BTC Brief

BUDGET & TAX CENTER

August 2016

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THE ROAD TO NOWHERE GOOD FOR N.C.:

Latest Tax Changes That Aim for Zero Income Tax Continue to Benefit the Wealthy at the Expense of Working North Carolinians and Communities

BY ALEXANDRA F. SIROTA, BTC DIRECTOR

Tax changes passed in the 2016 legislative session reduced the income tax rate and increased reliance on the sales tax. This continued flawed approach to taxation that policymakers have followed since 2013 has proven disastrous to other states' fiscal and economic outlook. Such an approach delivers the greatest reduction in the tax load to the wealthy while losing opportunities to make smart investments that can improve the quality of life for families and strengthen the vitality of communities. As such, it does not address North Carolina's economic challenges, but instead undercuts the foundations of what have proven to be economy-boosting public investments.[1]

Changes to the state's tax code—primarily raising the standard deduction from $15,500 to $17,500 for married couples filing jointly by 2017 and expanding the sales tax base to more services—build onto costly tax cuts passed since 2013 that have primarily benefited the top 1 percent of income earners while increasing the tax load on the poorest taxpayers in the state.[2]

> **The latest changes keep N.C. on the path to eliminating the state income tax, which puts at risk smart investments being made in North Carolina and shifts the tax load onto middle- and low-income taxpayers. This is a road to nowhere good for NC's economy.**

While this year's changes may appear to be modest compared to more complex tax policy changes enacted in the years since 2013, it nevertheless represents one more step toward eliminating the state income tax. North Carolina General Assembly leaders have made clear that this is their end goal, which should be of great concern.[3] Each step toward zero income tax further skews the state's upside-down tax system and further challenges our ability to make public investments that support thriving communities across the state.

This *BTC Brief* details how the tax plan fails to meet North Carolina's high standards of fiscal responsibility and will fail to put the state in a competitive position with our neighbors or the rest of the nation.

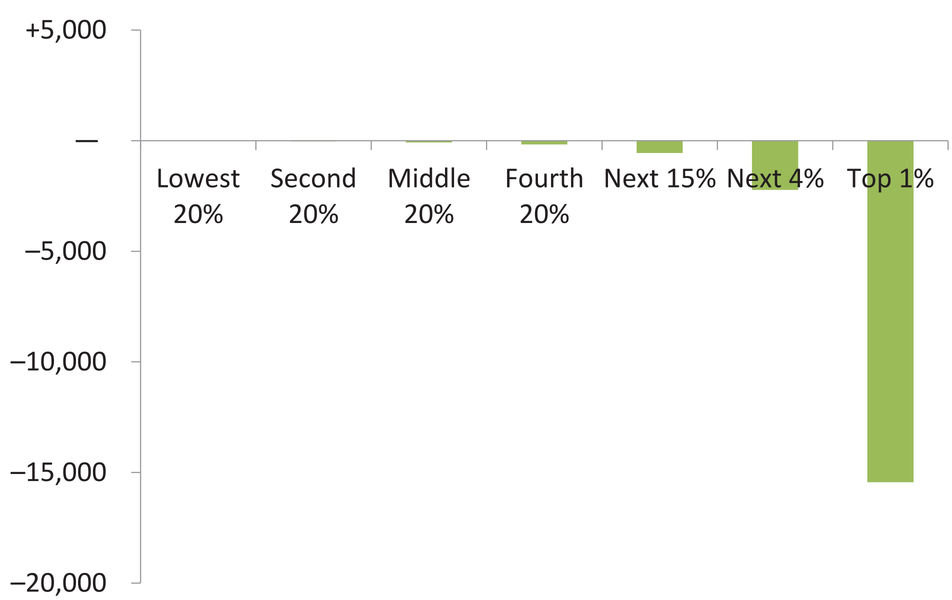
The end goal will hurt North Carolina's economy.

