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FINAL TAX PLAN FALLS FAR SHORT OF TRUE TAX REFORM

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The tax plan recently signed into law by Governor Pat McCrory fails to make the fundamental changes North Carolina needs to create a modern, adequate and fair revenue system that can boost the state's economy and strengthen schools, health care and other services families need to prosper and the economy needs to grow. The plan consists largely of cutting tax rates for personal and corporate income, in a way that will overwhelmingly benefit the wealthy, and does little to rid the tax code of costly tax loopholes (see details of the plan below). The result will be a significant loss of revenue and a greater reliance on the sales tax, which hits middle-class and low-income taxpayers the hardest. Further cuts to public education, health care and public safety are sure to follow, which will come on top of years of cuts to these vital services during and after the Great Recession.

The plan falls short on several key principles of tax reform:

- **Fairness**: It fails to ensure that state taxes are based on ability to pay, and actually shifts the tax load further to middle-class and low-income taxpayers as a result of changes such as allowing the state Earned Income Tax Credit and dependent care credit to expire, while expanding the sales tax to more goods and services. Wealthy individuals and profitable corporations get huge tax cuts under the plan.

- **Adequacy**: The tax plan reduces the amount of revenue available for public investments by $650 million annually. As a result, further cuts are likely to be made to public schools, higher education, health care, public safety, transportation and other public services in the years ahead. These are the very services that create a strong foundation for a growing economy, by fostering a skilled, highly educated workforce; ensuring companies can get their goods to markets; and making communities and businesses secure.

- **Simplicity**: The tax plan fails to meaningfully reduce the number, and dollar amount, of tax loopholes. These preferential tax provisions will continue to reduce the amount of revenue raised each year, even though many of them may fail to serve a useful purpose.

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WHAT REAL REFORM LOOKS LIKE

Real tax reform would enable the state to raise adequate revenue for schools, infrastructure, health care and other public investments in a way that reflects taxpayers' ability to pay and minimize fluctuations in revenue raised from year to year. Much of the recent legislative debate focused on plans that looked very little like tax reform and failed to live up to three core principles that should guide such debate.

Core Principles of Tax Reform

- **Fair:** A tax system that ensures that middle-class and lower-income households do not pay a higher share of their income in taxes than high-income households, and ensures that taxpayers in similar economic situations pay similar taxes.
- **Adequacy**: A tax system that raises enough revenue to pay for services that promote economic growth, public safety and other priorities, now and in the future.
- **Stability**: A tax system that is structured to avoid, to the extent possible, unpredictable fluctuations in the amount of revenue collected year to year.

The problems with the state's existing tax system are widely recognized. It was designed in the 1930s and has not been comprehensively updated in the decades since to reflect fundamental changes in the economy, which has steadily shifted toward services and technology and away from the production and consumption of manufactured goods. As such, North Carolina's tax system is unable to raise adequate revenue for public investments and is susceptible to wide fluctuations in the amount of revenue raised from year to year. Moreover, it is upside-down: Low- and middle-income taxpayers pay a greater share of their income in state and local taxes than higher-income taxpayers.

Unfortunately, the governor and the Legislature missed an opportunity to fix these harmful flaws. This failure will make it more difficult for North Carolina to gain a sound footing in its recovery from the recession and become a full participant in the 21st century economy.

Tax plan harms middle-class and low-income taxpayers

The majority of taxpayers, on average, will see their taxes increase under the plan, contrary to the claim made by proponents that all taxpayers will get a tax cut. Wealthy individuals and profitable corporations will receive huge tax cuts. As such, the tax plan shifts more of the costs of paying for North Carolina's schools and other public services to middle-class and low-income taxpayers, and away from the wealthy and corporations. The plan is particularly damaging to the finances of low-income families in North Carolina because it allows the state's Earned Income Tax Credit (EITC) to expire at the end of 2013. This credit supplements income earned by low-wage workers and is one of North Carolina's most effective tools for fighting poverty.

Accounting for the expiration of the state EITC, the bottom 80 percent of taxpayers, on average, will see their taxes increase under the tax plan compared to current tax law (Figure 1).

