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NORTH CAROLINA'S "TAX SWAP" GIVES BIGGEST BREAKS TO THE WEALTHIEST, UNDERMINES PUBLIC INVESTMENTS FOR US ALL

BY CEDRIC D. JOHNSON, POLICY ANALYST

Efforts to rely more on the state sales tax and less on the income tax to support public services have shifted tax obligations to less affluent North Carolinians, while saving the wealthiest the most money, and reduced resources available for public investments that build a strong economy.

The deliberate shift began in 2013[1] and gained momentum in 2015 with enactment of state income tax cuts accompanied by increasing the number of goods and services subject to sales tax. In both instances those who benefitted most were well-off people and profitable corporations.

Expanding the range of purchases on which the sales tax is levied is not inherently bad policy. Over time, purchasing habits in North Carolina and the nation have shifted dramatically. People used to spend more money on goods than services; today it is the other way around. To bring in the revenue needed to support schools, public health services and other public necessities, having a sales tax that reflects the modern economy makes sense. So to the extent that North Carolina now taxes more services, the state is acting responsibly.

The problem exists with the manner in which the sales tax expansion has occurred. When expanding the sales tax isn't combined with other important measures that promote equity in the state's tax system, the share of income paid in state and local taxes goes up for North Carolinians struggling to make ends meet and goes down for the wealthiest.

Part of the reason for the harmful inequity in North Carolina's tax system is that the lower a household's income the greater share of that income goes to buy things, meaning the share of income paid in sales taxes goes up. In general, people who make less money have less to save, so much more of what they earn goes to purchases. The wealthy, on the other hand, are able to save or invest a large share of their income, which is not subject to sales tax.

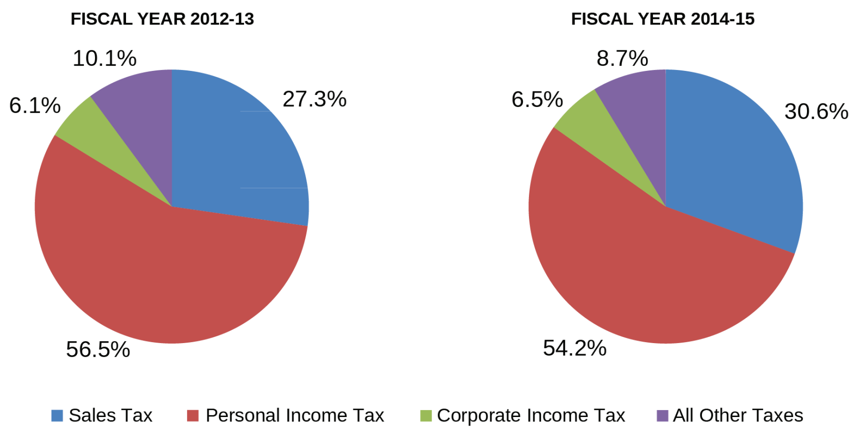
Tax Swap Shifts Tax Responsibility, Harms Ability to Invest Long-Term

North Carolina's sales tax raises around 30 percent of state General Fund tax revenue. For fiscal year 2015, this amounted to about $6.25 billion.[2] Together, the personal income tax (PIT), corporate income tax (CIT), and sales tax account for more than 90 percent of General Fund tax revenue.[3]

Since 2013, policymakers have sought to increase the state's reliance on sales tax

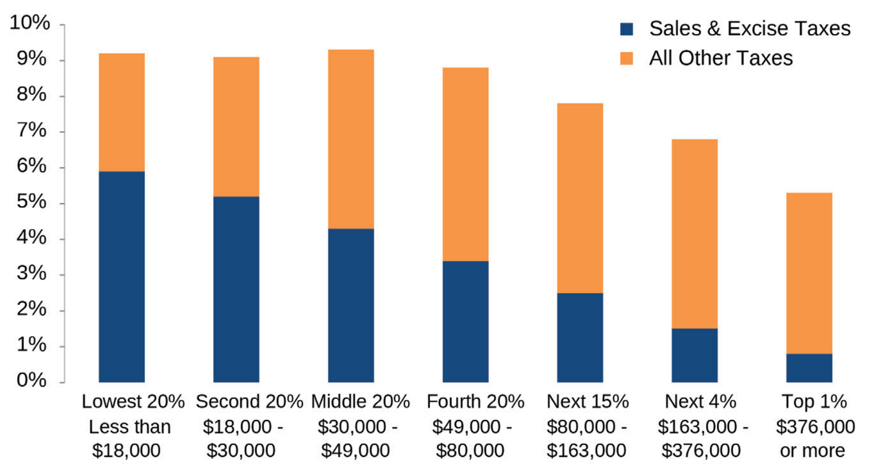
FIGURE 1: Shift to greater reliance on the sales tax and less on income taxes in recent years

