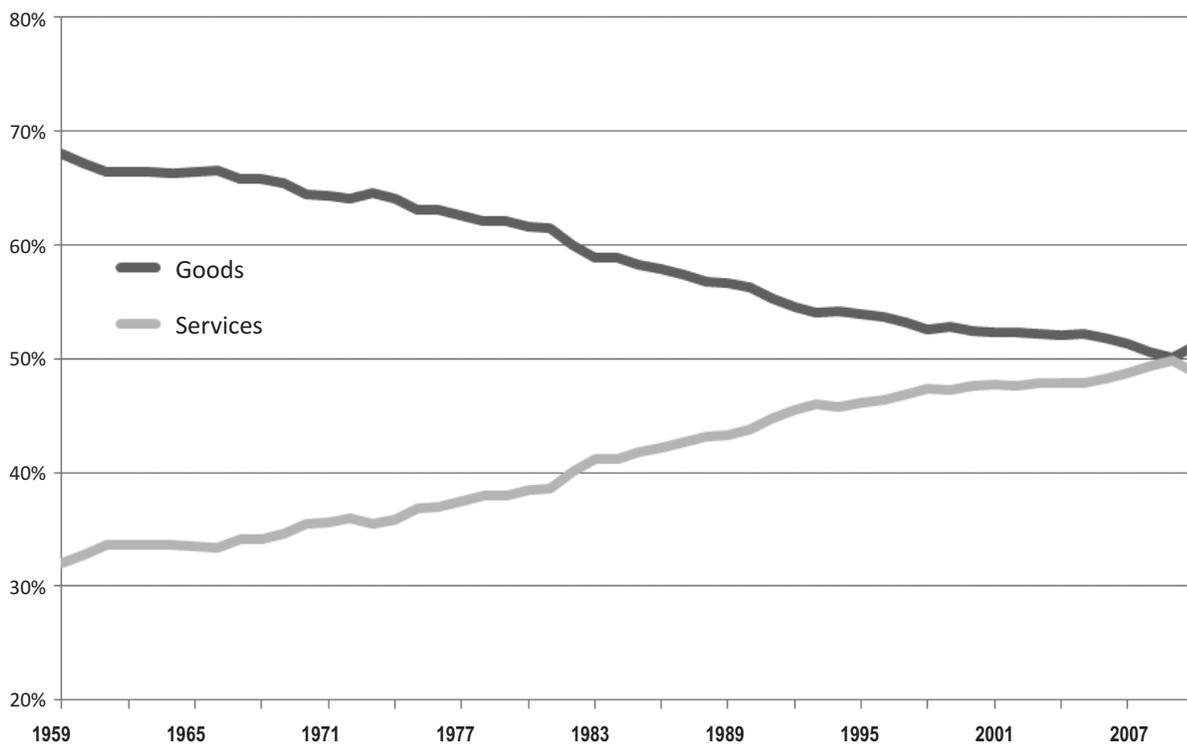
Indeed, studies show the erosion of the traditional state sales tax base is a major contributing factor to the ongoing gap many states face between the cost of meeting public needs and the resources available.¹⁷

North Carolina can address this inadequacy by expanding the sales tax to more consumer services. The Federation of Tax Administrators lists 168 services that states could tax. North Carolina's sales tax now applies to 30 of them. The most recent research shows that 32 states

FIGURE 4:

Growth of Services Erodes Goods-Based Sales Tax

Personal Consumption Expenditures, Share of Goods and Services (excludes health care, education, professional services, and housing)



SOURCE: US Department of Commerce, Bureau of Economic Analysis, National Economic Accounts

apply their sales tax to more services than North Carolina,¹⁸ and many states are strongly considering broadening their sales tax to include more services this year.¹⁹

Expanding the list of taxable items as broadly as possible – including all consumer purchases except health care, education and housing – would restore the viability of North Carolina’s sales tax. It would also change the current situation, which amounts to “picking winners” among

The shortcoming of the current state sales tax as a revenue source is that it hasn’t kept up with significant changes in the economy. In 1933, when North Carolina first enacted a 3-percent state sales tax, household consumption consisted primarily of goods rather than services. There was no such thing back then as downloading music, for example; people bought records.

consumers and producers of services based on consumption patterns. For example, today someone pays sales tax when he buys a lawnmower, but not when he hires a landscaping service for lawn care. People pay tax on home exercise equipment but not on gym memberships. These discrepancies not only cost the state needed revenue, but they also raise issues of fairness because households that rely more on services—and therefore avoid taxes—tend to be more affluent.

