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Revenue Options to Support Children's Educational Success

Here are three ways the N.C. General Assembly can meet the needs of a growing state without asking more from low- and middle-income taxpayers.

By ALEXANDRA SIROTA, Budget & Tax Center Director

The General Assembly legislative session begins on May 16, the same day teachers plan a day of action to highlight the unmet needs their students face in the classroom and their communities.

While the evidence is quite clear that supporting children's educational success can generate lifelong benefits for families and the broader economy[1], the NC General Assembly has consistently prioritized tax cuts for wealthy taxpayers and profitable corporations instead.

This year, their unrelenting pursuit of tax cuts each year is projected to hit a key test. With scheduled personal and corporate tax rate reductions in January 2019, the state General Assembly's Fiscal Research Division projects that the state tax code won't be able to keep up current services for the state's growing population after Fiscal Year 2019-20[2]. That remains true even with the projected over-collections reported last week for that Fiscal Year.[3]

It is time for the General Assembly to set up a tax code to meet the needs of a growing state seeking to compete and deliver a high-quality of life to everyone, no matter where they live, in a way that doesn't continue to ask more from middle and low-income taxpayers and less from the state's wealthiest ones.

Here are three options for the General Assembly to consider right away.

1. Stop the scheduled rate reductions in January 2019. The personal income tax rate is scheduled to drop from 5.499 to 5.25 percent and the corporate income tax rate from 3 to 2.5 percent in 2019. Stopping the scheduled rate reductions alone will mean $900 million in currently collected state revenue will stay available for investments in education and infrastructure.

2. Return the corporate income tax rate to 5 percent from its current 3 percent

1 Berger, Noah and Peter Fisher, August 22, 2013. A Well-Educated Workforce is Key to State Prosperity. Economic Policy Institute: Washington, DC, Accessed at: https://www.epi.org/publication/states-education-productivity-growth-foundations/
2 Memo from NC Fiscal Research Division, July 2017.
3 Analysis of revenue collections and expenditures based on NC Fiscal Research Memo on Revenue Forecast, January 2018.

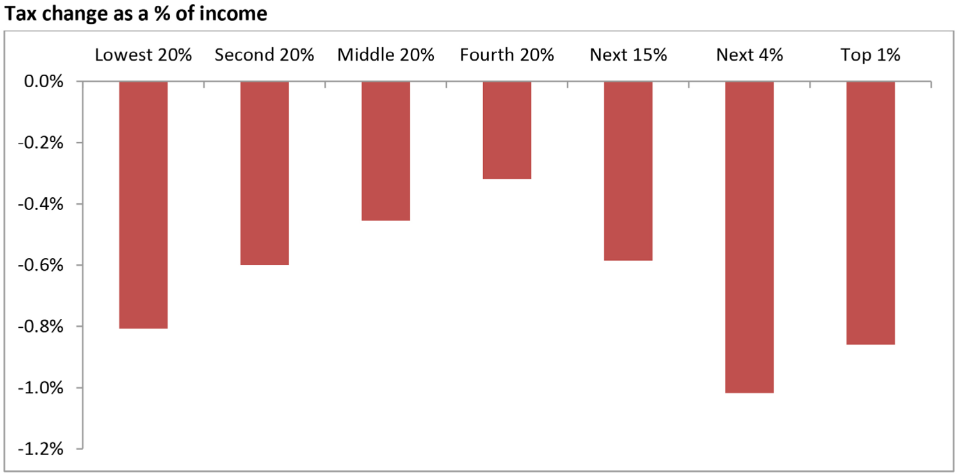
level, which is still below its pre-2013 rate of 6.9 percent. This rate would be in line with neighboring states and would mean $399 million in annual revenue (See Figure 2).[4] Very few businesses pay the full corporate income tax because of how they are organized and the availability of various loopholes and tax breaks. In light of the federal tax plan, which cut the federal income tax rate from 35 to 21 percent, the state's half percentage point of a rate reduction is better spent on investments proven to strengthen economic outcomes and well-being.

3. Establish a graduated rate structure for the personal income tax. By adding two top brackets for taxpayers in the top 1 percent with a rate of 6.499 percent on income above $500,000 and a rate of 7.499 percent on income above $1 million, North Carolina could align its tax code with ability to pay and ensure that the concentration of income growth at the top is being driven into broad-based benefits for both the wealthy and everyday North Carolinians. This rate structure for the wealthiest taxpayers, in combination with maintaining the 5.499 percent on income below $500,000 and the standard deduction move to $20,000, would address in part the upside-down nature of the state's tax code that has been made worse with a flat income tax rate. In addition, establishing a tax credit for working taxpayers with children who earn low-incomes would further ensure that these families aren't carrying a heavier tax load and benefit from a policy design that boosts workforce participation, children's developmental outcomes and lifetime earnings. Together, this would provide $208 million. [5] Over time, a graduated rate structure is better positioned to keep up with the state's income growth and helps address the state's upside-down tax code that asks more of middle and low-income taxpayers.

These tax changes, when compared to the pre-2013 tax code, would still deliver a tax cut to every income group (Figure 1). The top 1 percent whose income averages $1 million would receive the same tax cut as a share of their income as the lowest 20 percent of taxpayers whose income is less than $20,000 under this proposal. The middle and fourth income group of taxpayers, who have the smallest percentage change in their taxes paid, would receive on average $210 and $250, respectively, each year in tax cuts. This is roughly comparable to the average tax cut that they receive now under the tax changes since 2013, including the scheduled changes in 2019--$226 and $366 on average annually.[6]

Figure 1. The top 1 percent and lowest 20 percent would have received the same tax cut as a share of their income under this proposal.

Tax change as a % of income



Source: Special Data Request, Institute on Taxation and Economic Policy, May 2018.

4 Special Data Request, Institute on Taxation and Economic Policy, May 2018.
5 Special Data Request, Institute on Taxation and Economic Policy, May 2018.
6 Special Data Request, Institute on Taxation and Economic Policy, May 2018.

While statutory rates don't tell the full story of what people and corporations pay in taxes due to various deductions and credits, these rates are in line with neighboring states with regards to tax rates.

State	Personal Income Tax	Corporate Income Tax
North Carolina	5.499%	3.00%
Georgia	5.75%, temporary top rate in graduated structure	6.00%
South Carolina	7.00%, top rate in graduated structure	5.00%
Tennessee	6.00%, on investment income	6.50%
Virginia	5.75%, top rate in graduated structure	6.00%

Source: Tax Codes for each state in Tax Year 2018.

Taken together, these revenue options would mean $1.2 billion annually in revenue to meet the needs of our growing state and ensure a competitive foundation for delivering on the promise of a growing, inclusive economy that delivers well-being to all. [7]

7 Special Data Request, Institute on Taxation and Economic Policy, May 2018.