DETAILS OF 2013 TAX PLAN

Personal income tax

- Three-tier personal income tax rate – 6%, 7%, and 7.75% – replaced with a flat 5.75 percent tax rate by 2015
- Standard deduction increased to a maximum $15,000 from $6,000 based on filing status; itemized deductions limited to mortgage interest and property taxes and capped at $20,000 plus unlimited charitable contributions.
- Personal exemption allowance eliminated and state Earned Income Tax Credit allowed to expire at the end of 2013.
- Child Tax Credit increased by $25 per child for filers with adjusted gross income below $40,000
- Business pass-through income deduction and private pension deduction eliminated

Corporate income tax

- Corporate income tax rate to be cut to 5 percent from 6.9 percent by 2015 and if revenue triggers are met will be reduced to 3 percent by 2017.[1]

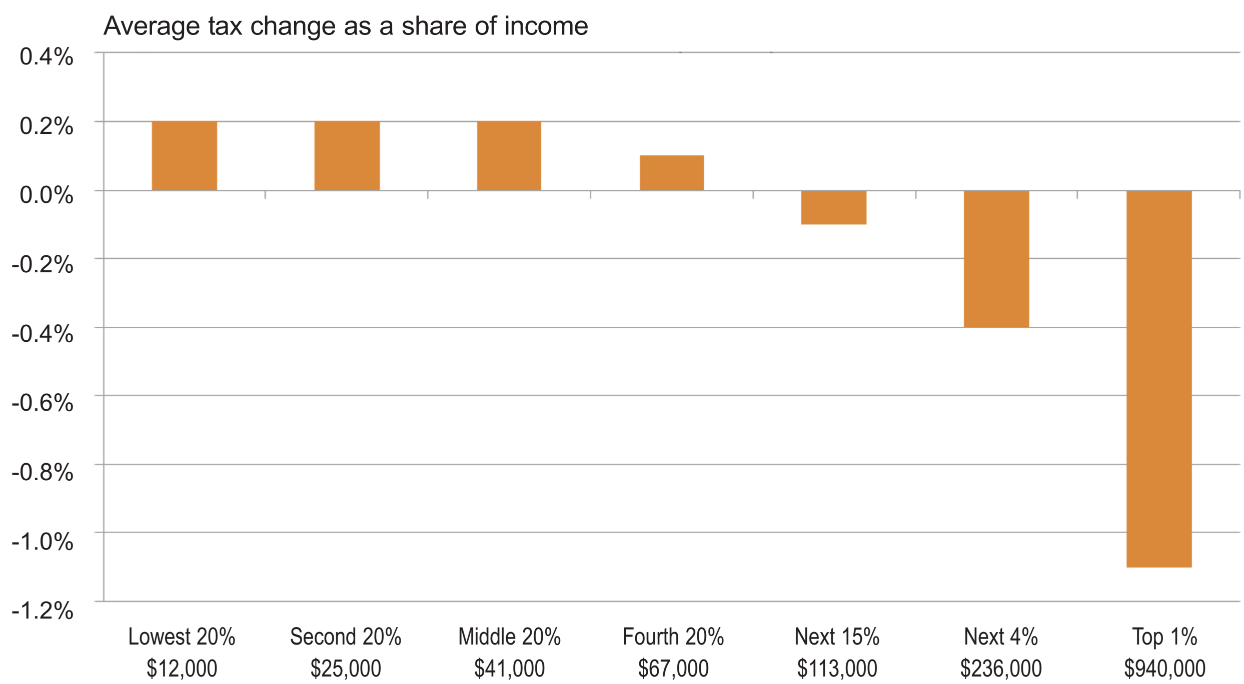
Sales Tax

- Expanded to include selected services such as warranty agreements for appliance purchases, auto repair contracts, and maintenance agreements.
- Electricity and piped natural gas taxed at combined general tax rate (franchise and excise tax on these items eliminated)
- Manufactured and modular homes taxed at general sales tax rate
- Entertainment and exhibitions taxed at general sales tax rate (privilege tax on these items eliminated)
- Sales tax holidays eliminated

Gas Tax

- Capped the gas tax at 37.5 cents per gallon

FIGURE 1: Tax plan increases taxes, on average, for bottom 80 percent of taxpayers



SOURCE: Special data request to ITEP, July 2013.

