BTC Report
BUDGET & TAX CENTER
September 2018

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Income tax rate cap amendment is costly for taxpayers, communities

Limiting the income tax rate permanently could hurt N.C.'s ability to meet its needs while benefiting the top 1 percent.

By Alexandra Forter Sirota, Budget & Tax Center Director

Imposing an arbitrary income tax cap in the North Carolina Constitution could fundamentally compromise our state's ability to fund our schools, roads, and public health, as well as raise the cost of borrowing. This could all happen even as the tax load shifts even further onto middle- and low-income taxpayers and the state's highest income taxpayers — the top 1 percent — continue to benefit from recent tax changes since 2013.

On Nov. 6, North Carolina voters will cast their ballot for or against a proposed change to the current maximum allowable income tax rate in the state Constitution. The proposed change would lower that maximum allowable rate from 10 to 7 percent.

It would not lower either individual or corporate income tax rates paid currently. Today, individuals pay a flat 5.499 percent on taxable income while corporations pay 3 percent. Those rates will drop further in January 2019 to 5.25 and 2.5 percent respectively.

Table 1: A 7 percent rate is arbitrary when compared to current and historic income tax rates for individuals and corporations.

	Tax Rate (2019)	Tax Rate (2017)	Tax Rate (2013)
Personal Income Tax	5.25%	5.499%	6%, 7 % and 7.5%
Corporate Income Tax	2.5%	3%	6.9%

Source: North Carolina, Department of Revenue, Tax Schedules for Tax Year

Proponents claim that lowering the cap on the income tax rate in the Constitution is necessary to hold down spending and put more money in the pockets of North Carolina taxpayers. However, an analysis of these claims and the proposal to set the maximum income tax rate allowable in the state constitution finds that:

1. **Millionaires are the primary beneficiaries when the income tax rate is not allowed to go above 7 percent.** The top 1 percent of taxpayers receive more than half of the total next tax cut from a 7 percent maximum income tax rate when compared to what would be possible with a graduated rate structure with brackets on higher incomes.

2. **Fewer dollars are available to make critical, transformative investments in our state.** A graduated rate structure that taxes income above certain income

thresholds at rates above 7 percent, like what was in place during the 2001-2006 period, would provide an estimated $2.4 billion in state revenue. Those dollars would allow North Carolina to get teacher pay to the national average and make investments in our children's education by funding textbooks, classroom supplies, and technology.

3. **Middle- and low-income taxpayers will see their tax load increase.** Research has shown that tax limits do little to ensure that taxes are held down. Instead, policymakers often raise taxes such as sales and property taxes to meet identified needs in communities. Raising the $2.4 billion in revenue that would be available under a graduated rate structure through the sales tax — which asks more of low- and middle-income taxpayers — would require the sales tax rate to increase from 4.75 percent to 6.29 percent. Under a sales tax change, the poorest taxpayers would see a 0.9 percent change in their taxes as a percent of their income versus just a 0.1 percent for those at the top — while under a graduated income tax proposal, anyone making less than $60,000 would experience no tax change.

4. **Barriers to equitable outcomes and reaching the full economic potential of the state is blocked when the state underinvests in opportunity for all and delivers tax cuts to the wealthy few.** One of the state's persistent economic challenges is that job growth has been uneven and barriers to opportunity remain, particularly for communities of color and rural places. These barriers are made worse and continue to compound over time when state investments are arbitrarily capped. By not ensuring that children from every background have access to a sound, basic education or the tools to be ready for kindergarten or reading by 3rd grade, North Carolina is missing the economic boost that is possible when every person in the state — regardless of race or ethnicity — is able to achieve their full potential.[1]

"One of the state's persistent economic challenges is that **job growth has been uneven and barriers to opportunity remain, particularly for communities of color and rural places.** These barriers are made worse and continue to compound over time when state investments are arbitrarily capped."