Policy leaders' stated goal of eliminating the state income tax would be a risk to smart investments being made in North Carolina, and it would shift the tax load onto middle- and low-income taxpayers who will be asked to pay a greater share of their income in sales taxes than the wealthiest. Legislative leaders in the Senate have repeatedly and consistently stated their goal of eliminating the income tax. Such a move would eliminate nearly 60 percent —more than $12 billion—of the state's General Fund tax dollars, which represents total revenue collected from personal and corporate income tax.[4] This would leave policymakers with the choice of either eliminating more than half of their investments in public schools, health care, economic development and public safety—an option unlikely to be realized given statutory requirements—or raising the sales tax by increasing the rate or expanding the sales tax to more goods and services, or both. If policymakers sought to replace all of the revenue lost from eliminating the income tax, the state sales tax rate under current policy would need to be 12 percent. The result would also be an increase in the tax load for, on average, taxpayers with incomes below $57,000 dollars.[5]

The tax code continues to deliver the greatest breaks to the top 1 percent.

Since 2013, analysis of all tax changes shows that on net the average tax change for taxpayers in the top 1 percent—the average income for this group is more than $1 million—was a cut in taxes of nearly $15,500. Middle-income taxpayers—the average income for this group is $44,000—receive on average a net tax cut of $167 or 1/100th of the tax cut for the state's wealthiest taxpayers. Meanwhile, the bottom 20 percent of income earners, those earning less than $12,000 on average, saw their taxes go up by $10.[6] While within each income group there are winners and losers, this analysis clearly shows the significant windfall received by the Top 1 percent. Several problems exist with such an approach to taxation, namely that the top 1 percent are not uniquely positioned to create jobs and that with incomes growing fastest at the top, a tax code that fails to reflect these economic realities will continually fall short of ensuring that all communities can thrive.

Top 1 Percent of Taxpayers Receive a Tax Cut Windfall
Average Tax Change by Income Quintile



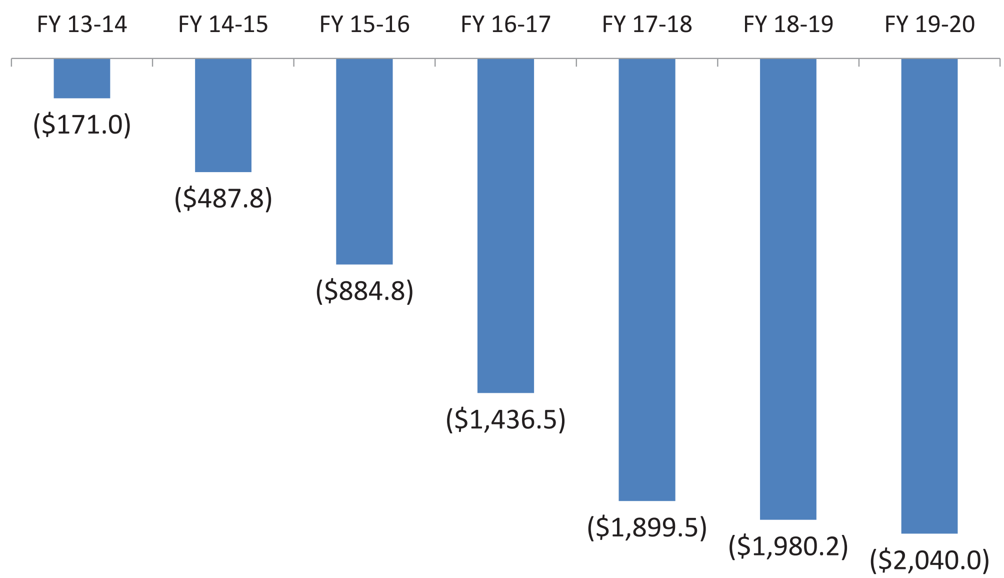
Source: Special Data Request to Institute on Taxation and Economic Policy, August 5, 2016

The tax plan is a big revenue loser.