Proponents claim that the plan includes sufficient protections for low- and middle-income taxpayers, such as an increased standard deduction allowance and a $25 increase to the child tax credit for families with income under $40,000. However, these benefits are diminished since the plan also lowers the amount of income a family can earn before it has to start paying income taxes. Under current tax law, a married couple with two kids must earn around $23,400 in taxable income before paying income taxes. Under the new tax plan, this family will begin to pay income taxes once they earn around $19,400 in taxable income.[2] As a result, North Carolina will tax the first dollar of income sooner than all bordering states except Georgia (see Appendix).[3] Some low-income taxpayers who are slightly above the new income threshold will likely end up paying more in taxes as well, when accounting for the combined effect of the expiration of the state EITC and the expansion of the sales tax.

INCIDENCE VERSUS SCENARIO ANALYSIS

An incidence analysis provides insight into how the *average taxpayer* within a particular income range will be affected by tax changes. This analysis is more informative and preferable to scenario or sample taxpayer analysis, which can be helpful in providing insight into how a *particular taxpayer* profile – e.g. income level, number of children, and filing status – will be affected by tax changes, but has limitations. Assessing the impact for a single taxpayer profile, as with scenario analyses, does not show how the typical taxpayer within a particular income group will be affected by tax changes.[4]

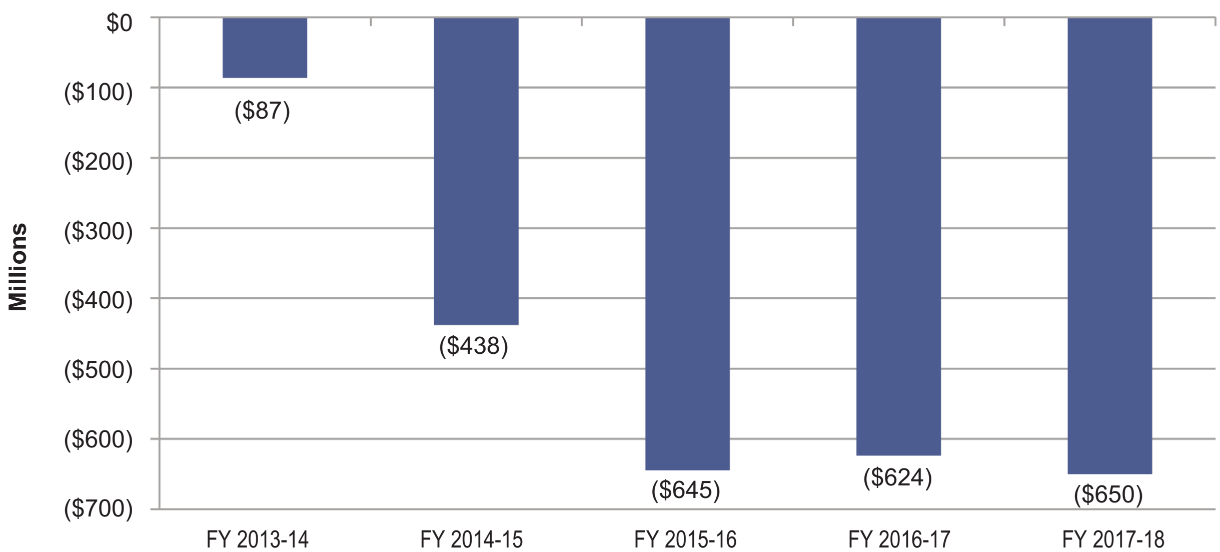
Fiscal Research conducted scenario analyses based on the tax plan and proponents incorrectly and misleadingly selected profiles with favorable outcomes – those in which taxpayers would get a tax cut – and used them to support their claim that all taxpayers would benefit under the tax plan. Proponents failed to present other scenarios conducted by Fiscal Research that show profiles in which the taxpayer would pay more in taxes under the plan. An incidence analysis makes clear that not all taxpayers will benefit under the tax plan and would have served as a much more informative analytical tool for policymakers.

