BTC Brief
BUDGET & TAX CENTER

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First Comprehensive Tax Proposal Out of the Gate Stumbles: Low- and Middle-Income Families Not Protected from Tax Shift

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KEY FINDINGS

- **80 percent of taxpayers would see slightly higher taxes under the first comprehensive tax legislation introduced this legislative session, while the top 1 percent of earners would get a tax cut.**
- **The proposal threatens to erode resources for schools, health care and other services North Carolina needs to be economically competitive.**
- **The proposal (Senate Bill 394) would create a flat personal income tax rate of 6 percent, but include a zero percent tax bracket for the first $11,000 of income. It would eliminate some deductions and loopholes, cut the corporate income tax rate to 6 percent, extend the sales tax to services and lower the rate from 4.75 to 4.5 percent, and make changes to the state's franchise tax.**
- **Creating a flat personal income tax rate will not improve economic growth. It would also erode revenue over the long term.**
- **A zero tax bracket is no substitute for a refundable Earned Income Tax Credit and is insufficient to protect low-income taxpayers from the disproportionate impact they would feel from higher sales taxes.**

Misnamed Tax Legislation Unlikely to Strengthen NC Economy

The first legislation of the 2013 legislative session to overhaul the state's tax code—Senate Bill 394, entitled "Lower Tax Rates for a Stronger NC Economy"— was filed by Senators Clodfelter, Hartsell, Jenkins and Meredith in March. This bill proposes changes to the personal, corporate, franchise and sales taxes, with the overall goal of achieving revenue neutrality by eliminating exemptions and loopholes and lowering all rates.

The legislation would eliminate North Carolina's current income tax bracket, in which people pay higher rates as their incomes rise, and replace it with a zero-percent bracket on the first $11,000 of income and a flat 6-percent rate. It would result in a significant reduction in state revenue from the personal income tax.

The bill also proposes lowering the sales tax rate and expanding the number and type of transactions to which it is applied, and it proposes lowering the corporate tax rate while eliminating some loopholes. Overall, the proposal would result in a tax cut for most high-income taxpayers and a tax increase for many low-income taxpayers.

While the proposal taken as a whole is supposed to be "revenue-neutral"—with revenue lost from changes to the personal income tax made up for by changes to the corporate and sales taxes—the net result could actually be a drop in tax revenue. Furthermore, the reductions to the personal income tax alongside expansions to the sales tax would shift the state's tax load away from high-income taxpayers and onto the shoulders of middle- and low-income families. While this shift may be slight, it is still harmful, particularly since these families continue to struggle in the wake of the Great Recession.

While supporters argue that lower personal income tax rates lead to growth, this has proven to be false. The experiences of more than 15 states over the last two decades have shown that income tax rate cuts did not deliver improved growth, a finding backed by extensive academic research.[1] Reductions in top tax rates have had little association with saving, investment, or productivity growth, according to one analysis.[2]

This BTC Brief analyzes the personal income and sales tax components of this legislation (See Appendix on Detailed Tax Components of Senate Bill 394).

Cuts taxes for top 1 percent of taxpayers while raising taxes for 80 percent of taxpayers

The changes to the personal would be made up by expanding the sales tax to services without significantly lowering the sales tax rate. Greater reliance on the sales tax to raise roughly the same overall revenue means that the bottom 80 percent of taxpayers would pay slightly more on average while the top 1 percent would see a tax cut on average under the plan.

The zero-percent tax bracket, which is intended to primarily benefit low-income taxpayers, and the elimination of itemized deductions, which would impact high-income taxpayers, together are insufficient to address the already upside-down nature of the state's tax system, which would be made worse by the creation of a flat tax rate.

As seen in Figure 1, these tax changes would actually shift the tax load further to low-income North Carolinians. Of those in the top 1 percent, 87 percent would receive a tax cut while just 35 percent of those in the bottom 20 percent would see their tax contributions reduced.

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2013 Income Level	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $19,000	$19,000 – $32,000	$32,000 – $52,000	$52,000 – $84,000	$84,000 – $169,000	$169,000 – $393,000	$393,000 – Or More
Average Income in Group	$12,000	$25,000	$41,000	$67,000	$113,000	$236,000	$940,000
Impact of Comprehensive Personal Income Tax Changes							
Tax Change as % of Income	–0.5%	–0.5%	–0.2%	+0.1%	–0.2%	+0.0%	–0.7%
Average Tax Change	–55	–118	–99	+63	–183	+86	–6,415
% with Income Tax Increase	+4%	+13%	+28%	+44%	+32%	+42%	+12%
Avg. Tax Increase for those with increase	+144	+255	+439	+805	+1,452	+2,123	+3,213
Share of Tax Increase	1%	3%	12%	33%	33%	17%	2%
% with Income Tax Cut	+35%	+61%	+59%	+53%	+66%	+57%	+87%
Avg. Tax Cut for Those w/ Cut	–173	–250	–380	–550	–973	–1,402	–7,766
Share of Tax Cut	4%	9%	13%	17%	28%	9%	20%
Impact of Personal Income and Sales Tax Changes Combined							
Tax Change as % of Income	+0.1%	+0.0%	+0.2%	+0.4%	+0.1%	+0.2%	–0.6%
Average Tax Change	+14	+9	+68	+275	+67	+383	–5,777

Source: Special Data Request from the Institute on Taxation and Economic Policy, March 27, 2013. Assumes higher cost of business tax exemption.

