

North Carolina Tax Reform: Fairness and Other Considerations

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Discussion Topics

- ITEP's tax model— how it works, what it's good for
- State tax fairness: nationwide perspective
- Other tax reform principles
- Thoughts on subcommittee recommendations
- Lessons from other states

About ITEP

- Founded in 1980
- ITEP's research focuses primarily on state tax issues, with an emphasis on tax fairness and adequacy.
- In the past decade, we've conducted studies of state tax systems in Arkansas, Illinois, Iowa, Minnesota and New York.
- We've also conducted hundreds of smaller-scale tax analyses in over 40 states.
- What makes us useful: **ITEP Microsimulation Tax Model.**

The ITEP Tax Model-What it Does

- Predicts the distributional effect of proposed tax changes on taxpayers at different income levels
- Predicts the overall revenue gain (or loss) from proposed changes
- Estimates the overall state and local tax burden in each of the 50 states and Washington, DC
- Measures the interaction between state and federal tax changes (how state tax changes affect federal taxes paid, and how federal “tax mandates” affect the states)

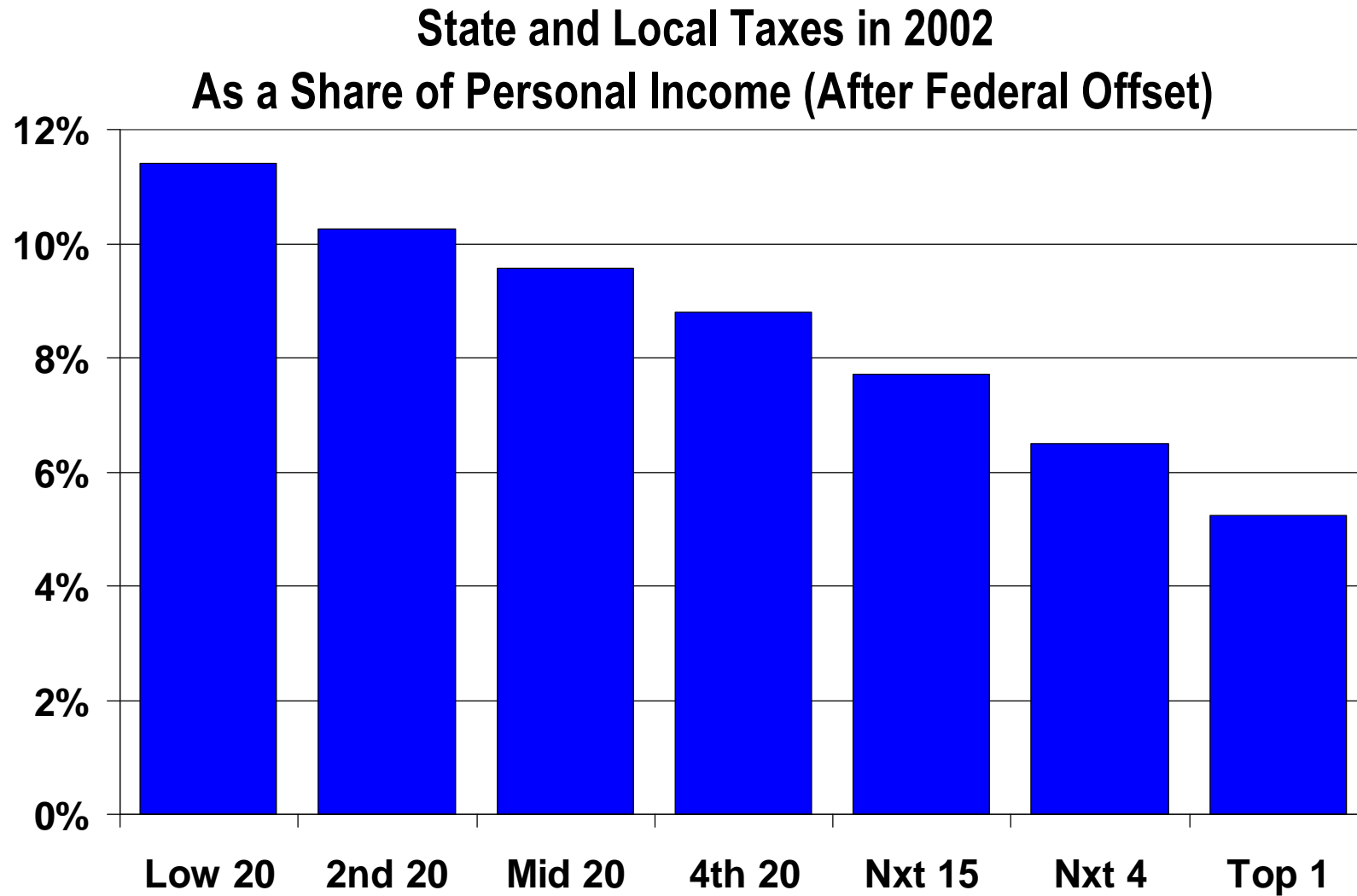
The ITEP Tax Model-How it Works

- Based on a sample of 750,000 federal tax returns, allows a statistically valid sample for all 50 states and D.C.
- Income data from these returns is “matched” with Consumer Expenditure Survey, Census Bureau, and other data to estimate property, sales and excise tax burdens for any year from 1988 to 2012.
- This “matching” process allows us to estimate the impact of proposed changes in sales, income, and property taxes in each state—and to estimate the impact of “tax swaps” involving more than one of these tax bases simultaneously.
- The use of federal tax data allows us to estimate the effect of state tax changes on federal taxes—and vice versa.