Tax plan creates massive revenue loss

The personal income and corporate tax cuts in the plan alone will reduce annual state revenue by at least $964 million once the plan is fully implemented.[5] Additional revenue from changes to the sales tax and the elimination of a handful of tax breaks will not be nearly enough to make up for that, resulting in $650 million in net annual revenue loss upon full implementation of the plan, or more than $2.4 billion in total over five years (Figure 2).[6]

The overall cost of the tax plan could be larger than the estimates provided by Fiscal Research. Fiscal estimates presented by Fiscal Research are based on economic data for 2010. At that point, the number of lower income taxpayers was greater and there

FIGURE 2: Tax plan reduces annual General Fund tax revenue by at least $650 million



SOURCE: Fiscal note provided with joint tax plan.

NOTE: Fiscal note bases current tax law estimates on consensus revenue for first two years and uses 20-year average inflation and population growth in the out years. Annual revenue loss from repealing the estate tax included and additional revenue from repeal of the School Capital Building Fund is included.

were fewer upper income taxpayers as a result of the Great Recession and the slow economic recovery. Given that the personal income tax cuts benefited the wealthiest taxpayers more, using that year to construct estimates suggests that the fiscal impact could be underestimated as upper-income taxpayer's incomes have recovered. And the potential for a corporate income tax rate cut to move down to 3 percent would further grow the annual fiscal impact from the estimated $650 million. Furthermore since the tax changes are phased in over time, the full fiscal impact will not be felt until after 2015.

Tax plan does little to curb costly tax breaks

Spending as a share of total personal income for North Carolina is at historic lows.[7] This is partly a result of the state's tax system not keeping up with a 21st century economy that has become more service-oriented over time.[8] The current system does not tax most services and thus foregoes needed revenue and the opportunity to better align the tax code with where economic activity occurs. Furthermore, costly loopholes in the state's tax code reduce the amount of annual revenue collected; the tax plan does little to address this issue.

This failure violates an important principle of sound tax policy, adequacy, which aims to ensure that sufficient revenue is raised for schools, health care, roads and other public investments. Reducing pervasive tax loopholes would not only increase state revenue but also simplify the tax code, since fewer tax loopholes would make the state's tax system easier to navigate and likely reduce compliance costs for businesses and individuals.

For tax year 2012, North Carolina's tax code included 318 different tax breaks that cost $9.2 billion in foregone tax revenue.[9] The new tax plan eliminates only about 47 of the tax breaks and falls far short of making up for the costly tax cuts in the plan.[10] The net result of tax cuts and other changes to the personal and corporate income, the elimination of tax breaks, changes in several credits and exemptions, and the sales tax expansion is an estimated revenue shortfall of $650 million upon full implementation of the tax plan.

CHARITABLE CONTRIBUTION DEDUCTIONS EXPANDED UNDER FINAL TAX PLAN

The tax deduction for charitable contributions will no longer be limited in North Carolina. This is a significant change from current law, which limits the total amount of itemized deductions that a taxpayer can claim.[11] The new tax plan allows taxpayers who donate to charities to deduct 100 percent of their contributions from their taxable income, with no limit on the total amount that can be deducted. This provision will result in around $139 million in lost revenue[12] – enough to place thousands of additional teacher assistants in K-12 classrooms[13] – and is unlikely to drive significant new donations to charities.[14] The tax benefit of making charitable contributions for taxpayers in the top income tax bracket is largely influenced by the top federal marginal income tax rate, which state law does not affect, according to analysis by the Urban Institute and the Tax Policy Center.[15]

Tax plan likely to hurt North Carolina's competitiveness

Proponents contend that the tax plan will make North Carolina more competitive with other Southern states. They cite North Carolina's persistently high unemployment rate as evidence that the state is uncompetitive, and claim that its marginal tax rates discourage businesses from coming to the state. However, evidence does not support the claim.

