



Seizing the Opportunity



ENSURING
NORTH CAROLINA'S
REVENUE MODERNIZATION
IS EVIDENCE-BASED,
ADEQUATE,
AND FAIR



Seizing the Opportunity

NORTH CAROLINA'S OUTDATED REVENUE SYSTEM is in dire need of comprehensive reform – and if done right, this reform will expand access to opportunity for all North Carolinians and support economic growth.



The need for changes in our tax system is clear. For decades, North Carolina's revenue system failed to keep pace with the growing economy, and then the Great Recession caused years of revenue collapse. The result – underfunded schools, transportation networks in disrepair, and communities struggling to remain healthy and safe.



After all, the purpose of our revenue system is to fund investments in public structures—schools, courts, colleges and universities, health care and infrastructure—that are critical to building and preserving a strong middle class and a competitive economy.

However, because North Carolina's revenue system is inadequate, unaccountable, upside-down, and out-of-date, it fails to achieve these important goals.

North Carolina must design a revenue system that is accountable and transparent, does not ask more from those with the least, raises enough revenue to support our valued public structures, and is up-to-date with today's economy.

UPSIDE-DOWN

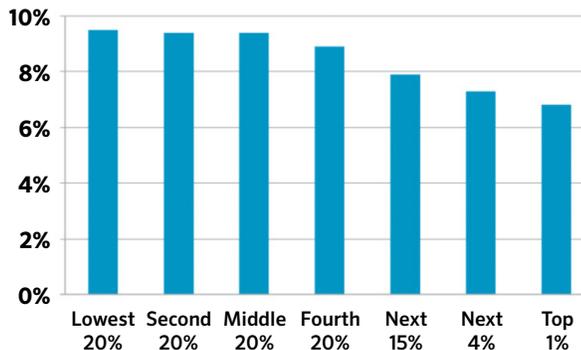
Because North Carolina's revenue system is upside-down, the average middle-income family pays a higher effective tax rate than the

richest people in the state. When you take all state and local taxes into account – income, sales and excise, property – someone who earns less than \$40,000 pays a 9.5% tax rate, while someone earning more than \$1 million pays only 6.8%.

Not only is this unfair; it contributes significantly to North Carolina's revenue problems. Thanks to the upside-down revenue system, North Carolina can't make needed investments in public structures that can help average families gain financial security.

Low- and Middle-Income Families Pay Greater Share of Income in State and Local Taxes than Wealthy

State and Local Taxes as a Share of Household Income in North Carolina



SOURCE: Institute on Taxation and Economic Policy - November 2009. Includes "federal offset" for reduced federal income taxes for state and local taxes deducted from federal taxable income.

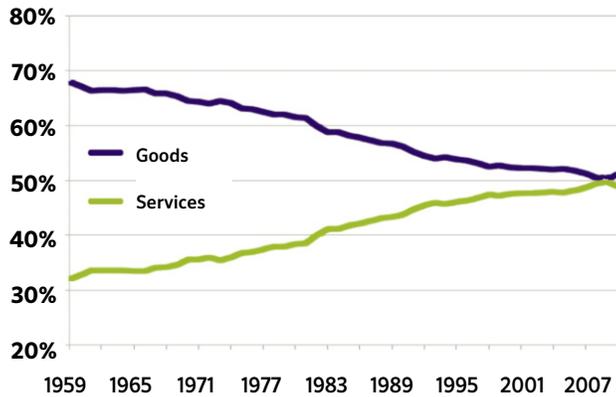
OUT OF DATE

North Carolina's revenue system was first established in the 1930s and has never been comprehensively updated. As a result, it fails to adequately capture a broad share of today's economic activity.

One example of this mismatch is the state sales tax, which is largely applied to the purchase of goods. In the 1930s, North Carolinians

Growth of Services Erodes Goods-Based Sales Tax

Personal Consumption Expenditures Share of Goods and Services (excludes health care, education, professional services, and housing)