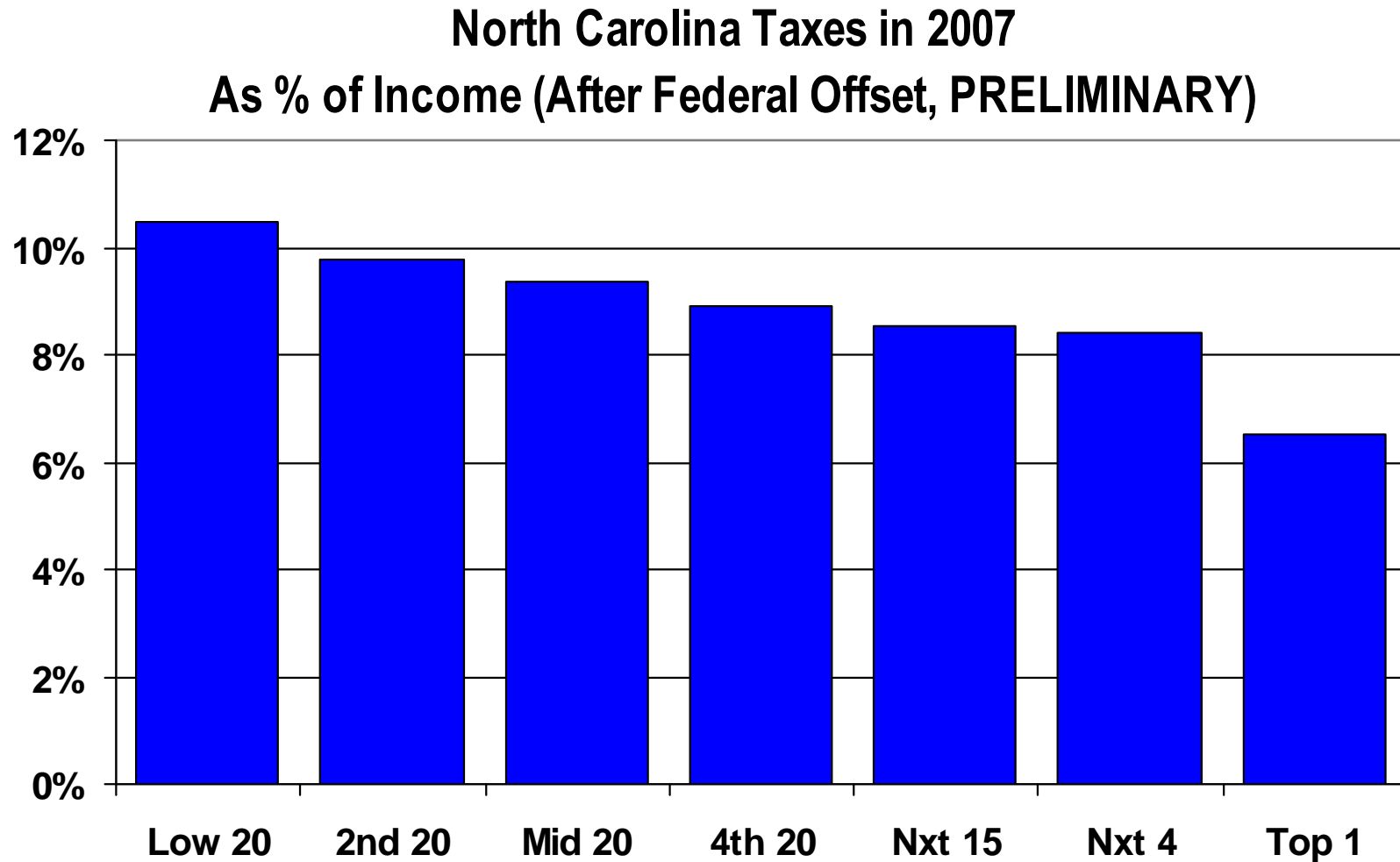
Principles for a 21st Century Tax System

- **Fairness:** Vertical and horizontal equity
- **Base-broadening** (broad base = low rate)
- **Adequacy**– short-term *and* long-term
- **Simplicity**
- **Economic Development Impact**
- **Neutrality**
- **Exportability**