North Carolina is in the middle of the pack with surrounding states in every major indicator of economic health except for its unemployment rate.[16] Excluding Virginia, the state has the lowest poverty rate in the region, the second-highest median household income, and the second-highest annual per capita economic growth rate.[17] North Carolina ranks high among surrounding states in research and development spending per capita and U.S. patents per capita. The state's high unemployment rate is largely a result of its relatively heavier reliance on declining and less competitive manufacturing industries over the past decade. If the state's manufacturing employment had simply matched national trends over that period, North Carolina would have at least 108,000 more jobs than we do today.[18]

In fact, the tax plan's significant corporate income tax cut is unlikely to boost the state's economy, and is more likely to hurt it since the tax cut will drain money from schools, colleges, public safety and other services that businesses rely on to help them thrive. All state and local taxes typically comprise only 2 percent or less of business costs, with state corporate income taxes representing a small share.[19] Cutting the corporate income tax rate is unlikely to lead a business to hire additional workers or expand its operations. Far more important to businesses' decisions about hiring is whether there is customer demand. Furthermore, businesses rely on many of the public investments – an educated workforce, quality roads and other infrastructure, and research and development – that will likely be cut as a result of the tax plan. A review of the academic literature on state and local taxes and economic performance by the Center on Budget and Policy Priorities highlights that the research landscape fails to support claims that lower state and local taxes are always better for economies.[20] The study notes that 18 of 20 relevant articles and edited compilations on the topic conclude that state and local tax levels have essentially no effect on various measures of state economic performance or suggest that adverse impacts are minimal or limited to particular taxes or time periods.[21]

Conclusion

The new tax plan puts North Carolina on the wrong track and will hamstring the state's ability to invest in public services that promote economic opportunity for all North Carolinians. By reducing the amount of revenue available for investment in public schools, health care, and public safety, the tax plan will continue to hamper our ability to meet the needs of a growing and changing North Carolina. More students in public schools and colleges will require additional investments. Students and families will likely continue to see the cost of a college education increase – tuition within the UNC System has increased by nearly 80 percent since 2002 when adjusted for inflation. Furthermore, North Carolina's overall population is aging, and over the next 20 years, one in four residents will be in the 60+ age group, meaning there will be a greater need for health care and other services for seniors.[22]

Much more work remains to be done to bring the state's tax system up to par with a 21st century economy in a manner that is fair, produces adequate revenue to meet our growing needs, and is stable from year to year. Clearly, true tax reform remains to be done in North Carolina.

See Appendix, page 8.

