BTC Reports

BUDGET & TAX CENTER

VOLUME 21 NUMBER 4 | October 2015

DIMINISHED EXPECTATIONS AND THE RESULTING DRAG ON NORTH CAROLINA'S ECONOMY:

A Summary of the Fiscal Year 2015-17 Budget

By TAZRA MITCHELL, POLICY ANALYST and CEDRIC D. JOHNSON, POLICY ANALYST

Tax Cuts Limit Possibilities to Support Foundations of Opportunity

The budget North Carolina will live under through June of 2017 will sharply constrain the state's ability to make public investments crucial to promoting widespread prosperity and a growing economy.

The reason: tax cuts. All of the tax changes in the recently adopted state budget will reduce available revenue for the biennium by $841.8 million. Those are resources the state will not have for public education, community economic development, the court system, and other vital services that helped deliver broad economic gains to North Carolinians in the past.

Within four years the annual cost balloons to over $1 billion each year because of the phase in of rate reductions for individual taxpayers and profitable corporations.

At this critical point in the state's uneven and slow economic recovery, policymakers chose to deliver greater benefits to the wealthiest few rather than build a solid foundation that supports opportunity for many.

The New Normal: State Investments Mired at Historic Lows

Public investments in a wide range of areas are the essential building blocks of long-term economic growth and shared prosperity. Decades ago North Carolina diverged from its southern neighbors and opted to invest in good roads, quality public schools and universities, healthcare, and early childhood programs. These investments paid off and North Carolina leapt ahead.

Today, state lawmakers have turned their backs on that bipartisan legacy. Ignoring how these investments delivered historic gains, they are continuing down a failed tax-cut path. Unlike many states that are using modest economic gains to reinvest in public systems that support families, communities, and a stronger economy, North Carolina lawmakers are hampering the state's future economic success.

Diminished Investments Compromise a Strong, Inclusive Economy

Public investments that promote a strong and inclusive middle class—quality schools, affordable healthcare, housing, and safe, healthy neighborhoods—are being

MEDIA CONTACT:

TAZRA MITCHELL

919/861-1451
tazra@ncjustice.org

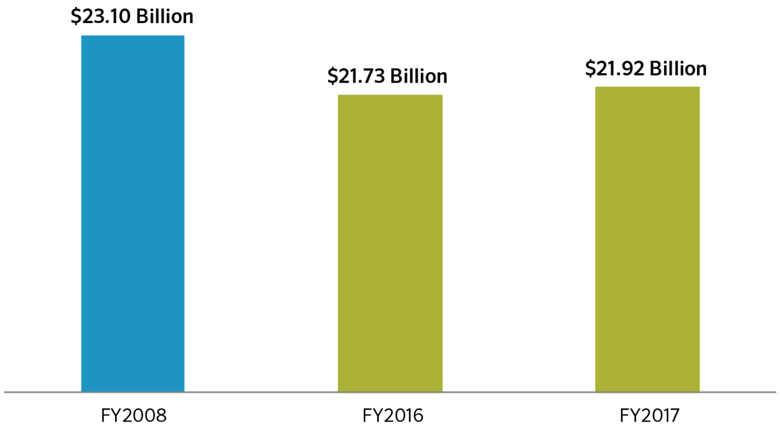
Budget & Tax Center

a project of the
north carolina
JUSTICE CENTER

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

www.ncjustice.org

Figure 1: **Eight Years Later, Final Budget Fails to Catch Up to Pre-Recession Levels Despite Growing Needs**



SOURCE: NCGA-approved budgets, FY2008, FY2016, and FY2017; FY2008 budget is adjusted for inflation.

sacrificed to pay for tax cuts that primarily benefit the wealthy and profitable corporations. Funding at a level below what it takes to meet growing public needs remains a reality even with the bump in total spending over the next two years. Compared to the 2015 fiscal year budget, the new plan increases total General Fund spending by 3.4 percent in the first year. In the 2017 fiscal year, annual spending rises by 0.85 percent.