5. **Limits on state revenue will put pressure on local budgets and lead to increases in local taxes like the property tax.** As local policymakers contend with fewer state dollars to support local needs, many counties will face greater difficulty in meeting local needs. The result will require local leaders to either cut services or raise property taxes. Since 2012-13, 76 counties have raised their property tax rates and many have also revalued properties in their local jurisdictions.[2]

This BTC Report analyzes the proposal to cap the state's income tax paid by individuals and corporations at a maximum allowable rate of 7 percent with particular focus on the costs of such a move for the state and for everyday North Carolina taxpayers. To conduct this analysis, we estimate the final economic incidence to taxpayers by income group as well as the total additional annual revenue that could be generated if a graduated income tax rate structure above 7 percent were in place that is based on prior top brackets in North Carolina's recent history.

In effect, a maximum allowable income tax rate of 7 percent precludes the addition of two top brackets that have been in place in our recent history: a 7.75 percent rate on income over $100,000 (representing the income level of the top 20 percent of taxpayers) and a 8.25 percent rate on income over $200,000 (representing roughly the income level of the top 5 percent of taxpayers). This analysis keeps in place the changes to taxable income that have been made since 2013 and assumes that the 5.25 percent rate, effective January 2019, is applied to income below $100,000.

Importantly, unlike the current flat income tax rate, a graduated income tax rate structure aligns with

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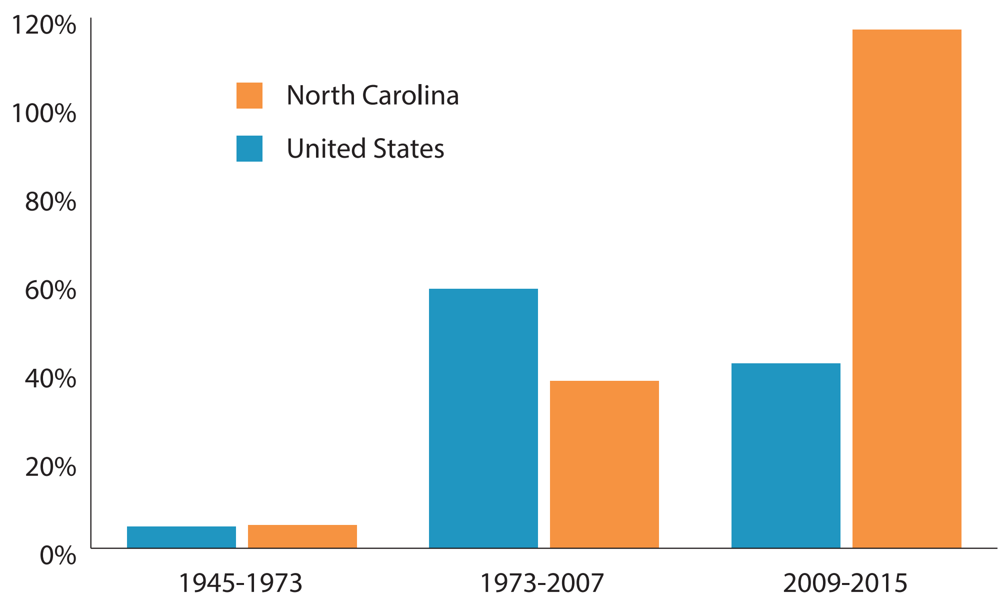
1 National Equity Atlas, Growth Indicators for North Carolina. Accessed at: http://nationalequityatlas.org/data-summaries

2 County Property Tax Rates and Revaluation Schedules, NC Department of Revenue. Accessed at: https://www.ncdor.gov/reports-and-statistics/county-property-tax-rates-and-revaluation-schedules

Figure 1: Income growth for the top 1 percent since 2009 has not followed historic patterns and is far greater than for the top 1 percent in the U.S. and bottom 99 percent in N.C.

Share of total income growth catpured by the top 1 percent in North Carolina and the U.S.