For North Carolina, a broader base for the sales tax could go hand in hand with a lower sales-tax rate. Broadly expanding the sales tax base to include 158 of the FTA’s 168 categories of services—and reducing the rate from 4.75 percent to 3.75 percent—would enable North Carolina to raise an additional \$500 million a year in revenue. Such a broad expansion would also enable the state to reduce the local sales tax rate to 1.5 percent from 2 percent without reducing revenues available to local governments. The overall combined state and local sales tax rate would decrease to 5.25 percent from 6.75 percent. North Carolina would not be venturing into uncharted territory by broadly expanding the base of its sales tax. Four states (Hawaii, New Mexico, South Dakota, and Washington) levy their state sales tax on virtually all services purchased by consumers.²⁰

These sales tax changes would raise considerable revenue at a relatively small cost to individual consumers (see Table 4). The yearly increase would range from about \$34 for households making \$11,000 to \$398 for those with average incomes of \$929,000. Furthermore, although research on the subject is not conclusive, the evidence on balance suggests that expanding the sales tax to include more services is likely to improve the overall stability of sales tax revenues.²¹

WHY NOT TAX BUSINESS-TO-BUSINESS SERVICES?

The proposed sales tax reform would not add the tax to transactions that primarily are business-to-business, such as legal, accounting and engineering services. While this would dramatically expand the state sales tax and allow for either significantly more revenue or a substantially larger rate reduction, doing so would likely have economic consequences better avoided.

If a business pays taxes on its accounting and legal fees, it will likely pass the costs on to its customers or clients who purchase their final products (which may again subject to the sales tax). Some research suggests that this “hidden” sales tax on business inputs falls particularly hard on low-income families because it often ends up increasing the price of basic necessities like food and utilities.²² In addition, large businesses that can afford in-house lawyers, accountants and engineers would avoid paying the sales tax because the services would be provided by their own employees. Applying the sales tax to such services would put smaller businesses that cannot afford such in-house specialists at a competitive disadvantage.

TABLE 4:

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	+0.3%	+0.3%	+0.2%	+0.2%	+0.1%	+0.1%	—
Average Tax Change	\$ +34	\$ +61	\$ +75	\$ +93	\$ +107	\$ +132	\$ +398

Revenue Change
\$+500,000,000

BUSINESS TAXES

Like other parts of North Carolina’s revenue system, the state’s corporate income tax is riddled with exemptions and loopholes that reduce state revenues and create inequities among taxpayers with similar ability to pay.

North Carolina’s corporate income tax rate of 6.9 percent ranks 25th among the 45 states²³ that have a corporate income tax. But the ranking is misleading; state and local business taxes in North Carolina, as a share of the state’s private-sector economy, are tied for the lowest in the country.²⁴ The corporate income tax makes up less than one-thirteenth of total state and local business taxes, and most North Carolina businesses are not subject to the corporate income tax. Corporate income taxes in North Carolina have been steadily declining as a share of all state taxes for several decades.

A major reason for declining state corporate income tax revenues is that fewer businesses are choosing to file as “C-Corporations.” Instead, more and more private businesses are opting to file as so-called “pass-through entities,” where business profits are passed on directly to owners and

Proposed Sales Tax Changes

- Broaden the base of the sales tax by applying the sales tax to include all consumer services except health care, education, and housing (158 of 168 categories of services, as defined by the Federation of Tax Administrators)
- Reduce the state sales tax rate from 4.75 percent to 3.75 percent
- Reduce the local sales tax rate from 2 percent to 1.5 percent
- Combined state and local rates would drop from 6.75 percent to 5.25 percent

taxed as personal income.²⁵ Significant revenue loss also can be traced to the proliferation of corporate tax breaks and subsidies given out by the state as well as the rise of tax avoidance strategies by multi-state corporations.²⁶ Several recent studies have demonstrated that many of the

State and local business taxes in North Carolina, as a share of the state's private-sector economy, are tied for the lowest in the country.

tax breaks offered to various businesses with the stated aim of increasing employment have in fact failed to create jobs or grow the state's economy.²⁷

The majority of states with a corporate income tax (23 out of 45) have also enacted a key reform to limit the ability of multi-state corporations to use creative

accounting to avoid paying taxes on profits earned in a state.²⁸ This reform, known as "combined reporting," requires all corporate parents and subsidiaries engaged in a shared business enterprise to file a single tax return. This reduces the ability of companies to create multiple entities and in effect shift profits made in one state to another state with a lower corporate tax rate or no corporate income tax at all. Enacting mandatory combined reporting in North Carolina would increase state tax revenues by an average of \$100 million per year, without compromising the state's status as a low-cost place to do business. The additional revenue would increase total state and local business taxes by less than 1 percent.²⁹

North Carolina's corporate tax code also includes other subsidies or loopholes worth eliminating. The Article 3J business tax subsidies are supposed to encourage job creation in North Carolina, but a recent study by the UNC Center for Competitive Economies showed that businesses receiving subsidies similar to the Article 3J credits actually lost jobs while the rest of the state's economy was growing. North Carolina's tax code also allows corporations to deduct capital losses beyond those allowed under the federal corporate tax code, with no evidence that doing so creates jobs. Ending these ineffective policies would increase state revenues by more than \$30 million each year.