Most of these new dollars will pay for higher public school costs due to rising enrollments, the UNC system, and Medicaid as well as pay raises and bonuses for teachers and other public employees. In other words, it barely covers some pressing needs and leaves little for rural economic development initiatives, environmental protection, and other vital services. In fact, overall state support for services in the 2016 fiscal year will be 5.9 percent below the 2008 fiscal year—the last budget in place prior to the economic downturn—when adjusted for inflation **(see Figure I).**

That would be fine if public needs had shrunk. But they have grown. Meanwhile, the state seeks to position itself competitively by delivering a high quality of life and key assets that promote business success. More progress could have been made absent the new round of deep tax cuts that lawmakers included in the budget.

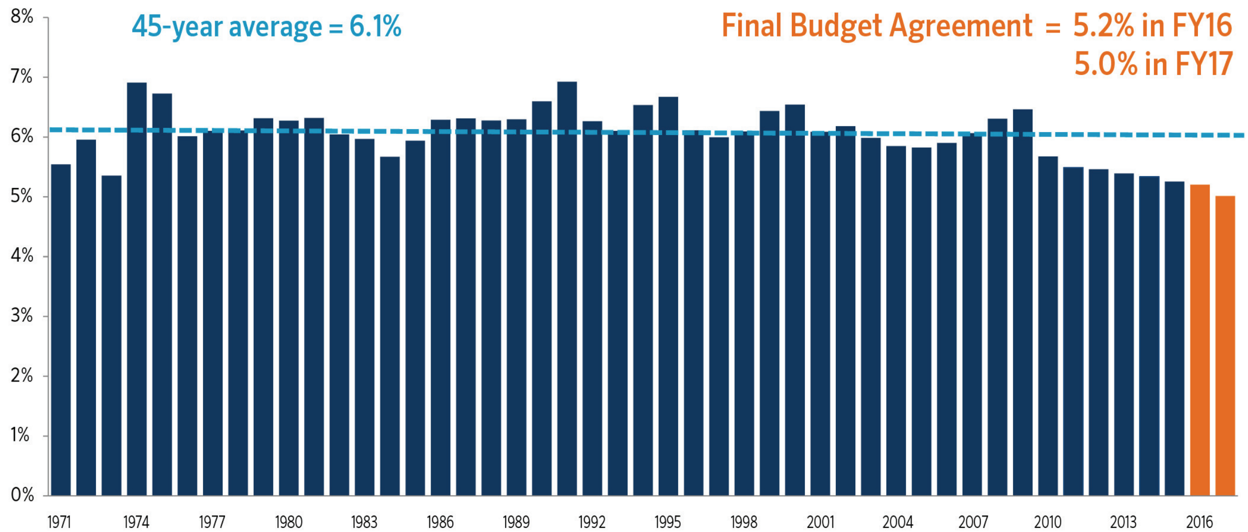
A New Low that Hurts All North Carolinians

The state budgets enacted since the 2010 fiscal year have increasingly failed to keep up with public needs. State spending as a part of the economy—measured by state personal income—has consistently fallen year after year in the past few years. The new budget continues this trend. In fact, it caps off the only period as far back as 1971 in which state spending declined as a part of the economy for seven and eight consecutive years while the economy itself grew. Under this measure, state spending remains below the 45-year average in both fiscal years of the two-year budget **(see Figure 2).**

Why is that a problem? State budgets typically allow spending to grow as the population grows and the economy changes, especially after an economic downturn when revenues plummet and services are frozen or cut. This growth in spending isn't done for its own sake. Rather, it enables the state to keep up with the needs of the people it serves—like building schools and purchasing enough textbooks to meet a growing number of students, or providing quality medical care and residential services to our growing number of seniors.

Failing to follow this best-practice can lead only to significant unmet needs. Today the state lacks enough slots in early childhood development programs for all who need them. Our schools have a shortage of textbooks and nurses. Community services for older adults—like day services and home delivered meals—aren't there for many who could use them.[1] Contrary to the claim made by supporters of tax cuts that they will boost the economy, the opposite is happening. Despite costly tax cuts in recent years, North Carolina's economy has not seen any extraordinary growth or boost in job

Figure 2: **State Spending as a Part of the Economy Continues to Shrink, Remain Below the 45-Year Average**



SOURCE: NCGA-Approved General Fund budgets via OSBM Post-Legislative Summaries and FRD Budget Highlights; FY2015-17 budget deal; and BLS State Personal Income and Projections using May 2015 Consensus Revenue Forecast.

creation. Rather, just like most other states, North Carolina's recovering economy is in large part the result of an improving national recovery.[2]

Further tax cuts means there simply will not be enough revenue to repair our crumbling infrastructure and develop the state's human capital in ways that position our state to compete.

