BTC Brief

BUDGET & TAX CENTER

April 2014

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WHO PAYS IN 2014:

Tax Plan Creates Winners and Losers in North Carolina

BY CEDRIC D. JOHNSON, PUBLIC POLICY ANALYST

Changes are coming to who pays taxes in North Carolina, and the news is not good for middle- and low-income taxpayers. This tax season marks the final year taxpayers will file their income taxes under the state's old tax code and by next year it will be apparent to many taxpayers that the tax plan has not just reduced available dollars for investing in core public services, but also has increased the tax load for many.

The tax plan passed by lawmakers last year shifts the responsibility of paying for public investments to middle- and low- income taxpayers and provides tax cuts to profitable corporations and wealthy taxpayers. Despite evidence showing no clear relationship between tax cuts and positive state-level economic performance[1], North Carolina lawmakers paid for these massive tax cuts for the wealthy by shifting the tax load onto middle- and low-income taxpayers, making the state's already upside-down tax system worse.

North Carolina's new tax code results in taxpayers at the lowest end of the income spectrum, with income of $17,000 or less, paying around 9.5 percent of their annual income in total state and local taxes while taxpayers at the upper end, with income of $345,000 or more, pay about 5.5 percent of their annual income in total state and local taxes (See Figure 1, p. 2).

A tax shift, not true tax reform

North Carolina's tax system raises around 90 percent of its annual General Fund revenue from the personal income tax (PIT), corporate income tax (CIT), and sales tax. The final tax plan includes huge tax rate cuts for both the PIT and CIT and partially pays for the lost revenue by expanding the sales tax to include selected services that were not subject to tax prior to the tax changes.[2] By virtue of who pays these respective taxes, the result of this fundamental shift in the way these three taxes are collected means that middle- and low-income taxpayers will see their taxes go up while wealthy taxpayers and profitable corporations will pay less, even as they continue to capture a greater share of income growth and profits as the economy continues to recover.[3]

The reduction in the personal income tax rate and the adoption of a flat tax rather

MEDIA CONTACT:

CEDRIC D. JOHNSON

919/856-3192
cedric@ncjustice.org

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P.O. Box 28068
Raleigh, NC 27611-8068

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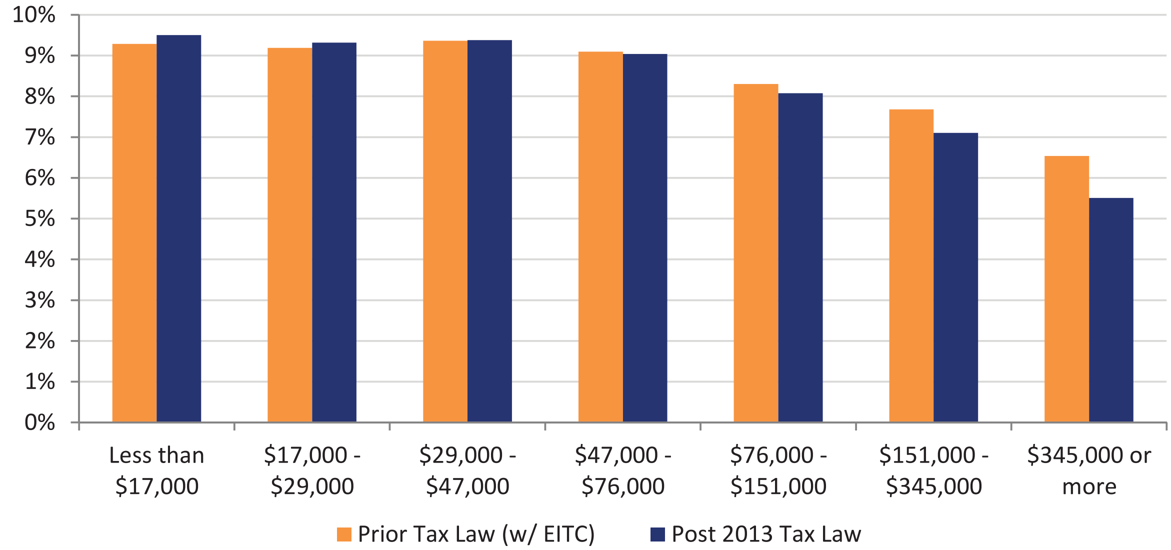
FIGURE 1: **Tax plan results in tax shift away from wealthy taxpayers and onto middle- and low income taxpayers.**