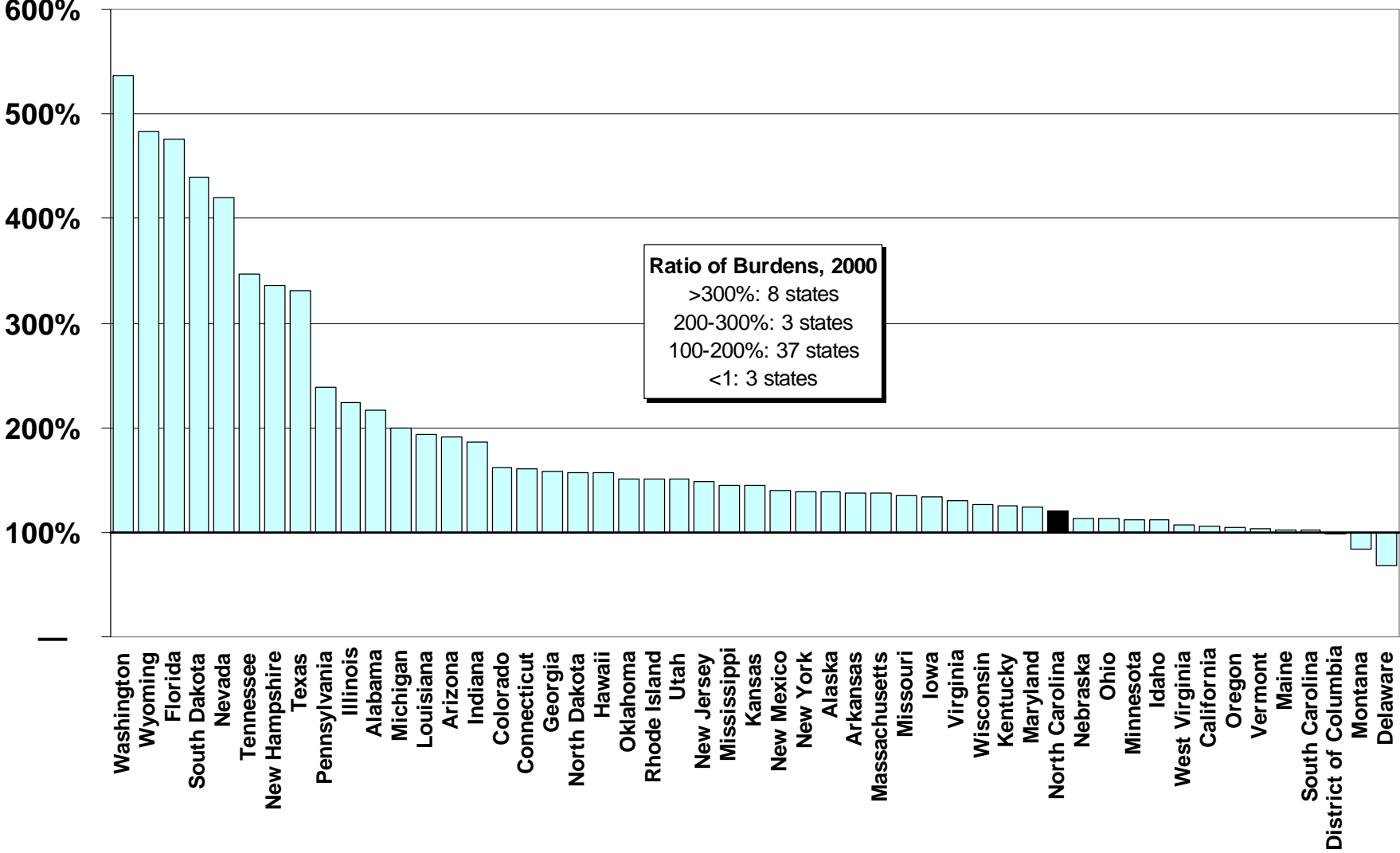
State and local taxes are regressive nationwide...



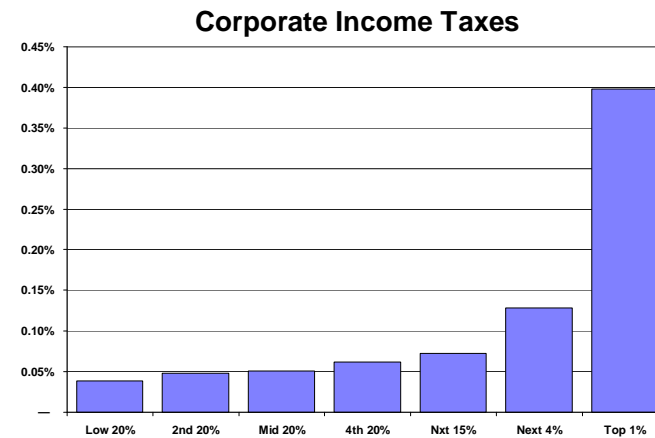
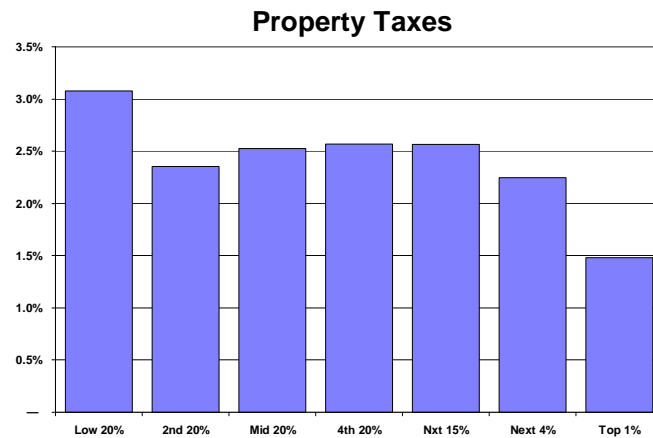
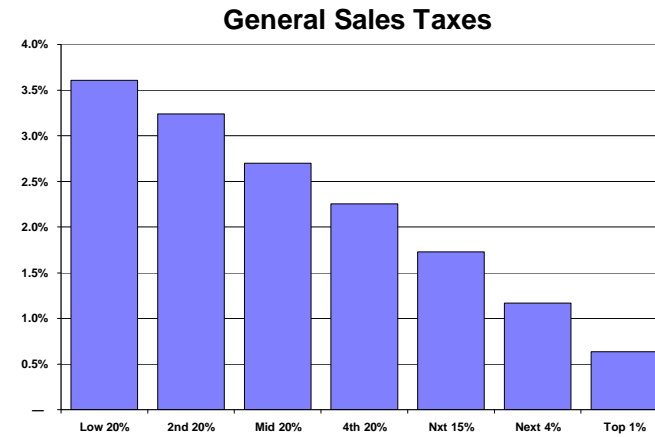
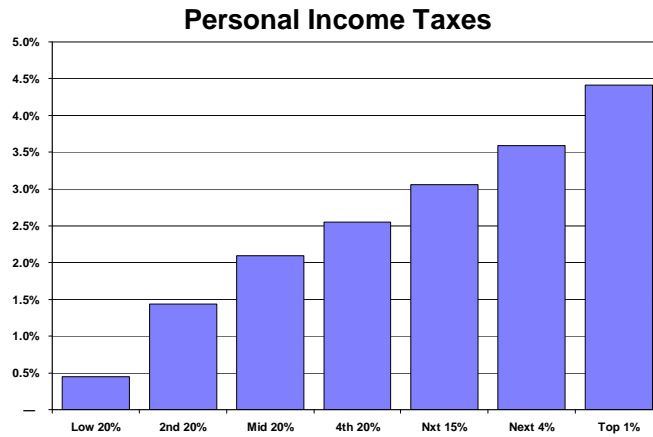
North Carolina's Tax System is Regressive Too