Source: Sommieller and Price, July 2018.

where income growth is concentrated. For every dollar of income held by the bottom 99 percent, the top 1 percent in North Carolina held $20.[3] From 2009 to 2015, the top 1 percent in North Carolina have captured more than 100 percent of the income growth, which means that any growth that happened and then some went to the top 1 percent because the bottom 99 percent lost income over that period.[4]

In a graduated income tax rate structure, the top two rates only are applied when income is over the defined threshold (see Table 2, next page). For this reason, a graduated income tax rate structure is more equitable and effective at raising revenue than simply increasing a flat rate, which would then apply to all taxable income, or turning to the sales tax (See "The Problem with a Flat Income Tax Rate", pg. 4).[5] It is also better able to keep up with growth in the economy, since the incomes of the top 1 percent grow even as the incomes of other taxpayers in North Carolina recently have fallen.[6]

This analysis provides an illustration of how much is at stake by taking away the ability to have higher rates on richer households. A lower income tax rate cap removes future lawmakers' ability to use progressive taxation to raise much needed revenue and ensure that every community can thrive.

Millionaires are the primary beneficiaries when the income tax rate is not allowed to go above 7 percent.

Setting a maximum income tax rate at 7 percent in the state Constitution would prohibit future policymakers from putting in place a graduated income tax rate structure like the one operating in the early-2000s or immediately before 2013 tax changes. The result is locking in a permanent tax break for millionaires.

3 Economic Policy Institute, Unequal States of America, Adapted from Estelle Sommeiller and Mark Price, *The New Gilded Age: Income Inequality in the U.S. by State, Metropolitan Area, and County*, an Economic Policy Institute report published in July 2018. Data are for tax units (single adults or married couples), referred to in the report as families, and for 2015, unless otherwise indicated.
4 Sommeiller and Price, July 2018.
5 Institute on Taxation and Economic Policy, 2011. The ITEP Guide to Fair State and Local Taxes. ITEP: Washington DC. Accessed at: **https://itep.org/wp-content/uploads/guide.pdf**
6 ITEP, 2011.

By limiting future lawmakers' ability to raise revenue with additional tax brackets on high-income earners, roughly 57 percent of the net tax cut would go to the top 1 percent of taxpayers. Notably, putting in place these two top brackets would generate no tax change on average for taxpayers with income below $100,000 — the bottom 60 percent of taxpayers.

Table 2: A graduated rate structure that would not be possible under a maximum allowable income tax rate of 7 percent

If your income is more than ...	But not over ...	Your tax would be ...
$0	$100,000	5.25% of net taxable income
$100,000	$200,000	$5,250 + 7.75% of the amount over $100,000
$200,000	-	$13,000 + 8.25% of the amount over $200,000

Source: NC Department of Revenue, Income Tax Rate Schedule for 2001 to 2006.

The top 1 percent of taxpayers in North Carolina, whose average income is $1.3 million, would have a permanent tax break of 2.1 percent as a share of their income. Again, the bottom 60 percent would see no change in their annual taxes paid as a share of their income.

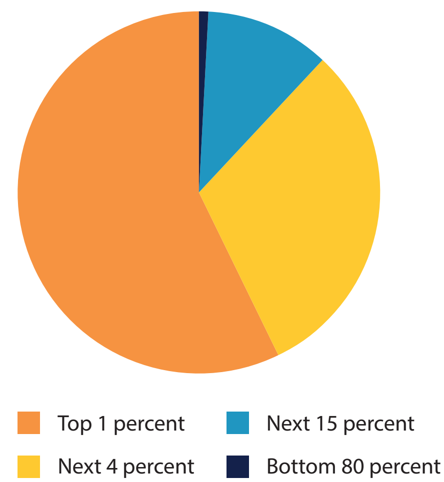
Fewer dollars are available to make critical, transformative investments in our state.