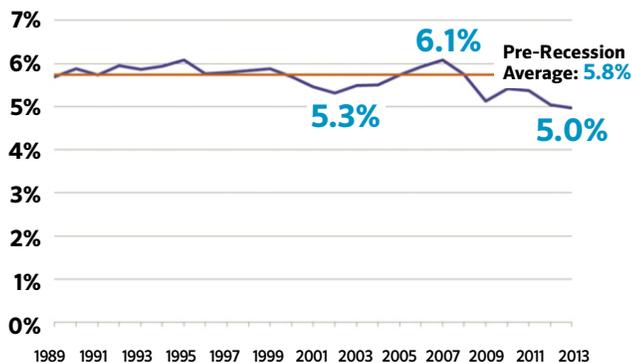


SOURCE: US Department of Commerce, Bureau of Economic Analysis, National Economic Accounts (For more information about revenue modernization, see the BTC report here: www.ncjustice.org/?q=node/789)

primarily purchased goods, such as farm equipment, food, or clothing. Today, most North Carolinians, like taxpayers across the country, purchase more services than goods, from dry cleaning to landscaping to housecleaning. As a result, the sales tax captures less and less of the activity occurring in the state's economy, resulting in lower overall revenues.

North Carolina Tax Revenues Projected to Reach Historic Lows

State Tax Collections Projected to Fall to 5 percent of State Personal Income in FY 2012-13



SOURCES: US Bureau of Economic Analysis, NC Office of State Budget and Management

INADEQUATE

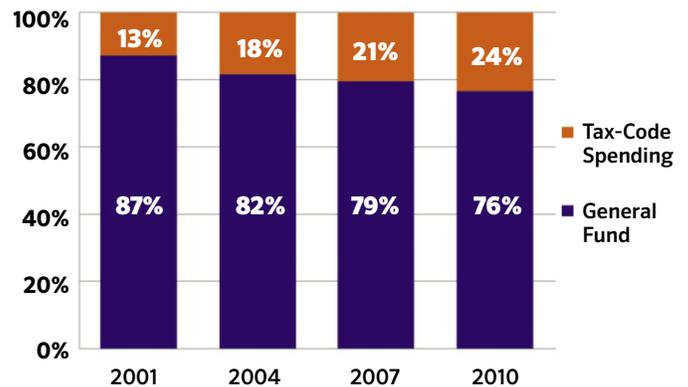
State revenue collections have collapsed in recent years as a result of the Great Recession. Without thoughtful and inclusive change, our state revenue system will be unable to keep pace with growth in the economy and fund adequate investments in education, health, safety, and infrastructure.

UNACCOUNTABLE

The revenue system isn't just about collecting money. Policymakers also spend public money through the tax code—rather than through the

Tax-Code Spending Grew by 80 Percent as Share of General Fund in 2000s

Ratio of Tax-Code Spending to General Fund Appropriations in Selected Fiscal Years



SOURCE: NC Biennial Tax Expenditure Reports; NC Fiscal Research (2001); Joint Conference Committee Reports

appropriations process—by creating tax breaks and “incentives.” Tax-code spending has grown in popularity with North Carolina lawmakers. But because this spending occurs outside of the regular budget process, it receives significantly less scrutiny in regards to the return on state investment.

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A REVENUE SYSTEM FOR THE 21ST CENTURY CAN SUPPORT ECONOMIC GROWTH AND ECONOMIC OPPORTUNITY

A growing body of research finds that **adequate, equitable and stable** revenue returns are great. Investments made with can boost economic output and expand tax revenues contribute to greater economic opportunity. When a state has economic opportunity and higher the funds available to make proven educational attainment, and they support investments in education, skills training, the expansion and attraction of businesses.¹

Comprehensive and effective revenue modernization must retain the three key components of the state's current revenue system: **the personal income tax, the corporate income tax, and the sales tax**. North Carolina needs the stability provided by diversified revenue sources in order to plan for the investments that will ensure its present and future competitiveness.

The following reforms are needed to improve the stability, equity and long-term adequacy of how these taxes work together to create a system that works for North Carolina.

- **Broaden the personal income tax by using adjusted gross income instead of federal taxable income. Adopt a more progressive rate structure, convert deductions to credits, and double the value of the state Earned Income Tax Credit.**
- **Broaden the sales tax to include services taxed by any other state in the nation. Reduce the state and local sales tax rates.**
- **Level the playing field in business taxes by enacting mandatory combined reporting for corporate income taxes, treating limited liability companies like other businesses, and eliminating ineffective business subsidies.**
- **Enhance accountability and transparency of tax-code spending by adopting a formal evaluation of existing tax-code spending and incorporating new tax-code spending proposals in the state budget.**

¹ Bauer, et al, 2006 and Chernick and Sturm, April 2005. Redistribution at the State and Local Level: Consequences for Economic Growth.

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THE BUDGET AND TAX CENTER IS A PROJECT OF THE



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