Zero Tax Bracket No Substitute for Refundable Earned Income Tax Credit

A zero-percent tax bracket and state Earned Income Tax Credit (EITC) are both strategies for helping low-income North Carolinians. The zero-percent tax bracket as proposed in Senate Bill 394 would mean all income below the threshold—$11,000 for married taxpayers filing jointly—would not be taxed, and taxpayers whose total income is below that threshold would face no income tax liability. However, many of these North Carolinians already owe no income taxes after taking the standard deduction and personal exemption.

A zero-percent tax bracket is a costly way to address the fact that the state's tax system asks lower- and middle-income households to pay more taxes than higher – income households. Implementing a standard deduction at the same threshold and phasing the value out for higher-income households would cost roughly $100 million less than a zero-percent tax bracket. [3]

A refundable EITC benefits only low-income taxpayers who work. This policy offsets a taxpayer's income liability, but unlike the zero-percent tax bracket, it also addresses

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their disproportionate contributions through sales and property taxes. In addition, the EITC increases with family size and phases out gradually, and its income thresholds are tied to inflation.

Proposal would Erode Revenue Over Time

Though supporters say it is revenue neutral, total state revenue might drop under this proposal. The revenue loss from personal income tax changes could range from $583 million to $809 million (the wide range is due to the unknown cost of the business tax deduction passed in 2011).[4] Whether the changes to the sales tax and corporate income tax will raise enough revenue to cover the loss in personal-income-tax revenue is difficult to predict.

In any case, to adequately fund schools, roads, health care and other vital services, North Carolina needs *more* revenue than it is currently taking in. North Carolina is at a 40-year low in revenue collections as a share of the state's economy, largely as a result of the Great Recession. Revenue-neutral tax changes would lock in this low level of revenue.

Moreover, creating a single, flat rate for the personal income tax would undermine the long-term abilit of the state's tax system to keep up with our needs. For the past three decades, income gains have been concentrated among the highest earners; therefore, a graduated income-tax-rate that rises along with a taxpayers' income is a more stable source of revenue for the state. A flat structure means revenue collection will be less able to keep pace with the needs in communities.

Base-Broadening Measures a Positive Step Towards Reform

While this legislation would not fix the problems of adequacy and equity in the state's tax system, it does contain measures that are positive steps toward reform. These measures primarily focus on broadening the base upon which the tax rates are applied and include:

- Eliminating and phasing out itemized deductions in the personal income tax
- Eliminating loopholes and exemptions for corporate income tax
- Expanding the sales tax base to some services

Policymakers could pursue these base-broadening measures and maintain the current income tax rates to increase revenue collections. Indeed, doing so would enable policymakers to better meet the state's needs for an educated workforce, safe communities and sound infrastructure.

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Conclusion

As North Carolina's policymakers debate proposals for state tax reform, it will be important that they heed the robust evidence that tax cuts are a poor strategy for growth and instead focus on fixing the upside-down nature of the tax system. Doing so would provide policymakers with the resources to make investments that support the state's economic growth, such as educating children, rebuilding community infrastructure and maintaining strong courts and public safety.

1 Michael Leachman, Michael Mazerov, Vincent Palacios, and Chris Mai. "State Personal Income Tax Cuts: A Poor Strategy for Economic Growth," Center on Budget and Policy Priorities, Washington, D.C., March 2013.
2 Thomas L. Hungerford, "Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945," Congressional Research Service, Washington, D.C., September 2012.
3. Special Data Request to Institute on Taxation and Economic Policy, March 27, 2013.
4 Sirota, Alexandra and Brenna Burch, BTC Brief: North Carolina's Business Tax Deduction: Who Benefits? N.C. Justice Center: Raleigh, NC.

Detailed Tax Components of Senate Bill 394

Personal Income Tax Changes

- Establishes a zero-percent tax bracket and flat 6-percent rate
- Eliminates personal exemptions
- Eliminates standard and itemized deductions
- Eliminates $50,000 business exemption
- Eliminates non-Bailey retirement deductions
- Taxes Social Security income the same as the federal government
- Eliminates the current child tax credit and establishes a new larger credit that phases out at higher incomes
- Eliminates the current charitable contribution credit for non-itemizers and establishes a new credit capped at $600
- Establishes a personal expense tax credit that is a minimum of $200 and capped at $800
- Eliminates the child and dependent care credit and several other credits

Sales Tax Changes

- Reduces the rate from 4.75 percent to 4.5 percent
- Expands the base to include some services taxed by other states; particularly focuses on services related to installation, repair and maintenance of real property
- Requires local governments to share half of the 2-percent food tax with the state

Corporate Income Tax Changes*

- Reduces the rate from 6.9 percent to 6 percent
- Closes most major tax loopholes except those related to research and development and low-income housing

Franchise Tax Changes*

- Reduces the rate from $1.50 per $1,000 to $1.00 per $1,000
- Expands the base to include all entities with limited liability

*These changes are not assessed in this analysis.

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