North Carolina is falling behind in meeting the needs of its communities and people because of years of income tax cuts that have primarily benefited the wealthy.[7] Projections have the state's revenue failing to keep up with current diminished service levels next fiscal year, a reality that would require revenue to be raised or further cuts to services.[8]

7 Johnson, Cedric, August 2017. Costly Tax Cuts in State Budget Continue Precarious Road Ahead for North Carolina. Budget & Tax Center Brief, NC Justice Center: Raleigh, NC

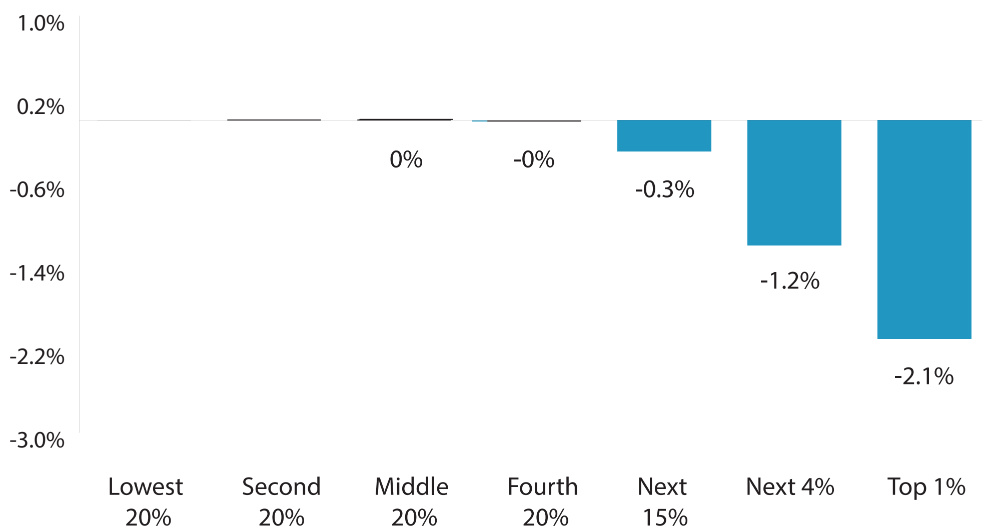
8 NC Fiscal Research Division, July 2017.

Figure 2: Blocking a graduated income tax rate structure over 7 percent gives millionaires 57 percent of the net tax cut.



Source: Special Data Request, ITEP, August 2018.

Figure 3: Millionaires receive the greatest tax cut as a share of their income each year.



Source: Special Data Request, ITEP, August 2018.

Capping the maximum income tax rate would limit a key tool for raising revenue to fund public schools, support community reinvestment and development, connect people to quality health care, and protect the environment. Specifically, a 7 percent maximum allowable income tax rate would lock in a loss of $2.4 billion in state revenue annually when compared to what could be raised if policymakers were able to add two top brackets on higher income.[9] $2.4 billion would allow North Carolina to raise teacher pay to the national average, restore funding for all school allotments to pre-Recession levels, and leave $500 million available to meet other critical state needs.

The ability to raise revenue through the income tax has been a critical tool for policymakers in our recent history. During both of the recessions in the 2000s — from 2001 to 2006 and from 2008 to 2011 — policymakers enacted temporary top brackets on high-income taxpayers to raise revenue

9 Special Data Request, ITEP, August 2018.

The Problem with a Flat Income Tax Rate

Current legislative leaders have argued that a flat income tax rate is fairer to everyday taxpayers because it applies the same rate to each dollar of income. The problems with a flat income tax rate are made clear, however, when one views the incidence of a rate increase to what would be the maximum allowable rate of 7 percent should the state Constitution be changed.