SOURCE: Institute on Taxation and Economic Policy

than a graduated rate structure will largely benefit wealthy taxpayers. The PIT rate is reduced to 5.75 percent by 2015. This new flat rate is lower than any of the tax rates within the state's prior graduated PIT rate structure – the lowest PIT rate was 6 percent. The new flat PIT and the huge reduction in the tax rate result in around two-thirds of net benefits from the tax plan flowing to the top 1 percent of income earners in North Carolina – the average annual income for these taxpayers is nearly $1 million.

Similarly, only a small share of the state's businesses will receive the bulk of the benefits from reducing the corporate income tax rate. Just 7 percent of North Carolina's businesses are subject to the corporate income tax. And of those companies that are subject to the tax, a few large ones make most of the taxable profits and therefore stand to receive most of the benefit from a corporate income tax cut. In 2009, for instance, more than half of total corporate income taxes came from less than 3 percent of all corporations that filed income taxes.[4]

Proponents claim that these corporate income tax cuts will benefit North Carolina workers and the economy. This claim is not supported by evidence and should not be taken as a guaranteed outcome. Consensus does not exist among economists regarding the actual percentage breakdown of the corporate income tax that is borne by workers and by corporate shareholders. However, corporate shareholders are typically deemed as bearing the majority of the tax burden from the corporate income tax.[5] In its economic incidence analyses, the U.S. Treasury Department assumes that 82 percent of the corporate tax is borne by corporate shareholders[6] – meaning the bulk of the benefits from reducing the CIT rate will flow to corporate shareholders and not workers.

A portion of these corporate shareholders who will benefit from the CIT rate cuts reside outside of North Carolina, which further reduces any impact the tax cuts could potentially have on North Carolina's economy. Corporate profits typically flow to corporate shareholders in the form of dividend payments. Dividends going to shareholders living outside of the state will likely not be spent in

North Carolina. Corporations can also use corporate profits to buy back company stock from outside shareholders and to acquire other companies, which do not necessarily support the creation of jobs.[7]

Together, the income tax rate reductions drive a significant amount of the cost of the tax plan and require revenue to be raised elsewhere – which means ultimately raising taxes on middle- and low-income taxpayers by increasing the sales tax, or cuts to important public services.

A CLOSER LOOK AT THE TAX SHIFT

Personal Income Tax

The final tax plan replaced the state's graduated personal income tax (PIT) rate structure with a flat tax rate of 5.8 percent for 2014. The PIT rate is reduced to 5.75 percent in 2015.

The graduated PIT rate structure that the state abandoned is designed to take into account a taxpayer's ability to pay – the PIT rate increases as a taxpayer's level of income increases. Conversely, the flat PIT rate that the state has adopted does not account for a taxpayer's ability to pay. As a result, the 5.75 percent PIT rate – compared to the prior 7.75 percent top marginal PIT rate under the graduated tax structure – will largely benefit taxpayers at the upper end of the income spectrum, who will now pay a much lower tax rate on their income.

Corporate Income Tax

The tax plan includes a series of corporate income tax (CIT) rate cuts. For 2014, the CIT rate is reduced to 6 percent from 6.9 percent. For 2015, the CIT rate is further reduced to 5 percent. Additional provisions within the tax plan allows the tax rate to fall to as low as 3 percent by 2017.