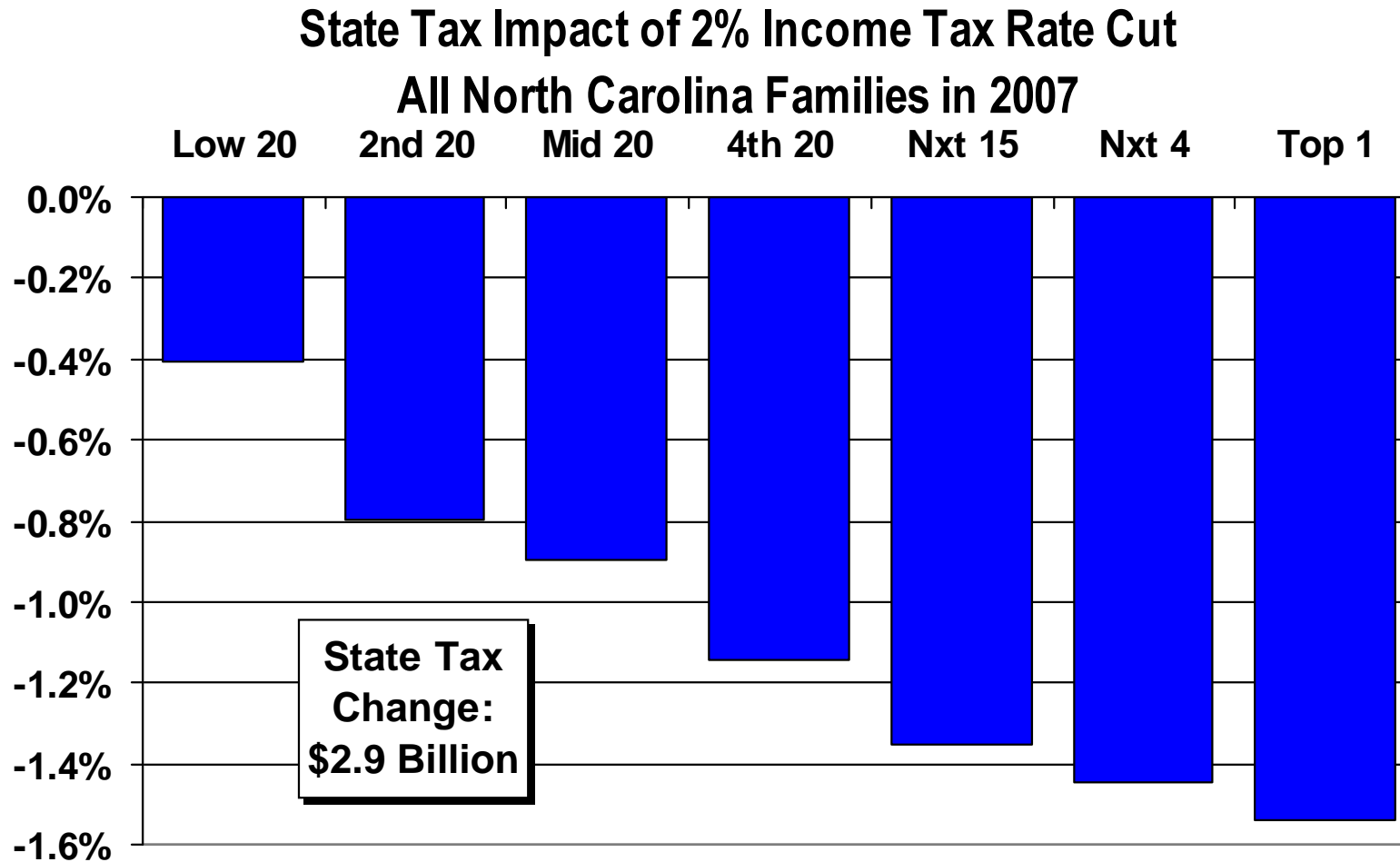
North Carolina's Tax System is Less Regressive Than That of Most Other States