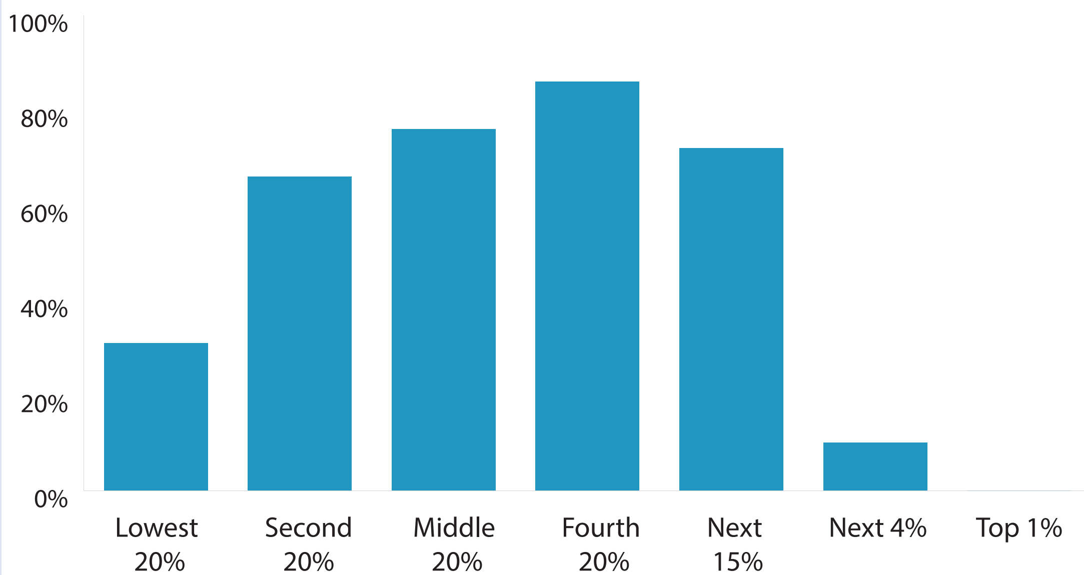
The majority of taxpayers across nearly all low- to middle-income groups would see their taxes increase because a flat rate applies to all taxable income (See Figure 4). The top 1 percent would continue to receive a tax cut on average that represents a nearly 1 percent decline in state and local taxes paid as a share of their income.

Such a tax change would also only provide $400 million in additional revenue.

In contrast, a graduated approach applies an income tax rate on taxable income over certain income thresholds and, thus, minimizes the impact on those whose incomes do not reach those thresholds — while also providing 5 times the revenue raised under the increase of a flat rate.

Figure 4: A flat income tax rate of 7 percent across all income would raise the tax load for the majority of middle- and low-income taxpayers compared to the tax structure in the early 2000s.

Percent of Taxpayers by Income Group with an Increase of the Flat Income Tax Rate to 7%



Source: Special Data Request, ITEP, August 2018.

that minimized cuts to public schools, public health, and other investments that were important to the long-term well-being and economic success of the state.

With the first recession in the 2000s, significant state budget shortfalls persisted, aid to local governments was cut by more than $300 million in one fiscal year alone, and local governments were provided the option of raising local sales taxes to make up for the state revenue losses caused by the downturn.[10] State lawmakers chose to put in place a temporary top bracket on income over $200,000 for taxpayers married, filing jointly as part of the response to that downturn. Similarly, in the Great Recession, state policymakers put in place a temporary surcharge on income over $100,000 and $250,000 that provided millions in additional funding to support public schools at a time when budget shortfalls topped $4 billion.[11]

The legislative choice to hold down spending despite the current economic expansion may not be the approach that future policymakers deem appropriate nor may it be one that can be pursued when an economic downturn or natural disaster occurs. In fact, researchers have found that temporary tax changes, particularly on high income taxpayers, are preferable to budget cuts when assessing the long-run impacts on the economy.[12] By placing into the state constitution a permanent lower maximum on the income tax rate, future policymakers will not have the same set of tools that have been available to and used by North Carolina policymakers in the 1990s, 2000s, and most recent Great Recession.

Middle- and low-income taxpayers will see their tax load increase.

Already, North Carolinians who have middle and low incomes pay nearly two times more as a share of their income in state and local taxes than the top 1 percent.[13] To raise the same amount as would be possible with the addition of two top brackets to the state's current tax code, North Carolina's sales tax rate at the state level would need to increase from 4.25 percent to 6.29 percent. A North Carolina taxpayer with income below the state median income would see their annual sales tax contributions increase by $233, roughly the equivalent of two weeks of groceries (See Figure 5). Moreover, the poorest taxpayers would see a 0.9 percent change in their taxes as a percent of their income versus just a 0.2 percent for those at the top. Under a graduated income tax proposal, anyone making less than $60,000 would see no tax change even as the state raised revenue to meet critical needs across communities.