Sales Tax

The tax plan includes numerous changes to the sales tax that results in the average taxpayer paying more in sales and local taxes. The following products and services were previously untaxed or taxed at a lower preferential rate but now will be taxed at the general sales tax rate of 4.75 percent:

- **Some services such as auto repair contracts and warranty agreements for appliances**
- **Entertainment (e.g. movie theater tickets) and exhibitions**
- **Manufactured homes (previously taxed at 2 percent with a $300 maximum tax)**
- **Modular homes (previously taxed at 2.5 percent)**
- **Electricity and piped natural gas now taxed at combined (state and local) general sales tax rate**

Additionally, the plan eliminated the state Earned Income Tax Credit, which had helped offset the fact that lower-income families pay a higher portion of their income in state and local taxes.

The Big Squeeze

While the highest income households and most profitable corporations see big benefits from North Carolina's tax plan, middle- and low-income North Carolinians will have to carry a heavier tax load as a result. No provisions included in the tax plan mitigate the increased share of income paid in state and local taxes for middle- and low-income families as a result of the tax plan.

One part of the tax shift is the elimination of a number of tax provisions that benefit low- and middle-income taxpayers, like the personal exemption and the child and dependent care tax credit, for example. In addition, the loss of the medical expense deduction, long-term care credit, and non-Bailey qualifying pension income deduction[8] hurt fixed-income households, particularly older North Carolinians.

These deductions and credits were eliminated to help pay for income tax rate reductions that primarily benefit taxpayers at the upper end of the income spectrum. While the standard deduction is increased under the tax plan, for some taxpayers, the combined value of the eliminated credits and deductions is greater than the value of the higher standard deduction.

As a result, the income level at which the first dollar is taxed is reached sooner under the tax plan compared to prior tax law. Under the tax plan, a single parent family of three will begin paying income taxes on income over $16,400 compared to $19,100 under prior tax law.[9] A two-parent family of four would begin paying income taxes upon earning around $19,400 of income compared to $23,400 under prior tax law.[10]

Another part of the tax shift is the expansion of the sales tax to services, which means that those who spend a greater share of their income on goods and services will pay more taxes. Families at the lowest rung of the income spectrum pay around 6 percent of their income in sales and excise taxes.[11] By contrast, taxpayers at the upper end pay only around 1 percent of their income in sales and excise taxes.[12] Including more goods and services in the base of the sales tax not only results in higher sales taxes paid, but also results in higher prices as businesses pass a share of the sales tax along to consumers.

Expansion of the sales tax to services can be a good thing, but only if it is paired with efforts to protect lower income households that need every dollar they earn to pay for necessities. Unfortunately, the tax plan did just the opposite by letting the state Earned Income Tax Credit (EITC) expire, eliminating a proven tool for offsetting the negative impact of sales taxes on low income workers. The tax credit helps working families that earn low wages keep more of what they earn by reducing the state and local taxes they pay so that they can support their children and avoid poverty and public assistance. Nearly one million North Carolina families across the state's 100 counties will claim the state EITC for the last time as they file their 2013 taxes.[13]

Tax shift threatens long-term ability to pay for key services like schools and will not boost North Carolina's economy

Shifting the tax load to middle- and low-income taxpayers is unlikely to spur economic growth and will further challenge the tax system's ability to adequately fund essential public services in the years ahead. Asking taxpayers whose incomes have stagnated – and more recently declined – to carry a heavier tax load than wealthier taxpayers who have captured the majority of income growth in the past decade compromises revenue availability and dampens consumer spending.

Middle- and low-income taxpayers readily spend most of their income and increasing their tax load reduces their capacity to spend. A key aspect of promoting and strengthening the current economic recovery is boosting and maintaining demand for goods and services in the economy. Middle- and low-income taxpayers are the engine of the consumer demand needed to catalyze job growth. Proponents of the tax cuts suggest that high tax rates on wealthy taxpayers thwart the work efforts and investments that spur economic growth. However, evidence shows that the greatest positive impact on work participation, for example, occurs when tax rates are reduced for low-income workers and secondary wage earners, not the wealthy.[14] Moreover, consensus does not exist among economists regarding the claim that tax cuts generate the increased savings, investment or expansion of employment opportunities necessary to deliver improved economic growth.[15]