Tax Cuts Deepen Cracks in Opportunity

The erosion in the quality and reach of public services is in deep contrast to North Carolina's experience during previous economic recoveries, when state investments returned to and exceeded pre-recession levels far more quickly.[3] North Carolina's former leaders understood that investing in critical public structures spurs economic growth for communities across the state. Today's leaders continue to choose tax cuts over meaningful reinvestment that boosts the economy—a choice that will only deepen existing and damaging cracks in the infrastructure of opportunity.

There are public investments in several vital areas that are either inadequate or completely missing from the 2016 fiscal year budget. Examples of inadequacy in the budget include, for example:

- Flat year-over-year spending on the pre-kindergarten program that serves at-risk 4-year olds, which fails to restore the more than 6,400 slots lost since 2009 or give opportunity to the 7,200 children stuck on the waiting list.
- Investment per student in public schools is well below 2008 pre-recession levels—nearly $500 less per student—which limits the level of staff and tools available to help preserve good schools and improve learning in the classroom. Though spending is higher than in the 2015 fiscal year budget there will be thousands of fewer teachers and teacher assistants compared to 2008, and textbook spending is below half its 2010 peak level, leaving some schools with outdated textbooks or with no textbooks at all.[4]

- Tuition at community colleges will rise for the seventh consecutive year to $76 per credit hour from $72—an 81 percent increase since 2009—increasing the likelihood of a college education being out of the reach of many.

Examples of investments that are completely missing in the 2016 budget include, for example:

- No cost-of-living adjustment for retired public employees like former state troopers and teachers despite their shrinking purchasing power due to changes in the economy.
- By not expanding Medicaid, the budget denies affordable health care to about 500,000 North Carolinians.
- No funding for the Healthy Corner Store Initiative. This program would help small convenience store owners stock healthy food and earn more money, with the goal of supporting small businesses and making healthier food options available to the more than 1.5 million North Carolinians who live in neighborhoods with limited access to affordable and healthy food retailers.
- No support to ensure that all rural communities have reliable high-speed internet access that is increasingly essential to participating in the global economy—which leaves struggling rural communities further behind urban areas.

These examples show that lawmakers can spend more in the overall budget—as the 2015-17 budget does compared to the 2015 budget—but still fall short of what's needed to support families and grow a strong economy.

Details of Tax Changes in the Budget

Personal income tax

- **Reinstates medical deductions, effective for tax year 2015**
- **Increases standard deduction to a maximum of $15,500 from $15,000 based on filing status in 2016**
- **Reduces personal income tax rate in 2017 to 5.499% from 5.75%**

Corporate income tax

- **Reduces corporate income tax rate to 4 percent from 5 percent in 2016**
- **Requires reduction of corporate income tax rate to 3 percent upon total General Fund revenue exceeding $20.975 billion in any fiscal year after 2016**
- **Phases in Single Sales Factor apportionment formula over three years**
- **Repeals bank privilege tax, which commercial banking institutions pay for the privilege of conducting business in the state.**
- **Changes how bank holding companies determine their income tax liability**

Sales tax

- **Expands sales tax base to include certain repair, maintenance, and installation services**
- **Changes how additional revenue generated from expanding sales tax base is allocated to local governments**