> "Already, North Carolinians who have middle and low incomes pay nearly two times more as a share of their income in state and local taxes than the top 1 percent."

The need to raise revenue is not an abstract one. Already as noted above, the state's Fiscal Research Division has identified that the current tax code will require revenue to be raised or services to be cut in the coming fiscal year. To maintain current service levels, state policymakers will need to raise revenue to provide each child with the current per pupil spending investment and each North Carolinian with health care, for example. Policymakers need to raise at least $1 billion to meet identified pressing needs, that include ensuring North Carolina schools meet the standards in providing school nurses and counselors for children's health and well-being, monitoring air and water quality for everyone's well-being, and addressing the rising cost of housing and child care. In 2009, the last year the state invested at the 45-year average, North Carolina was able to fund Child and Early Development initiatives at a higher rate per child and assign more classroom teachers and teacher assistants across the state. To return to historic levels of state spending as a share of the economy, North Carolina policymakers would need to commit an additional $4 billion.

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10 Mejia, Elaine, February 26, 2006. Surplus or Shortfall? Finally some breathing room, but not much… BTC Brief: NC Justice Center, Raleigh NC. Accessed at: http://www.ncjustice.org/?q=budget-and-tax/btc-brief-surplus-or-shortfall-finally-some-breathing-room-not-much

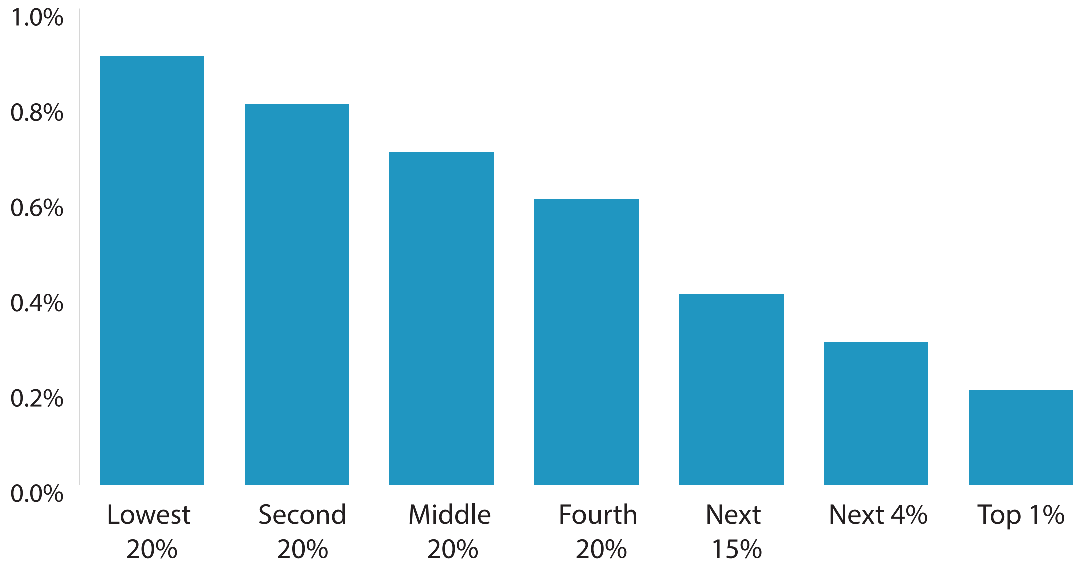
11 Mejia, Elaine, May 2009. Between a Rock and a Hard Place: NC's Worsening Budget Gap Calls for Spending Cuts and Revenue Increases. BTC Brief. NC Justice Center, Raleigh, NC. Accessed at: http://ncjustice.org/?q=btc-brief-between-rock-and-hard-place-nc%E2%80%99s-worsening-budget-gap-calls-spending-cuts-and-tax

12 Nicholas Johnson. 2008. Budget Cuts or Tax Increases at the State Level: Which is Preferable During an Economic Downturn? Center on Budget and Policy Priorities: Washington, DC

13 ITEP, 2015. Who Pays?, Fifth Edition. Accessed at: https://itep.org/whopays/

Figure 5: Using the sales tax to raise much needed revenue asks more from middle- and low-income taxpayers.