APPENDIX

2011 State Income Tax Thresholds Single-Parent Family of Three			Enacted Tax Plan Single-Parent Family of Three			2011 State Income Tax Thresholds Two-Parent Family of Four			Enacted Tax Plan Two-Parent Family of Four		
Rank	State	Threshold	Rank	State	Threshold	Rank	State	Threshold	Rank	State	Threshold
1	Alabama	$9,800	1	Alabama	$9,800	1	Montana	$12,500	1	Montana	$12,500
2	Illinois	$10,000	2	Illinois	$10,000	2	Alabama	$12,600	2	Alabama	$12,600
3	Montana	$10,300	3	Montana	$10,300	3	Illinois	$13,100	3	Illinois	$13,100
4	Georgia	$12,700	4	Georgia	$12,700	4	Georgia	$15,900	4	Georgia	$15,900
5	Hawaii	$13,800	5	Hawaii	$13,800	5	Ohio	$16,600	5	Ohio	$16,600
6	Mississippi	$14,400	6	Mississippi	$14,400	6	Hawaii	$17,800	6	Hawaii	$17,800
7	Missouri	$14,500	7	Missouri	$14,500	7	Missouri	$18,300	7	Missouri	$18,300
8	Ohio	$15,000	8	Ohio	$15,000	8	Iowa	$19,300	8	Iowa	$19,300
9	Lousiana	$16,800	9	North Carolina	$16,400	9	Mississippi	$19,600	9	North Carolina	$19,400
10	Oregon	$17,000	10	Lousiana	$16,800	10	Oregon	$20,200	10	Mississippi	$19,600
11	West Virginia	$18,500	11	Oregon	$17,000	11	Indiana	$20,500	11	Oregon	$20,200
12	Indiana	$18,500	12	West Virginia	$18,500	12	Louisiana	$21,300	12	Indiana	$20,500
13	Kentucky	$18,500	13	Indiana	$18,500	13	Arkansas	$22,200	13	Louisiana	$21,300
14	Arkansas	$18,500	14	Kentucky	$18,500	14	West Virginia	$22,400	14	Arkansas	$22,200
15	Iowa	$18,900	15	Arkansas	$18,500	15	Kentucky	$22,400	15	West Virginia	$22,400
16	North Carolina	$19,100	16	Iowa	$18,900	16	North Carolina	$23,400	16	Kentucky	$22,400
17	North Dakota	$19,600	17	North Dakota	$19,600	17	Arizona	$23,600	17	Arizona	$23,600
18	Colorado	$19,600	18	Colorado	$19,600	18	North Dakota	$26,400	18	North Dakota	$26,400
19	Idaho	$19,700	19	Idaho	$19,700	19	Colorado	$26,400	19	Colorado	$26,400
20	Utah	$20,000	20	Utah	$20,000	20	Idaho	$26,500	20	Idaho	$26,500
21	Arizona	$20,100	21	Arizona	$20,100	21	Utah	$26,900	21	Utah	$26,900
22	Wisconsin	$22,000	22	Wisconsin	$22,000	22	Wisconsin	$27,500	22	Wisconsin	$27,500
23	Virginia	$23,300	23	Virginia	$23,300	23	Virginia	$27,700	23	Virginia	$27,700
24	Oklahoma	$24,200	24	Oklahoma	$24,200	24	Oklahoma	$28,400	24	Oklahoma	$28,400
25	Maine	$25,000	25	Maine	$25,000	25	Massachusetts	$29,500	25	Massachusetts	$29,500
26	Pennsylvania	$25,500	26	Pennsylvania	$25,500	26	Maine	$29,700	26	Maine	$29,700
27	South Carolina	$26,100	27	South Carolina	$26,100	27	Michigan	$30,800	27	Michigan	$30,800
28	Massachusetts	$26,300	28	Massachusetts	$26,300	28	Kansas	$31,200	28	Kansas	$31,200
29	Michigan	$26,400	29	Michigan	$26,400	29	Pennsylvania	$32,000	29	Pennsylvania	$32,000
30	Delaware	$26,800	30	Delaware	$26,800	30	Delaware	$32,100	30	Delaware	$32,100
31	Nebraska	$27,700	31	Nebraska	$27,700	31	District of Columbia	$32,800	31	District of Columbia	$32,800
32	Kansas	$27,800	32	Kansas	$27,800	32	South Carolina	$32,900	32	South Carolina	$32,900
33	District of Columbia	$29,800	33	District of Columbia	$29,800	33	Nebraska	$33,700	33	Nebraska	$33,700
34	New Jersey	$31,300	34	New Jersey	$31,300	34	New Jersey	$35,200	34	New Jersey	$35,200
35	Maryland	$32,800	35	Maryland	$32,800	35	Maryland	$37,300	35	Maryland	$37,300
36	Rhode Island	$33,000	36	Rhode Island	$33,000	36	Rhode Island	$39,000	36	Rhode Island	$39,000
37	Vermont	$33,600	37	Vermont	$33,600	37	Minnesota	$39,300	37	Minnesota	$39,300
38	Minnesota	$33,600	38	Minnesota	$33,600	38	Vermont	$39,300	38	Vermont	$39,300
39	New Mexico	$34,200	39	New Mexico	$34,200	39	New Mexico	$40,000	39	New Mexico	$40,000
40	New York	$34,900	40	New York	$34,900	40	Connecticut	$40,500	40	Connecticut	$40,500
41	Connecticut	$35,000	41	Connecticut	$35,000	41	New York	$40,700	41	New York	$40,700
42	California	$46,900	42	California	$46,900	42	California	$49,400	42	California	$49,400
	Average Threshold	$23,131		Average Threshold	$23,067		Average Threshold	$27,545		Average Threshold	$27,450

NOTE: A threshold is the lowest income level at which a family has state income tax liability. In this table thresholds are rounded to the nearest $100. The threshold calculations include earned income tax credits, other general tax credits, exemptions, and standard deductions. Credits that are intended to offset the effects of taxes other than the income tax or that are not available to all low-income families are not taken into account.