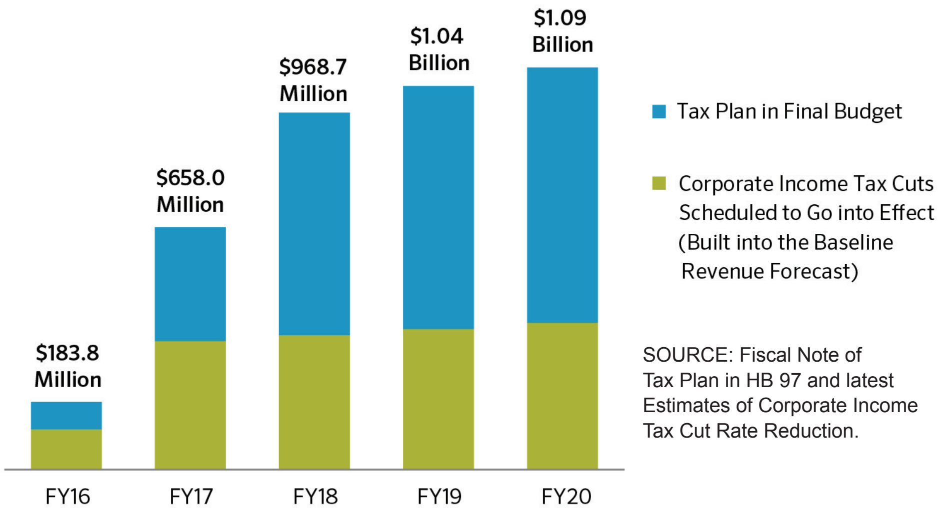
New Income Tax Cuts and Sales Tax Expansion are a Costly Tax Shift that Won't Boost Economy

Further tax cuts and the increasing shift away from state income taxes towards more reliance on sales taxes and fees limit North Carolina's capacity to make much-needed investments that support the state's economy. The tax changes significantly reduce the availability of revenue at the same time they shift taxes away from the wealthiest North Carolinians and large, profitable, out-of-state corporations onto everyone else. *(See box, left, for an outline of tax changes.)*

Tax Plan Greatly Reduces Revenue Available For Public Investments for Years to Come

Overall, the combined tax changes included in the budget will reduce available revenue for the biennium by $841.8 million. This revenue loss includes another reduction in the corporate income tax rate starting January 1, 2016.

Figure 3: **Cost of Tax Cuts in Final Budget Will Continue to Squeeze Out Needed Investments**



SOURCE: Fiscal Note of Tax Plan in HB 97 and latest Estimates of Corporate Income Tax Cut Rate Reduction.

The hidden reality is that the bulk of the damage due to the tax cuts will occur in the years ahead. Once all tax changes are fully phased in, annual revenue loss will balloon to more than $1 billion **(see Figure 3)**.

The timing in which tax cuts in the budget take effect was structured so state lawmakers did not have to show the full impact in the two-year 2015-17 fiscal year budget. In 2016, for example, a reduction in the corporate income tax rate—which was approved in 2013—will occur and will reduce available revenue. Lawmakers assumed this revenue loss when determining the total dollars available for investment in the budget. As such, this revenue loss is not highlighted in the budget like the new round of tax cuts are—it is "hidden" and baked into tax revenue estimates. State lawmakers could have prevented this corporate income tax cut but chose not to.

In 2017, more income tax cuts will occur—both personal and corporate tax rate reductions—along with other tax changes that will further reduce available revenue. The cost of these tax cuts and changes grows in subsequent years to the point where annual revenue loss reaches more than $1 billion. Less available revenue will likely mean that support for public schools continues to lag behind growing needs, health care services for North Carolinians who need them erode, and the condition of the courts and other legal services deteriorate.

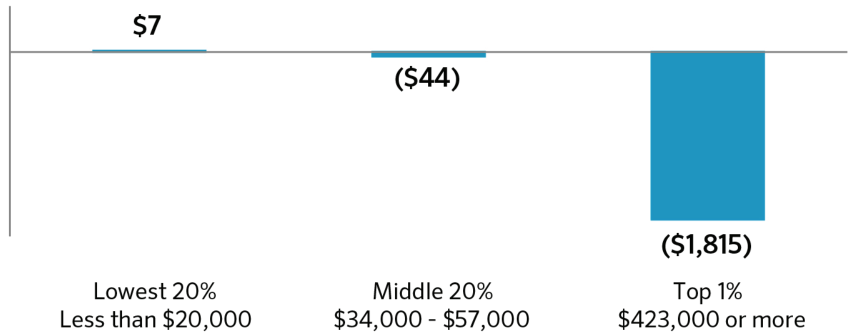
Increasing Sales Taxes to Pay for Income Tax Cuts Is a Bad Deal for Average North Carolinians

To, at least in part, make up some of the money lost by cutting income tax rates, state lawmakers expanded the state sales tax to apply to repair, maintenance, and installation services. The $204 million in new revenue this tax expansion raises over the biennium will pay for one-fifth of the cost of the personal and corporate income tax cuts in the two-year budget. The total amount the state will forego from cutting income taxes alone over the period is $1.04 billion.[5]