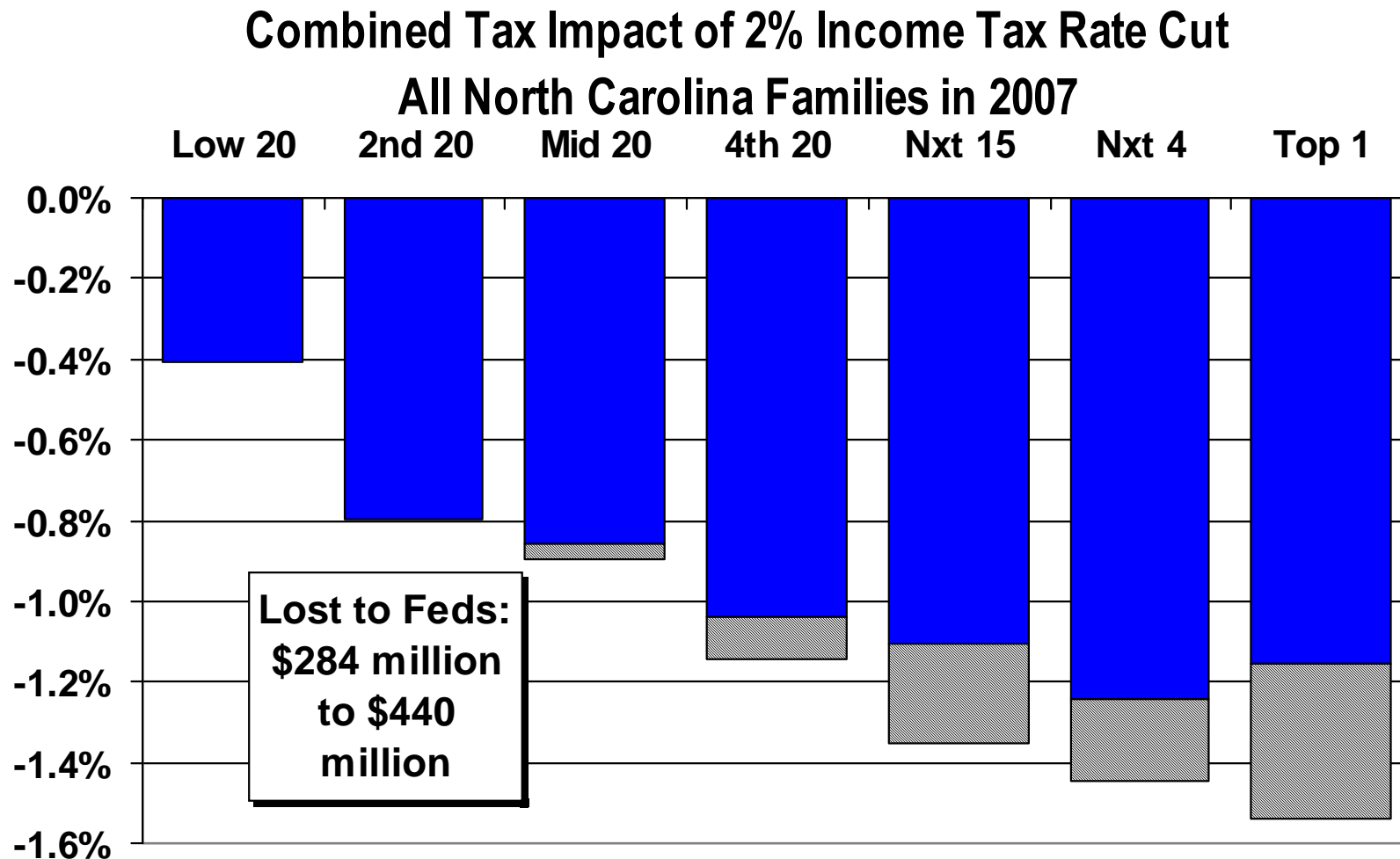
Building blocks of tax equity: progressive, proportional, regressive taxes.



“Across the Board” Income Tax Rate Cuts Would, Taken On Their Own, Make North Carolina’s Tax System More Regressive



But between 10 and 15 percent of this tax cut would never see the inside of Tarheels' wallets.