Impact for each income group of increasing the state's sales tax rate to 6.29 percent (up from the current 4.75 percent), as a percent of income



Source: Institute on Taxation and Economic Policy, August 2018

Raising income taxes with a flat rate on individuals would ask more from middle-income taxpayers, further worsening the upside-down nature of the tax code. At the same time, turning to fees to fund government services creates a host of challenges for the state's ability to meet its obligations of public service and avoid a range of negative impacts.

Researchers have found that states with tax limits are not guaranteed to experience lower levels of government spending or lower taxes overall.[14] Research has found that states with tax and spending limits are more likely to use fees and service charges to raise revenue than states without such limits.[15] Research into the impact on schools has found inequitable and inadequate funding results across school districts when states impose tax and spending limits.[16] Separate research has found that states with tax and spending limits have higher indebtedness and higher borrowing costs as well.[17] Finally, when state revenue is constrained, researchers have found shifts in responsibility to local governments for raising taxes and funding services.[18]

Moreover, researchers have also found states with tax and spending limits experience negative effects on student's educational achievement — greater than what is measured by budget cuts alone — and that there is no relationship between tax and spending limits in a state and the state's economic growth.[19]

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14 Mullins, Daniel and Philip, Joyce, 1996. "Tax and Expenditure Limitations and State and Local Fiscal Structure: An Empirical Assessment." Public Budgeting and Finance, 16 (1); Kousser, et al. For Whom the TEL Tolls? Can Tax and Expenditure Limits Effectively Reduce Spending. University of California at San Diego.

15 Johnston, J. M., Pagano, M. A., & Russo, P. A. J. (2000). "State Limits and State Aid: An Exploratory Analysis of County Revenue Structure." State and Local Government Review, 32(2) and Shadbegian, R. (1999). "The Effect of Tax and Expenditure Limitations on the Revenue Structure of Local Government, 196287." National Tax Journal, 52(2).

16 Resnick, Phyllis, Charles Brown and Deborah Godshall, August 2015. Measuring the Impact of Tax and Expenditure Limits on Public School Finance in Colorado. Lincoln Institute of Land Policyand Mengedoth, Jospeh and Santiago Pinto, 2015. Show and TEL: Are Tax and Expenditure Limitations Effective? District Digest, Federal Reserve Bank of Richmond.

17 *Bahl* Roy and *Duncombe* William. *1993*. "State and Local Debt Burdens in the 1980s: A Study in Contrast." Public Administration Review 53;,Clingermayer, James and Dan Wood, 1995. Disentangling Patterns of State Debt Financing. American Political Science Review, Volume 89, Issue 1; Poterba, James and Kim Rueben, November 2001. Fiscal News, State Budget Rules and Tax Exempt Bond Yields. Journal of Urban Economics. Volume 50, Issue 3.

18 Skidmore, M. (1999). "Tax and Expenditure Limitations and the Fiscal Relationships between State and Local Governments." Public Choice, 9

19 Bae, Suho, Seong-gin Moon and ChanghoonJung, August 2012. Economic Effects of State Level Tax and Expenditure Limitations. Public Administrativeon Review, Volume 72 and Issue 5 and Mengedoth and Pinto, 2015

Barriers to unlocking North Carolina's full economic potential would be even higher.

Research has found that a flat income tax delivers the greatest benefits to those who already have high incomes and wealth, while undermining the pathways for others to connect to opportunity and build wealth. Given the historic barriers to asset accumulation and access to high-paying jobs, researchers consistently find that white taxpayers benefit from flat income tax proposals whereas taxpayers of color are hurt by such proposals.[20]

Table 3: An income tax rate cap would benefit white taxpayers more.