Proponents of this tax shift have said it will help the state's finances, on the assumption that revenue from sales taxes is more stable during business cycle fluctuations than income tax revenue. In fact, a graduated income tax—where rates rise along with income—has been proven to be the most reliable revenue source available to states because it displays more robust growth in the long run than sales, property, or excise taxes.[6]

This is borne out by tracking done by the General Assembly's Fiscal Research Division. Between 1997 and 2013, FRD found that neither revenue source fully kept up with growth in the state's economy, but that the personal income tax provided significantly more robust resources as it outpaced sales tax revenues.[7] The sales tax, however, tends to be a more stable revenue source during economic downturns because people still must buy things such as basic necessities, even as their incomes fall. Accordingly, having both a graduated income tax and a sales tax allows states to better weather economic

Figure 4: **Top 1 Percent of Taxpayers Continue to Receive Greatest Tax Cut in the Final Budget**



SOURCE: Special Data Request to the Institute for Taxation and Economic Policy, September 2015.

downturns and realize gains when the economy is recovering and thriving.[8]

In North Carolina the wealthier someone is the lower share of his or her income goes toward state and local taxes compared to everyone else.[9] The tax changes reflected in the new budget exacerbate this disparity. On average, North Carolinians making $20,000 a year or less will see their overall state taxes go up slightly by $7. Those making between $34,000 and $57,000, on average, will receive a tax cut of $44, which equates to $3.67 per month. The top 1 percent, those making at least $423,000 a year, will on average receive a tax cut of nearly $2,000 **(see Figure 4)**.

The fact that the new budget increases the standard tax deduction people receive by up to $500 will be of little consequence compared to the other tax changes. At most, it is expected to provide a cut of around $27.50.[10] Increasing the standard deduction is a costly and less efficient way to offset the disproportionate share of total taxes that low-income North Carolinians pay—people who need and spend their money the most. A state Earned Income Tax Credit is a more targeted tool for addressing this problem with the tax code and also delivers strong long-term returns for children and the broader well-being of families and the community.[11]

More Tax Cuts for Profitable Corporations Unlikely to Spur Job Creation or Boost Economy

Under the new budget, large, profitable corporations get tax cuts at the same time the state is reducing support for vital services. There is no reason to believe these tax cuts will spur meaningful economic growth. State and local taxes typically represent a very small fraction, only 2 percent or less, of business costs.[12] Expenses for labor, property, equipment, and transportation are much more substantial. Accordingly, tax cuts for profitable corporations are unlikely to lead them to create new jobs or boost capital investment in the state.

The corporate income tax (CIT) rate will go down to 4 percent from 5 percent in 2016.[13] The budget mandates that the CIT rate be further reduced to 3 percent once total net General Fund revenue exceeds an arbitrarily low threshold of $20.975 billion. The earliest this further corporate tax cut can occur is January 1, 2017, but that appears unlikely.[14] For the 2016 and 2017 fiscal years, state officials expect net General Revenue is expected to be $20.934 billion and $21.062 billion, respectively, meaning a reduction of the CIT rate down to 3 percent is likely to kick in by January 1, 2018 at the earliest unless lawmakers pursue more tax cuts next year.[15]

The way North Carolina taxes multistate corporations also changes. Shifting to what's known as a *single sales factor* (SSF) will base business taxes solely on how much a corporation makes from sales within North Carolina.[16] Corporations currently pay state income taxes based on three things: corporations' property, payroll, and sales in North Carolina—with sales factored in more heavily. The SSF formula will only consider the sales component. This change will provide a tax cut to certain corporations, with no guarantee of job creation. At the same time North Carolina-based businesses with little or no out-of-state sales will be at a competitive disadvantage; they get no tax reduction. Of the eight states that had an SSF formula in effect from 2003 through 2012, six were below the average of all states in retaining manufacturing jobs.[17]

More income tax cuts for profitable corporations and shifting to an SSF will further reduce revenue for public investments that promote economic growth. Once both business tax cuts are fully phased in, the loss in annual state revenue from the corporate tax breaks will be nearly $471.7 million.[18]

Changes to the Tax Distribution of Local Sales Tax Revenue Limits Some Local Governments' Ability to Support Public Services

All of the additional revenue raised from expanding the sales tax base will be distributed to counties based on percentages that are somewhat similar to those used for distributing revenue raised from the sales tax under the current tax code. A total of $84.8 million will be used this way, with $17.6 million coming from revenue generated under the existing sales tax code and the remaining $67.2 million from additional revenue expected to be raised from expanding the sales tax base to more services.