North Carolina General Fund Tax Revenue, By Tax Source



SOURCE: NC Department of Revenue, Statistical Abstract of North Carolina Taxes. NOTE: Non-tax revenue sources not included.

FIGURE 2: Lower income taxpayers pay greater share of income in sales taxes compared to higher income taxpayers



SOURCE: Institute on Taxation & Economic Policy, Who Pays, 2015. NOTE: The chart does not account for tax changes passed by the NC General Assembly in 2015.

and reduce collections from the personal and corporate income taxes. They did so by broadening the sales tax to include some services not previously taxed and reducing income tax rates. Because the state Earned Income Tax Credit (EITC) was allowed to expire at the end of 2013, North Carolina became the only state to have created a state EITC and subsequently eliminate it.[4] The state has also done very little to make sure that the tax swap hasn't shifted responsibility onto those least able to pay.

The tax swap is highlighted in the changing composition of General Fund tax revenue in recent years. Just prior to enactment of the 2013 tax changes, the share of total General Fund revenue raised through the income tax (PIT and CIT) decreased 2 percentage points by fiscal year 2015 while the share of revenue raised by the sales tax increased by 3.3 percentage points (**see Figure 1**). Prior to the 2015 tax changes, the lowest-income taxpayers in North Carolina paid more than seven times more in sales taxes as a share of their income than the highest-income taxpayers (**see Figure 2**). Further income tax cuts and even more services now subject to the sales tax as a result of the 2015 tax changes will likely widen this already wide disparity.

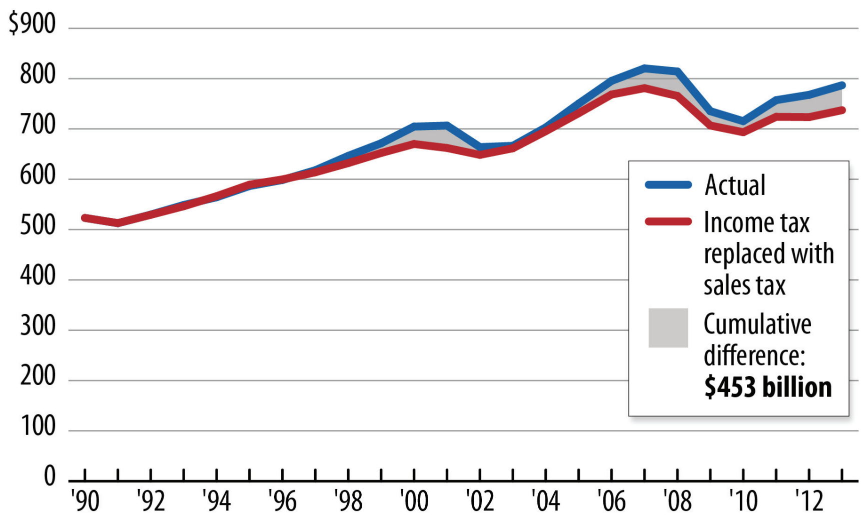
Improving North Carolina's Sales Tax Requires a Change in Income Tax Policy

Aligning North Carolina's sales tax to better reflect a 21st century economy generates more revenue for public investments, preventing the long-term erosion of sales tax revenue as the economy becomes more service oriented.[5] Prior to tax changes enacted in 2013, the sales tax applied to few services in North Carolina – only around 20 percent of more than 180 potentially taxable services were applicable to North Carolina's sales tax.[6] Since 2013 the sales tax has been expanded to some services, including repairs, maintenance, and installation services on certain motor vehicles.[7]

FIGURE 3:

Replacing Personal Income Tax With Sales Tax Would Reduce Revenue Without Eliminating Volatility

Annual actual collections and estimated collections with income tax replaced with sales tax, FY90 - FY13, in billions



Source: CBPP analysis of Census and National Association of State Budget Officers data.