The tax year 2011 thresholds for North Carolina include a state EITC equal to 5 percent of the federal credit amount, only accounts for non-elderly households, and do not include the impact of the business deduction. Threshold estimates for North Carolina under final tax plan provided by the Institute on Taxation and Economic Policy and accounts for a typical non-elderly, low-income household.

1 The tax plan includes a trigger that allows the corporate income tax rate to be reduced to 4 percent for FY 2016 and 3 percent percent for FY 2017 if net General Fund tax collection reaches certain levels during the previous tax year.

2 These figures are based on 2011 tax laws in which the value of the state EITC was 5 percent of the federal EITC. For 2013, the value of the state EITC was reduced to 4.5 percent of the federal EITC. As a result the income threshold at which a married couple with two children would begin to pay income taxes is actually even low as a result of reducing the value of the state EITC.

3 Center on Budget and Policy Priorities and Institute on Taxation and Economic Policy

4 Mazerov, Michael, January 2002, Developing the Capacity to Analyze the Distributional Impact of State and Local Taxes: Issues and Options for States. Center on Budget and Policy Priorities: Washington, DC.

5 Revenue figure is based on fiscal analysis conducted by Fiscal Research Division and provided with joint tax plan.

6 Ibid

7 Tazra Mitchell, "The 2013-15 Fiscal Year Final Budget: Putting North Carolina on a Path to Mediocrity," NC Budget and Tax Center, Raleigh, NC, August 2013.

8 "Seizing the Opportunity: Ensuring North Carolina's Revenue Modernization Is Evidence-based, Adequate, and Fair," NC Budget & Tax Center, Raleigh, NC, November 2012.

9 North Carolina Biennial Tax Expenditure Report, 2011; North Carolina Department of Revenue, Policy Analysis and Statistics Division.

10 The report author identified a total of 47 different tax provisions, or tax loopholes, for the personal income, corporate income, and sales taxes under the plan that are repealed in the tax plan. The estate tax is also repealed in the tax plan but not included as one of the 47 repealed tax loopholes. The estimate also account for costs associated with modified and additional tax provisions under the plan, such as the enhanced child tax credit and an increased sales tax rate on electricity and piped natural gas.

11 Limitations on the amount of itemized deductions a taxpayer can claim on their federal income taxes is based on the Pease amendment. The Tax Policy Center provides an overview regarding how the Pease provision works.

12 Special data request to ITEP, July 2013.

13 The final state budget for FY2014 includes a $120 million funding cut for K-12 teacher assistant. The NC Department of Instruction estimates that a $142.3 million funding cuts would equate to 4,580 fewer teacher assistant positions. The $139 million revenue loss from the charitable contribution equates to around 4,473 positions.

14 Chye-Ching Huang, Chuck Marr, and Robert Greenstein, "Pease" Provision in Fiscal Cliff Deal Doesn't Discourage Charitable Giving and Leaves Room for More Tax Expenditure Reform, Policy report, Center on Budget and Policy Priorities, Washington, D.C., January 2013.

15 Joseph Rosenberg, C. Eugene Steuerle, and Katherine Toran, "What Does the Fiscal Cliff Deal Mean for Nonprofits?," Urban Institute and Tax Policy Center, January 2013.

16 Allan Freyer, North Carolina's Economy Is Competitive with Neighboring States, BTC Brief, NC Budget and Tax Center, Raleigh, NC, May 2013.

17 Ibid.

18 Ibid.

19 Cedric D. Johnson and Alexandra F. Sirota, Cutting Corporate Income Taxes Won't Be an Economic Boon for North Carolina, BTC Brief, NC Budget and Tax Center, Raleigh, NC, April 2013.

20 Michael Mazerov, "Academic Research Lacks Consensus on the Impact of State Tax Cuts on Economic Growth: A Reply to the Tax Foundation," Center on Budget and Policy Priorities, Washington, D.C., June 2013.

21 Ibid.

22 A Profile of People Age 60 and Over, North Carolina; North Carolina Division of Aging and Adult Services report, 2012.

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