The determination of how the additional revenue raised from expanding the sales tax base appears arbitrary in that allocation percentages do not correspond in all cases to such factors as a county's economic condition or its capacity to raise local revenues. For example, eight of the 20 least economically distressed counties receive nearly 15 percent of the total additional sales tax revenue, while nine counties in worse shape receive no revenue. Despite proponents' claim that this change will go a long way to support rural communities' needs, it fails to represent a robust and sufficient rural economic development strategy.

If expanding the sales tax base does not raise the projected $67.2 million, the revenue shortfall will be taken from existing sales tax revenue and distributed to local governments under the new distribution formula. Also, local governments are restricted in how they can use the additional revenue raised from expanding the sales tax base. It must go toward economic development, K-12 schools, and community colleges. ■

---

1. Authors' analysis of publicly-available data, including waiting lists.
2. Patrick McHugh, "Growth Without Prosperity: Seven Years after the Great Recession Started, Recovery Still Eludes North Carolina," NC Budget and Tax Center, 2015.
3. Tazra Mitchell et al., "2015 Budget Undermines North Carolina's Competitiveness: It Is Unstainable, Inadequate, and Hampered by the Costly 2013 Tax Plan," *BTC Report*, NC Budget and Tax Center, September 2014.
4. The authors excluded the pay raises from the total education budget so that accurate overtime comparison can be made. In 2008, pay raises appeared in the salaries and reserve section of the budget, not the education budget; and "NC schools deal with fewer dollars for textbooks," *The News & Observer*, December 17, 2013.
5. Total cost includes $458.2 million in revenue loss over two-year budget period from the reduction of the corporate income tax rate to 4 percent from 5 percent on January 1, 2016 and a further reduction to 3 percent on January 1, 2017.
6. "In It for the Long Haul: Why Concerns over Personal Income Tax "Volatility" Are Overblown," Institute on Taxation and Economic Policy, Washington, DC, March 2011.
7. Alexandra Sirota, "The Case for North Carolina's Personal Income Tax," *BTC Report*, NC Budget and Tax Center. April 2012. At the time the analysis was conducted, 2013 data included projections.
8. Ibid.
9. "Who Pays?," Institute on Taxation and Economic Policy, Washington D.C., January 2015.
10. Increasing the standard deduction by $500 based on a personal income tax rate of 5.499% as included in the final budget equates to a reduction in state income tax liability taxes of $27.50.
11. Chuck Marr et al, "Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds." Center on Budget and Policy Priorities, Washington D.C., April 2015.
12. Cedric D. Johnson and Alexandra Forter Sirota, "Cutting Corporate Income Tax Won't Be an Economic Boon for North Carolina," *BTC Brief*, NC Budget & Tax Center, Raleigh, NC, April 2013.
13. The final budget maintains language from the 2013 tax plan that allows the CIT rate to be reduced to 4 percent if total General Fund revenue for the 2015 fiscal year exceeded a determined threshold. Revenues exceeded this threshold and the reduced CIT rate will take effect on January 1, 2016.
14. Cedric D. Johnson, "State lawmakers lower the bar, profitable corporations get more tax cuts," blog post, the Progressive Pulse, May 2015.
15. Total expected net General Fund revenue for FY2015-17 budget. Reflects Revised General Fund Availability and excludes non-tax revenue that is included in the General Fund.
16. Cedric D. Johnson, "Tax Change for Multistate Corporations: A Measure that Would Harm Critical State Investments and Fail to Help Economy," *BTC Brief*, NC Budget & Tax Center, Raleigh, NC, March 2014.
17. Ibid.
18. Fiscal Impact: Joint Draft [Budget], Fiscal Research Division, September 14, 2015 and latest analysis of corporate income tax cuts.

north carolina
JUSTICE CENTER

north carolina
JUSTICE CENTER

P.O. Box 28068 • Raleigh, NC 27611-8068
919/856-2176 • alexandra@ncjustice.org

BTC *Reports*