Center on Budget and Policy Priorities | cbpp.org

In effect, though, the additional revenue raised from changes to North Carolina's sales tax only partially offset the massive revenue loss from income tax cuts that primarily benefit the wealthy and profitable corporations and does not increase the overall resources needed for public investments that grow the economy. So the state reaps no benefits from sales tax base-broadening. The approximately $992 million brought in since 2013 from broadening the sales tax pales compared to the nearly $2.5 billion in revenue lost from personal and corporate income tax cuts and other tax changes that state lawmakers enacted over the same period.[8] In order to replace the full amount of revenue lost through income tax cuts, the state sales tax rate would have to be increased to 6.02% from 4.75%. Such a tax rate increase would further increase the tax load for low- and middle-income taxpayers.[9]

In the long-term, even when aligned with where economic activity occurs, the sales tax falls short compared to a graduated income tax in its ability of to align with the economy.[10] Analysis by the Center on Budget & Policy Priorities shows that replacing the personal income tax entirely with the sales tax across all states reduces revenue collections by as much as $453 billion over more than two decades (**see Figure 3**).

North Carolina's broadening of the sales tax needs to be accompanied by at least two income tax policies if it is to lessen the tax shift that now requires low- and middle-income taxpayers to pay more. The two policies would also help ensure that the state has the revenue needed to keep up with growing needs in communities.

Reinstate a State Earned Income Tax Credit

The EITC is widely recognized as one of the most effective anti-poverty tools nationwide, especially for children. It is available only to families that work, and used to offset other taxes they pay. For families working hard for low pay it is an important leg up. The extra money inevitably goes toward necessities like car repairs or children's clothes and as a result helps local economies. In 2012, the state EITC helped over 900,000 North Carolina families, including nearly 1.2 million children.[11]

The state EITC pumped around $108 million into local economies across the state in 2012, helping to spur local economic activity.[12] Because expanding the sales tax reduces the amount of disposable income available, low- and moderate-income families would be helped by once again having a state EITC.

State lawmakers consider another flawed tax change

State lawmakers are considering raising by up to $2,000 the standard deduction available to people who owe state income tax. This would reduce the income tax owed by all taxpayers that opt to take the standard deduction (rather than itemized deductions) but is expensive and fails to efficiently assist low- and middle-income taxpayers who carry a heavier tax load, as a percentage of their income, than wealthy taxpayers.

The General Assembly's Fiscal Research Division estimates that such a proposal would reduce state revenue by more than $200 million in 2017. The actual cost may be higher, considering that a higher than estimated percentage of North Carolina taxpayers is likely to take the standard deduction rather than the itemized deduction as a result of tax changes since 2013.

A state Earned Income Tax Credit is a better tool. An EITC at 5 percent of the federal credit level would help nearly one million families working for low pay and would cost half as much as increasing the standard deduction. That's because increasing the standard deduction would give a break to far more people, including those who don't need the help and whose tax obligation is barely affected by the expansion of the sales tax.

Just 28 percent of the more than $200 million tax cut from increasing the standard deduction would go to taxpayers with incomes below $35,000.[13] Sixty percent of taxpayers in the top 20 percent, whose incomes are $95,000 or higher, would receive a tax cut with the increased standard deduction proposal. In contrast, a state EITC would provide no tax cut to taxpayers making $95,000 or more, and 87 percent of the total tax cut would go to taxpayers making $35,000 or less.[14]

Stop future income tax cuts and reform the rate structure to align with ability to pay

Further income tax rate reductions are set to take place as part of tax changes enacted in 2015. The PIT rate is scheduled to drop to 5.499% from 5.75% on Jan. 1, 2017. The CIT rate is set to drop to 3% from 4% once General Fund tax collections for a fiscal year exceed a fixed, specified threshold, which could be reached as soon as 2017.