Policymakers designed the tax changes to provide tax breaks immediately as well as in future years. The gradual roll out of the tax breaks will cause the price tag to grow each year, meaning that ordinary taxpayers have yet to feel what the full impact will be to the state's ability to provide core public services. This also poses challenges for future policymakers, who will need to contend with an even more inadequate tax code as they grapple with a growing number of students in schools and the inability to move teachers to the national average in pay. The cost of the tax changes since 2013 has slowly eroded the states' ability to keep up with a growing population, meet the needs of a changing economy and realize the desire to be innovative in its approach to governance. Revenue loss from the tax cuts passed since 2013 equates to nearly 10 percent of total General Fund spending for the 2017 fiscal year. The $2 billion in annual revenue lost when all tax changes are fully implemented is equivalent to the state's entire Commerce and Community College budget.[7]

Tax changes dig a hole for North Carolina

Net Cost of Tax Changes since 2013



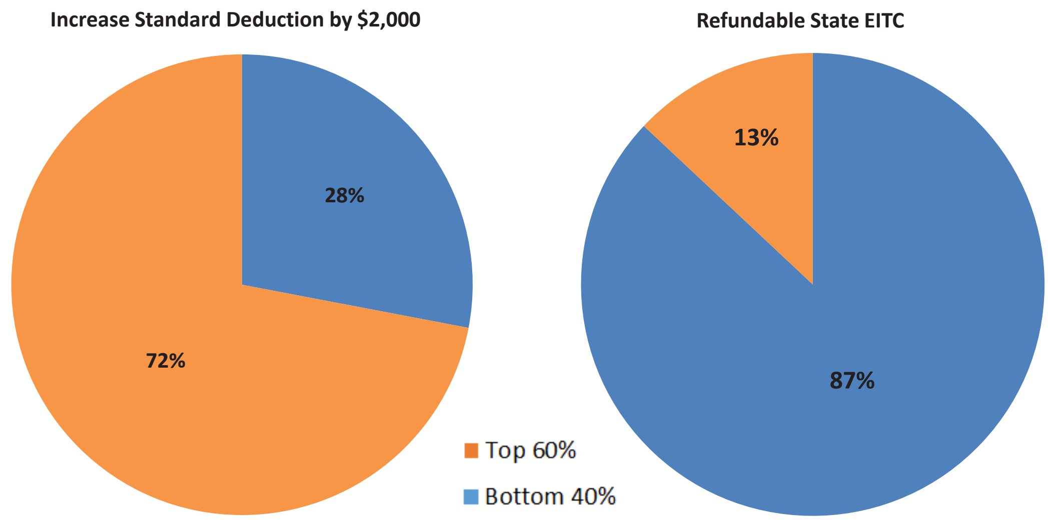
Source: Analysis of Fiscal Research Division

The standard deduction is costly AND fails to target low-wage workers.

Increasing the standard deduction by $2,000 not only is costly, but it is also a poorly targeted way to help moderate- and low-income taxpayers keep more of what they earn. Increasing the standard deduction reduces the income taxes paid for all tax filers who don't itemize, including millionaires, not just lower income North Carolinians. Given that over 80 percent of North Carolina taxpayers take the standard deduction, this is a roughly $120 income tax cut for the vast majority of taxpayers—barely noticeable for millionaires but not really enough to help workers who are struggling with a lack of wage growth and higher cost of living. The Earned Income Tax Credit (EITC) would better target those North Carolina workers who are struggling. As seen in the graph on the next page, only 28 percent of the tax cut from an increased standard deduction goes to those earning less than $34,000, while 87 percent of a refundable state EITC would go to these taxpayers.[8]

A refundable state EITC is the best tool for addressing the state's upside-down tax code

Share of Tax Cut Going to Bottom 40% of North Carolina Taxpayers



Source: Special Data Request to Institute on Taxation and Economic Policy, February 2016.

The way that the state raises revenue is important for families and communities. The tax code as it stands today is not helping everyday North Carolinians nor does it promote broad-based economic prosperity. Tax cuts for the wealthy and powerful, alongside a low-investment strategy by lawmakers, keeps North Carolina from being able to make smart investments that boost the economy. Moreover , it is a strategy that has and will continue to shift the tax load to those who are struggling to get by in an economic expansion while giving the wealthy a tax cut.