Enacting mandatory combined reporting and eliminating corporate loopholes would also benefit small- and medium-sized businesses based in North Carolina by putting them on more equal footing with multi-state corporations. Smaller, locally owned businesses typically lack the means to shelter profits from taxation or lobby for tax breaks. Combined reporting and similar reforms would end the disadvantage of local companies when it comes to bottom-line profits.

LEVEL THE PLAYING FIELD BETWEEN S CORPORATIONS AND LLCs

Another tax change that would help level the playing field for all businesses operating in North Carolina is the expansion of the state's franchise tax to include all limited liability companies (LLCs). Since they were first authorized under North Carolina law in 1989, LLCs have proliferated and now account for more than two of every five businesses in the state.³⁰ Although studies have shown that non-tax factors are more important than taxes in determining which form a business takes,³¹ changes in the business form have significantly affected how businesses pay taxes.

State tax policy in North Carolina has not kept up with the rise of LLCs as the preferred form of

business entity. North Carolina has long granted legal and tax benefits to closely held, predominantly family-owned businesses that file as “S corporations” in the state. North Carolina’s S corporations are currently exempt from the state’s corporate income tax, but they do pay the state franchise tax.³²

LLCs, which are typically not closely held, family-owned businesses, currently enjoy the same legal benefits and the exemption from the state corporate income tax as S corporations without the restrictions S corporations face on ownership characteristics and the distribution of profits.³³ Unlike S corporations, however, most LLCs are currently exempt from the state’s franchise tax. Instead, most LLCs pay a modest \$200 reporting fee.

There is no policy justification for giving LLCs the same preferential tax treatment as S corporations. Ending this practice, as recommended in the 2009 budget proposal of the North Carolina House of Representatives, would eliminate the competitive disadvantage faced by closely held S corporations vis-à-vis LLCs. Extending the franchise tax to all limited liability companies—replacing the flat \$200 reporting fee and the state and local privilege taxes on businesses—would add nearly \$70 million in revenue to the state’s General Fund.³⁴

TABLE 5:

Recommended Corporate Tax Changes	Revenue Estimate (millions)
Disallow net capital losses not deductible from federal taxable income	\$15
Eliminate ineffective Article 3J tax credits	\$17
Adopt Mandatory Combined Reporting for multi-state corporations	\$101
Extend franchise tax to all LLCs	\$135
Eliminate LLC report fee and report fee credit	(\$39)
Eliminate state and local privilege taxes	(\$26)
TOTAL	\$202 million

■ Tax-Code Spending from the Hidden Budget

North Carolina tax-code spending grew more than five times faster than the state budget over the past decade, reaching \$5.8 billion during the 2010 fiscal year, according to the most recent Biennial Tax Expenditure Report of the state Department of Revenue. About \$1 billion of that money in the most recent year came from tax breaks for specific industries.

Tax-code spending, also known as tax expenditures, is similar to money appropriated through the budget in that it amounts to spending taxpayer dollars. Rather than collecting taxes and then spending the money, however, state government spends tax expenditures by not collecting the tax in the first place. This form of spending includes special tax credits, deductions, exemptions and preferences.

There is no substantive difference between lawmakers carving out a tax preference for specific classes of taxpayers and the state collecting all taxes due and writing those taxpayers a check. But

an important difference is that spending through budget appropriations is subject to rigorous review during the biennial budget process – scrutiny that often results in significant changes in spending priorities and sharp reductions during difficult economic times when revenue is short.

There is no substantive difference between lawmakers carving out a tax preference for specific classes of taxpayers and the state collecting all taxes due and writing those taxpayers a check.

But once tax preferences are enacted – each one by separate legislation – they receive at most perfunctory review and far less often that every two years. Unlike state budget appropriations, tax expenditures are

virtually open-ended. If someone qualifies the money keeps flowing and often increases; such spending is not reduced when economic times cause cuts in other forms of spending. For all intents and purposes, most tax expenditures tend to be permanent.