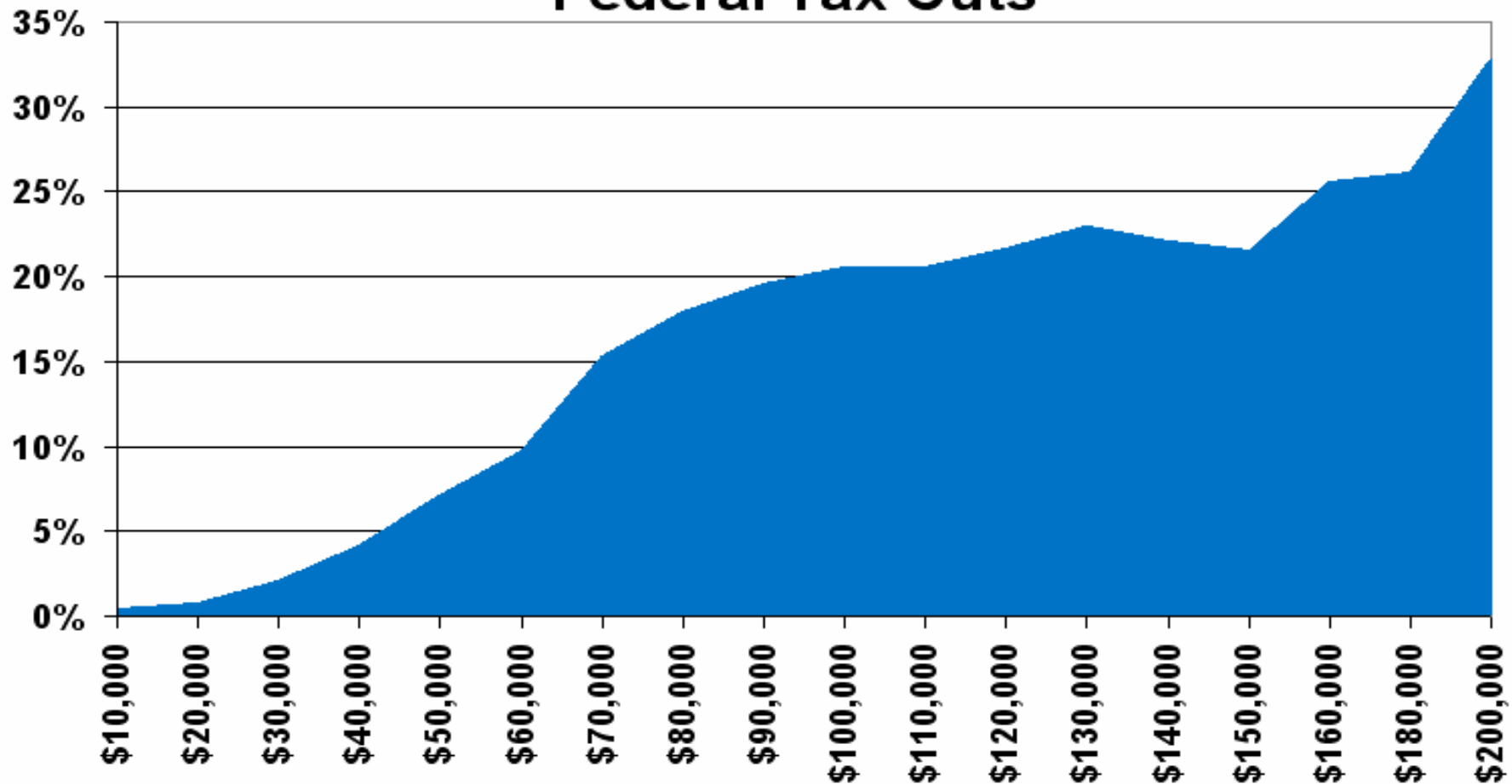


The “Federal Offset”: A Closer Look

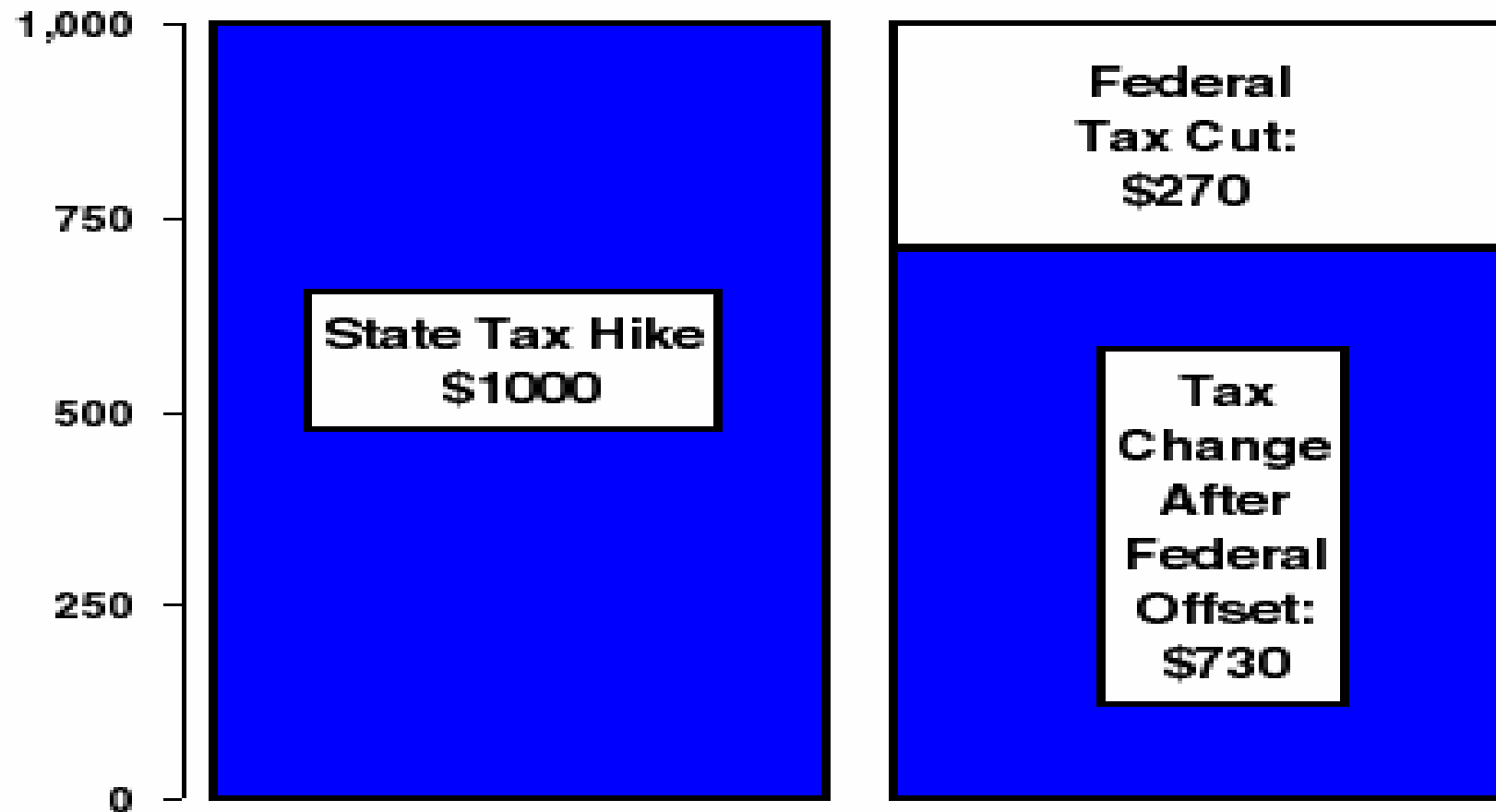
- North Carolina families who itemize their federal income taxes can write off their state income taxes.
- This is also true of property taxes and (temporarily) sales taxes, but only the income tax is targeted to federal itemizers who pay at high federal rates.
- The federal alternative minimum tax affects the federal offset because AMT taxpayers have this itemized deduction disallowed.
- Federal offset estimate varies depending on what you assume about federal AMT reform: under current law, offset is \$284 million (10% of state tax cut). Under 2006 AMT exemptions, offset is \$440 million (15%)