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1. Sirota, Alexandra, July 2015. BTC Policy Basic: The Reality of Tax Cuts. NC Justice Center: Budget & Tax Center, Raleigh, NC accessed at: http://www.ncjustice.org/?q=budget-and-tax/btc-policy-basic-reality-tax-cuts and Leachman, Michael and Michael Mazerov, May 2015. State Personal Income Tax Cuts: Still a Poor Strategy for Economic Growth. Center on Budget & Policy Priorities: Washington DC.
2. Mitchell, Tazra and Cedric Johnson, July 2016. BTC Reports: 2017 Fiscal Year Budget Falls Short of Being a Visionary Plan for North Carolina's Economic Future. NC Justice Center: Budget & Tax Center, Raleigh, NC access at: http://www.ncjustice.org/?q=budget-and-tax/btc-reports-2017-fiscal-year-budget-falls-short-being-visionary-plan-north-carolina%E2%80%99s
3. Johnson, Cedric, January 2013. BTC REPORTS: A "Laffable" Plan for Tax Reform - The Civitas/Laffer/Senate Plan for North Carolina Shifts Load to the Poor, Middle-class. NC Justice Center: Budget & Tax Center, Raleigh, NC accessed at: http://www.ncjustice.org/?q=budget-and-tax/btc-reports-laffable-plan-tax-reform-civitaslaffersenate-plan-north-carolina-shifts
4. NCGA Fiscal Research Division, Where the Money Comes From – FY 2015-16 Budget (General Fund), http://www.ncleg.net/fiscalresearch/presentations/Where%20the%20Money%20Comes%20From%20and%20Goes_2015-16.pdf
5. Special Data Request to Institute on Taxation and Economic Policy, August 2016.
6. Special Data Request to Institute on Taxation and Economic Policy, July 2016. The baseline comparison includes the state EITC and documents the incidence of all income and sales tax changes since 2013. Sirota, July 2015. Within each income group, there are winners and losers, so the average tax changes give the best population-level estimate of what N.C. taxpayers will experience.
7. Analysis based on NCGA Fiscal Research Division, General Fund Budgets.
8. Special Data Request to Institute on Taxation and Economic Policy, 2016.

Combined Impact of Fully Phased-In PIT and Sales Tax Changes 2013-2016

All North Carolinians, 2016 Income Levels, with 5% EITC in the old law baseline

2016 Income Level	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $20,000	$20,000 – $34,000	$34,000 – $57,000	$57,000 – $92,000	$92,000 – $186,000	$186,000 – $425,000	$425,000 – Or More
Average Income in Group	$12,000	$27,000	$44,000	$73,000	$123,000	$259,000	$1,072,000

COMBINED IMPACT OF FULLY PHASED-IN PIT AND SALES TAX CHANGES 2013-2015							
Tax Change as % of Income	+0.1%	–0.1%	–0.2%	–0.2%	–0.5%	–0.9%	–1.4%
Average Tax Change	+10	–25	–83	–167	–559	–2,220	–15,439

Major Components

Fully Phased-In Impact of PIT Changes							
Tax Change as % of Income	–0.2%	–0.3%	–0.4%	–0.4%	–0.6%	–0.9%	–1.5%
Average Tax Change	–27	–90	–173	–284	–706	–2,403	–15,901

% with Income Tax Cut	+36%	+55%	+62%	+71%	+81%	+89%	+96%
Avg. Tax Cut for Those w/Cut	–176	–261	–404	–591	–1,043	–2,900	–16,555
Share of Tax Cut	+2%	+5%	+9%	+15%	+22%	+18%	+28%

% with Income Tax Increase	+28%	+25%	+22%	+25%	+15%	+10%	+3%
Avg. Hike for those with Hike	+128	+217	+353	+550	+938	+1,716	+1,039
Share of Tax Hike	+8%	+12%	+18%	+30%	+23%	+8%	+0%

Fully Phased-In Sales Tax Base Changes (State and Local Impact)							
Tax Change as % of Income	+0.3%	+0.2%	+0.2%	+0.2%	+0.1%	+0.1%	+0.0%
Average Tax Change	+36	+65	+90	+117	+147	+182	+462

Source: Institute on Taxation and Economic Policy, August 2016