North Carolina can learn from the experience of other states that have recently enacted huge tax cuts that shift the tax load to middle- and low-income taxpayers. The recent example of Kansas is telling. After passing huge tax cuts in 2012 that shifted the tax load to the state's middle- and low-income taxpayers, Kansas has added jobs more slowly than the U.S. as a whole since the tax cuts took effect and the net growth in registered businesses was smaller in 2013 than in 2012, the year before the tax cuts took effect.[16]

Self-inflicted budget crises and tax shifting often go hand in hand largely because the base broadening needed to pay for tax cuts is difficult to achieve through the policy process. Consequently, revenues are immediately lower than what they would have been had measures been taken to fully pay for tax cuts. North Carolina tax system's heavier reliance on revenue from taxpayers whose incomes have

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stagnated or fallen will further challenge its ability to raise the revenue needed to keep up with growth in the economy over the long-term. This, in turn, challenges the ability to invest in educating children, retraining workers, and quality infrastructure – which have all been shown to deliver strong support to state economic growth.[17]

The tax shift resulting from the tax plan passed by North Carolina state leaders last year does not represent a fair tax system that promotes shared economic prosperity for all North Carolina and will actually undermine the state's economy and the ability of the tax system to fund essential public services.

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1 Mazerov, Michael, "**State Tax Cuts on Economic Growth: A Reply to the Tax Foundation**," Center on Budget and Policy Priorities, Washington, D.C., June 2013.

2 Examples of services that are not subject to sales tax include auto repair services contracts and warranties on appliances.

3 Saez, Emmanuel, "**Striking it Richer: The Evolution of Top Incomes in the United States**," University of California at Berkeley, September 2013.

4 Johnson, Cedric D., "**Cutting Corporate Income Taxes Won't Be an Economic Boon for North Carolina**" BTC Brief, Budget & Tax Center, NC Justice Center, Raleigh, NC, April 2013

5 Cronin, Julie-Anne, Lin, Emily Y., Power, Laura, and Cooper, Michael, "**Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology**," Technical Paper 5, Office of Tax Analysis, U.S. Department of the Treasury, May 2012. Also see: Gravelle, Jennifer C., "**Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis**," Working Paper 2010-03, Congressional Budget Office, Washington, D.C., May 2010.

6 Ibid

7 Carnevale, Chuck, "**The Best Use of Corporate Profit (Cash)**", F.A.S.T. Graphs, Research article, December 2012.

8 Taxpayers receiving retirement income under the Bailey settlement are allowed to exempt this income from the NC taxable income.

9 Johnson, Cedric D., "**Final Tax Plan Falls Far Short of True Tax Reform**," BTC Report, Budget & Tax Center, NC Justice Center, Raleigh, NC, August 2013. (see appendix)

10 Ibid

11 ***Who Pays? A Distributional Analysis of the Tax Systems in All 50 States***, 4th edition, Institute on Taxation and Economic Policy, Washington, D.C., January 2013.

12 Ibid

13 Mitchell, Tazra, "**First In Flight From The EITC: Low-Income Working Families Bid Farewell to North Carolina's Earned Income Tax Credit**," BTC Brief, Budget & Tax Center, NC Justice Center, Raleigh, NC, March 2014.

14 **The Effect of Tax Changes on Labor Supply in CBO's Microsimulation Tax Model**, Background Paper, Congressional Budget Office, Washington, D.C., April 2007.

15 See endnote 1

16 Leachman, Michael and Mai, Chris, "Lessons for Other States from Kansas' Massive Tax Cuts," Center on Budget and Policy Priorities, Washington, D.C., March 2014.

17 Berger, Noah and Fisher, Peter, "**A Well-Educated Workforce Is Key to State Prosperity**," Economic Policy Institute, Washington, D.C., August 2013. Also see: Fisher, Peter S., "**Corporate Taxes and State Economic Growth**," Policy Brief, Iowa Fiscal Partnership, revised February 2012.