**Lesson #1: Federally deductible taxes are a good deal.
Cutting them is a bad deal.**

**% of State Income Tax Hikes Offset By
Federal Tax Cuts**

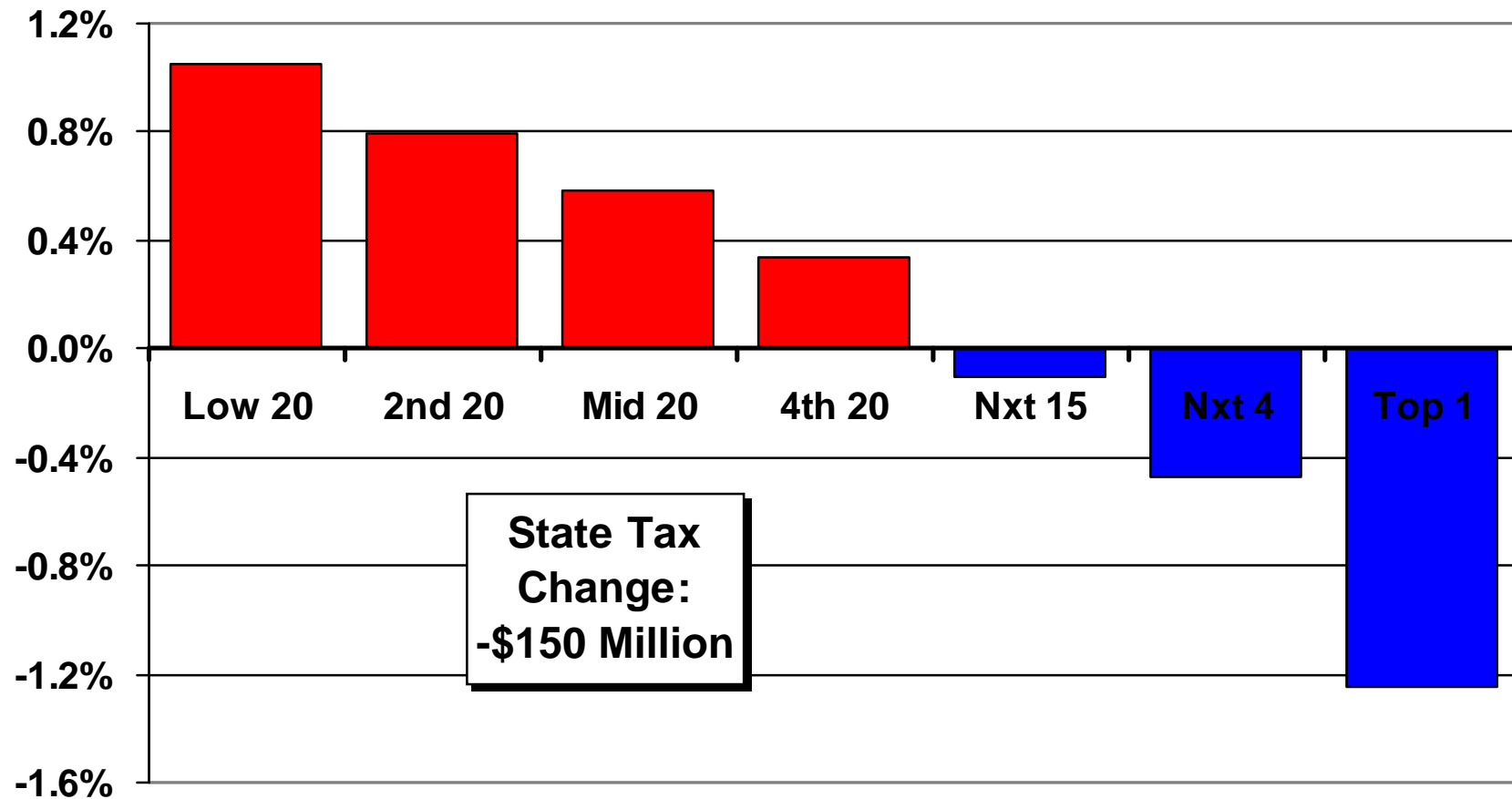


Lesson #2: federally deductible taxes are never as burdensome as they seem.



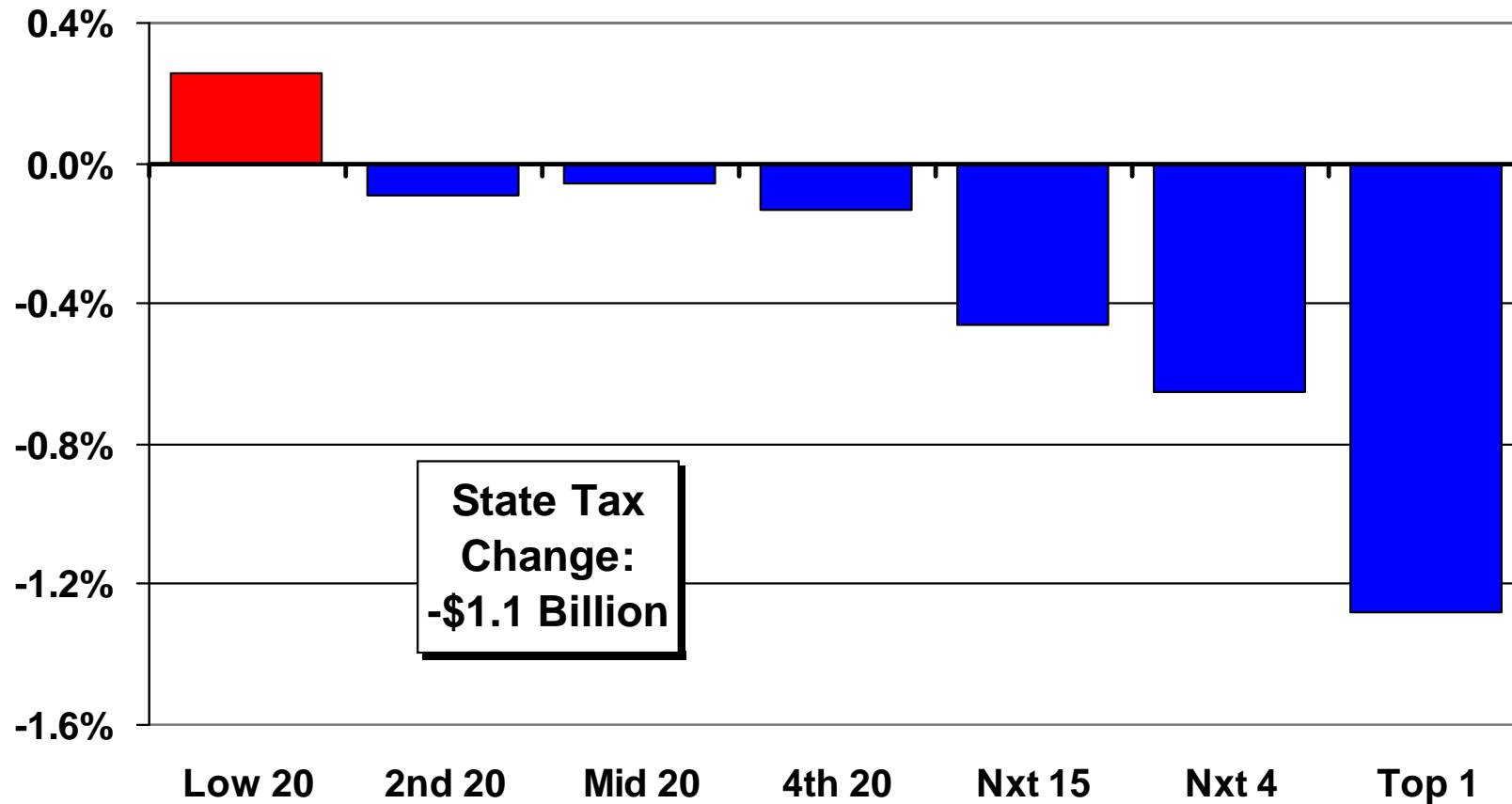
**Combining Rate Cuts With a Broader Base, Take 1:
Base= Slightly Modified Federal AGI
Poorest 80% of Income Distribution Sees a Tax Hike**