Although many tax-code spending provisions have unclear policy objectives or have little evidence that they achieve their goals in a cost-effective manner, many other tax-code spending provisions do promote desirable public policy goals. The child tax credit, the standard deduction, and the state Earned Income Tax Credit, for instance, are important tools for better aligning the tax code to ability to pay. Other tax-code spending provisions, such as the mortgage interest deduction and deductions for charitable donations, have laudable public policy goals but would better achieve those goals if restructured as credits.

An efficient approach to state spending would dictate that tax-code spending should receive the same level of scrutiny as appropriations. Policymakers should put in place a process under which each tax break is reviewed to determine whether it is meeting public policy goals (for example, creating jobs if that was the stated aim of the legislation creating a tax break) in a cost-effective manner that could not be equally well addressed on the appropriations side of the budget. This process should

Examples of “tax-code spending”

THE GOOD

- NC Child Tax Credit (\$147 million)
- NC Earned Income Tax Credit (\$104 million)

THE BAD

- Sales tax cap on boats and private aircraft (\$10 million)
- Tax discount for tobacco and alcohol companies who file taxes on time (\$9 million)
- Sales and use tax holiday (\$12 million)

THOSE WITH ROOM FOR IMPROVEMENT

- Mortgage interest deduction (\$675 million)
- Deduction for charitable contributions (\$320 million)

Sources: NC Biennial Tax Expenditure Report (2009); NC Fiscal Research presentation – “NC Personal Income Tax Base” (February 2010); Institute on Taxation and Economic Policy (special data request – February 2011)

include most tax-code spending items listed in the Department of Revenue's Biennial Tax Expenditure Report (which lists tax breaks but does not evaluate them) and could include a citizens' commission similar to what the state of Washington currently uses to evaluate and make recommendations regarding the state's tax-code spending.

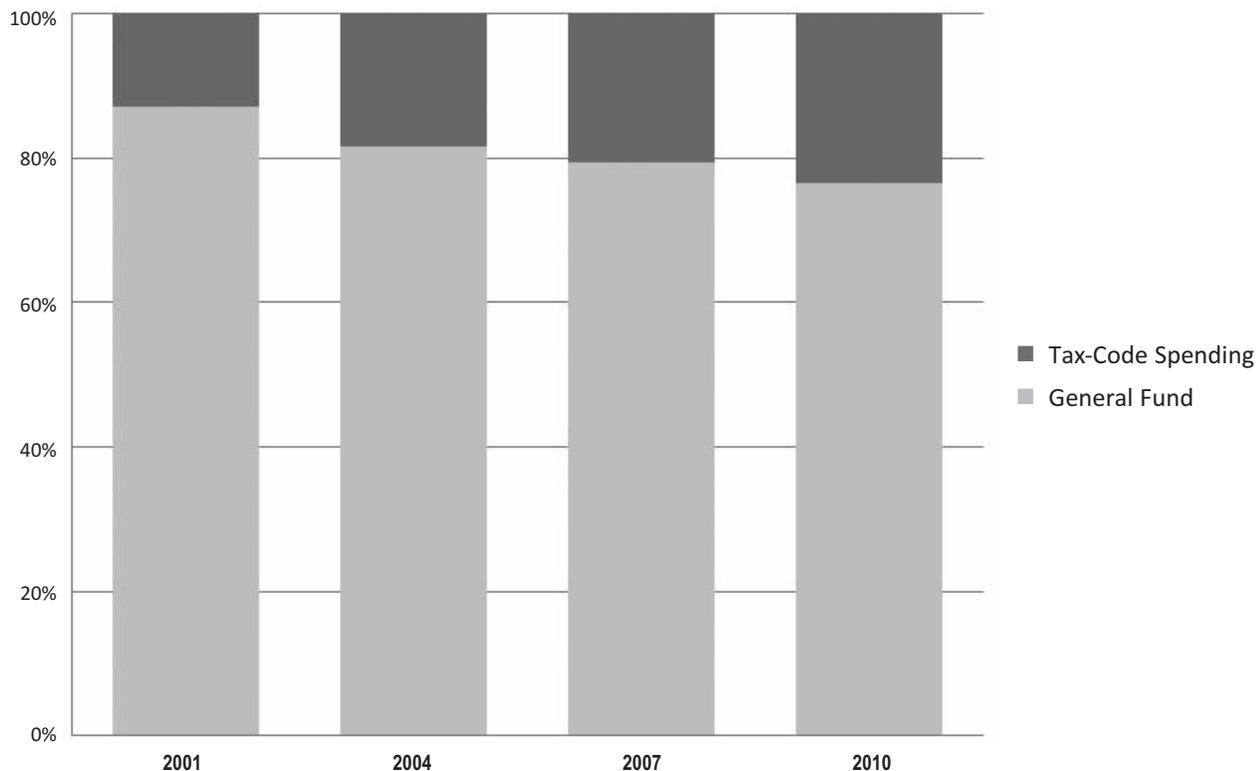
As new tax-code spending is proposed, lawmakers should improve accountability by enacting them as part of the state budget. This way it is more likely the expenditures will include cost estimates and be weighed from a priority standpoint against such other spending.