Regardless, a further reduction in the CIT rate will occur in the near future, as the General Fund tax revenue threshold was set at a level that can easily be met. The further reduction in PIT and CIT rates would reduce revenue by an additional $677 million for the fiscal year that starts July 1, 2016, with the cost growing in subsequent years.[15] This further reduction in revenue available for public investments builds onto the nearly $1.4 billion in annual revenue loss from income tax cuts since 2013. These are dollars that otherwise would be available for public schools, making higher education more affordable, healthcare services for the elderly and poor, and helping ensure that economic growth extends to rural and distressed communities across the state.

State lawmakers should also re-establish a PIT rate structure that takes the ability of taxpayers to pay into consideration. The tax changes enacted in 2013 replaced the then-existing graduated PIT rate structure rate with a flat tax rate, which fails to account for ability to pay. The switch to a flat PIT rate and subsequent income tax rate cuts provided a significant tax cut to the wealthy, even after accounting for expanding the sales tax to more goods and services. In contrast, low-income taxpayers pay slightly more in taxes as a result of tax changes since 2013. These taxpayers see little to no benefit from income tax cuts, pay more in sales tax, and lose the state EITC. Returning to a graduated PIT rate structure would create a more equitable tax system – one that reverses recent shifts of the tax load away from the wealthiest and onto everyone else.

1. Cedric D. Johnson, “Final Tax Plan Fails Far Short of True Tax Reform,” BTC Report, NC Budget & Tax Center, Raleigh, NC, August 2013. http://www.ncjustice.org/?q=budget-and-tax/btc-reports-final-tax-plan-falls-far-short-true-tax-reform

2. North Carolina Office of the State Controller, General Fund Monthly Financial Reports, FY2015, June 30 2015 report (page 4) **http://www.osc.nc.gov/pdfs/June_2015_Gen_Fund_Monthly_Report.pdf** NOTE: Judicial fees, non-tax revenue, and unreserved Fund Balance revenue not included as part of General Fund tax revenue.

3. Ibid.

4. Tazra Mitchell, “First in Flight from the EITC – Low-Income Working Families Bid Farewell to NC’s Earned Income Tax Credit,” BTC Brief, NC Budget & Tax Center, Raleigh, NC, March 2014.

5. Michael Mazerov, “Why Tax Services?”, Off the Charts blog, Center on Budget and Policy Priorities, Washington, DC, February 15, 2012. **http://www.offthechartsblog.org/why-tax-services/**

6. Federation of Tax Administrators, Services Taxed in North Carolina, FTA 2007 Services Taxation Survey. **http://www.taxadmin.org/fta/pub/services/services.html**

7. Cedric D. Johnson, “Latest Sales Tax Expansion Highlights Need for State EITC,” The Progressive Pulse blog, NC Policy Watch, Raleigh, NC, March 2016 **http://pulse.ncpolicywatch.org/2016/03/01/latest-sales-tax-expansion-highlights-need-for-state-eitc/**

8. Cost estimate for PIT and CIT rate cuts, sales tax base expansion and other tax changes since FY2013 through FY2016 based on original fiscal estimates by the General Assembly’s Fiscal Research Division.

9. Data request to ITEP, April 2016.

10. Elizabeth McNichol, “Strategies to Address the State Tax Volatility Problem – Eliminating the State Income Tax Not a Solution,” Center on Budget and Policy Priorities, Washington, DC, April 2013. **http://www.cbpp.org/research/strategies-to-address-the-state-tax-volatility-problem**

11. Tazra Mitchell, **“First in Flight from the EITC: Low-income Working Families Bid Farwell to NC’s Earned Income Tax Credit,”** Budget Brief, Budget & Tax Center, Raleigh, NC, March 2014.

12. Ibid.

13. Alexandra F. Sirota, “State EITC Allows Working North Carolinians Keep More of What They Earn, Boosts Economy,” Prosperity Watch, Issue 58, No. 3, NC Budget & Tax Center, Raleigh, NC, February 2016. **http://www.ncjustice.org/?q=budget-and-tax/prosperity-watch-issue-58-no-3-state-eitc-allows-working-north-carolinians-keep-more**

14. Ibid.

15. NC General Assembly Fiscal Research Division, General Fund Revenue Consensus Forecast, February 2016 Cost estimate for PIT reduction to 5.499% from 5.75% based on estimates by the NC General Assembly Fiscal Research Division. Cost estimate for a CIT reduction to 3% percent from 4% is based on