	White	Latinx	Black
Total share of overall tax cut	86%	1%	6%
Total share of overall returns filed	71%	4%	19%

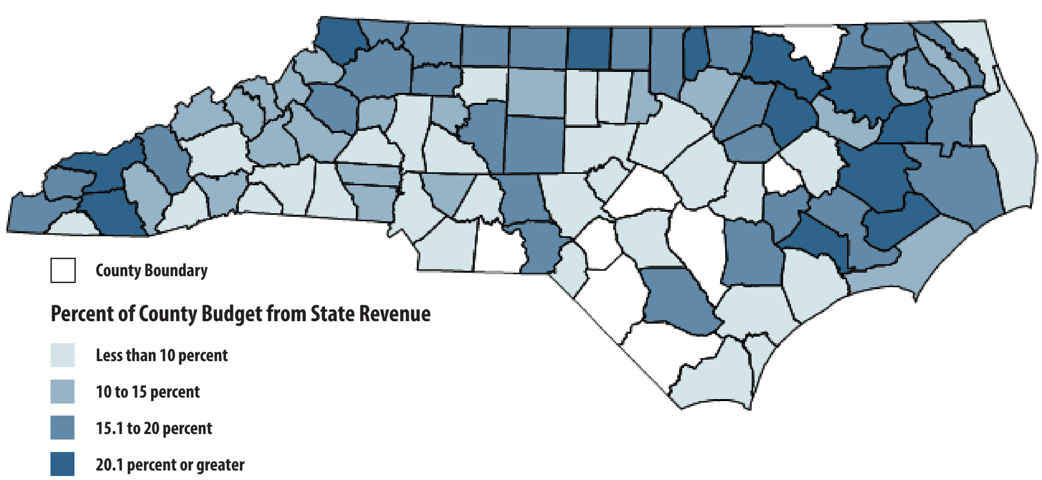
Source: Special Data Request, ITEP, August 2018.

In North Carolina, a cap on the income tax rate would deliver the greatest benefits to white taxpayers while Black and Latinx taxpayers would see very little tax cut. Black taxpayers receive 6 percent of the overall tax cut, despite filing 19 percent of overall returns, while Latinx taxpayers receive 1 percent of the overall tax cut, despite filing 4 percent of all returns. In stark contrast to Black and Latinx taxpayers, white taxpayers actually receive a greater share of the overall tax cut, 86 percent, despite filing 71 percent of all returns.

Counties that rely on state revenue for more than one-tenth of their annual budget would be hard hit by limits on state dollars.

Local communities are often faced with the difficult decision of what to cut when state revenue is cut back. In many of North Carolina's more rural counties, state revenue represents more than 15 percent of the county's revenue source to fund public safety, public health, parks and recreation, and child well-being.

Figure 6: The state's rural counties would be hit hard by limits on state revenue options.



Source: NC State Treasurer, Annual Financial Information Report by County. Note that counties in white did not provide data for the report.

The loss of state revenue will put pressure on local leaders to identify revenue sources or cuts to services given that local governments need to balance their budget each year. Due to limits on

20 Hamilton, Darrick and Michael Linden, May 2018. The Hidden Rules of Race are Embedded in the New Tax Law. Roosevelt Institute; Einhorn, Robin, 2006. American Taxation, American Slavery. University of Chicago Press: Chicago, IL; Faricy, Christopher, April 2016. "How the US Tax System Disadvantages Racial Minorities" Washington Post; Petrella, Christopher, April 2017. Wealth, Slavery and the History of American Taxation. Black Perspectives.

the revenue-raising authority of local governments, the primary tools are property and sales tax, and these will likely be used to ensure that budgets are balanced instead of or alongside cuts to spending. Already since 2012-13, 74 counties have raised their property tax rates and many have also revalued properties in their local jurisdictions, during the recovery from the Great Recession and with the existing approach of cutting income taxes at the state level.[21]

There are real costs associated with capping the maximum allowable income tax rate at 7 percent that include but aren't limited to an ability to use progressive taxation to raise much needed revenue so every community and each North Carolinian can thrive. This analysis provides an illustration of the costs and their ripple effect through the lives of individual North Carolina taxpayers and communities across the state.

21 County Property Tax Rates and Revaluation Schedules, NC Department of Revenue. Accessed at: https://www.ncdor.gov/reports-and-statistics/county-property-tax-rates-and-revaluation-schedules