Reforming tax-code spending will be a long-term process, and the state should not expect substantial savings in the first year of this biennium. Over time, however, formal recognition that a dollar spent through the tax code is a dollar not spent on such priorities as education, health and public safety would be an important step toward ensuring that the North Carolina's public dollars are focused on the public's highest priorities.

FIGURE 5:

Tax-Code Spending Grew by 80 Percent Relative to General Fund in 2000s

Ratio of Tax-Code Spending and General Fund in Selected Fiscal Years



SOURCE: NC Biennial Tax Expenditure Reports; NC Fiscal Research (2001); Joint Conference Committee Reports

Putting “Revenue Neutral” Modernization in Context

Some proponents of state revenue modernization have asserted that any comprehensive reform must be “revenue neutral.” It is critical, however, that those tasked with modernizing the state’s revenue system not take a narrow view of revenue-neutral reform.

The historic trend in revenue collections is critical to understanding the discussion of revenue-neutral modernization. Using only next year’s projected revenues as a baseline for revenue-neutral reform would “lock in” today’s temporarily depressed state tax revenues, at great cost to North Carolina’s ability to make public investments in the future. Instead, revenue neutrality should account for revenue collections through several business cycles to ensure that revenues are adequate to sustain public investments.

As revenue collections recover under a new modernized revenue system, like the plan outlined here, it would be possible to consider reducing the income tax rate on upper-income households and lowering the sales rate further. However, considering these types of changes when revenues are at their current depressed levels could jeopardize the system’s ability to meet the need for investment to support North Carolinians and the economy.

Conclusion: How the Pieces Fit Together

The proposals contained in this report would increase North Carolina state revenues by \$1.3 billion per year. At the same time they would move the tax system closer to one that is based on ability to pay, as opposed to the current structure under which the higher someone’s income the lower the share of it they pay in state and local taxes.

As the table below shows, modernizing and adjusting the tax system as proposed would mean an overall decrease in state income and sales taxes for households with taxable incomes below \$29,000. For everyone else the increase would range from barely a tenth of 1 percent to just over a half percent.

If these proposals were adopted, North Carolina would have a 21st century tax structure that reflects the nature of today’s economy and produces the revenue required to meet the growing needs of a growing state, allowing continued investment on necessities that help promote prosperity and job creation. By changing the relative emphasis of various forms of taxation, the overall structure would better keep up with growth in the state’s economy and the needs

of state residents, while also withstanding economic downturns.

Change is never easy. Changes that involve a comprehensive discussion of taxes are harder still. It will take leadership for the reforms proposed here to happen. But for the sake of the families and businesses that are the state’s future, a modern tax system is essential if North Carolina is to remain a state that offers opportunity.

TABLE 6:

BTC Plan Balances Distribution of State and Local Tax Responsibility							
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than \$17,000	\$17,000 – \$29,000	\$29,000 – \$48,000	\$48,000 – \$77,000	\$77,000 – \$158,000	\$158,000 – \$367,000	\$367,000 – Or More
Average Income in Group	\$11,000	\$23,000	\$38,000	\$62,000	\$105,000	\$223,000	\$929,000
Taxes Share of Income - Current	9.5%	9.4%	9.4%	8.9%	7.9%	7.3%	6.8%
Taxes Share of Income - BTC Plan	9.0%	9.1%	9.5%	9.2%	8.3%	7.9%	7.5%
Tax Change - BTC Plan	-0.5%	-0.3%	0.1%	0.3%	0.4%	0.6%	0.7%

SOURCE: Institute on Taxation and Economic Policy
 *Includes impact of deducting state and local taxes from federal taxable income (i.e. federal offset)

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NORTH CAROLINA JUSTICE CENTER

Opportunity and Prosperity for All

224 S. Dawson Street • P.O. Box 28068 • Raleigh, NC 27611
919/856-2570 voice • 919/856-2175 fax • www.ncjustice.org

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