**State Tax Impact of Rate Cut, AGI Base
All North Carolina Families in 2007**

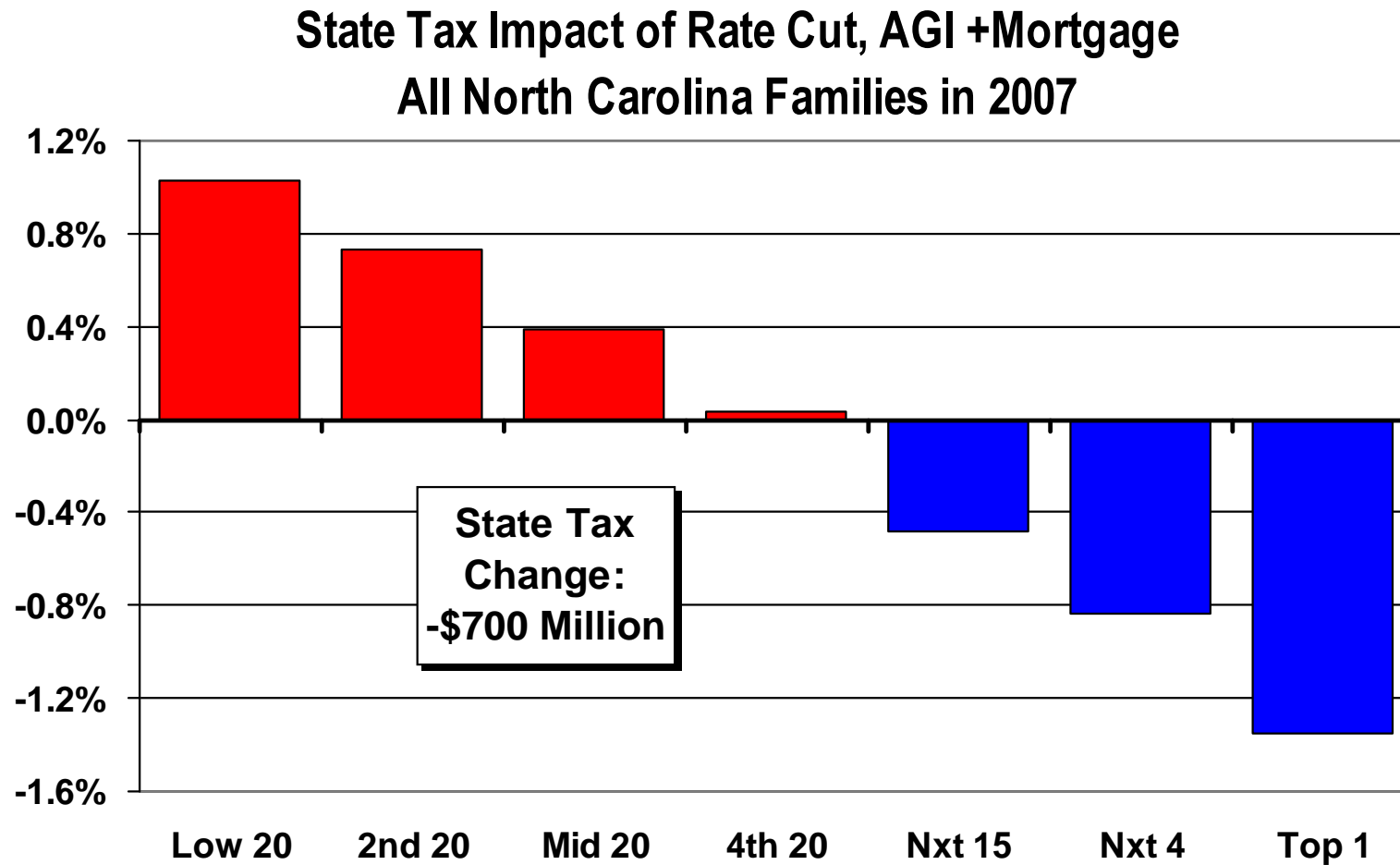


**Combining Rate Cuts With a Broader Base, Take 2:
Base= Federal AGI Minus Exemptions
Poorest 20% of Income Distribution Sees a Tax Hike**

**State Tax Impact of Rate Cut, AGI + Exemptions
All North Carolina Families in 2007**

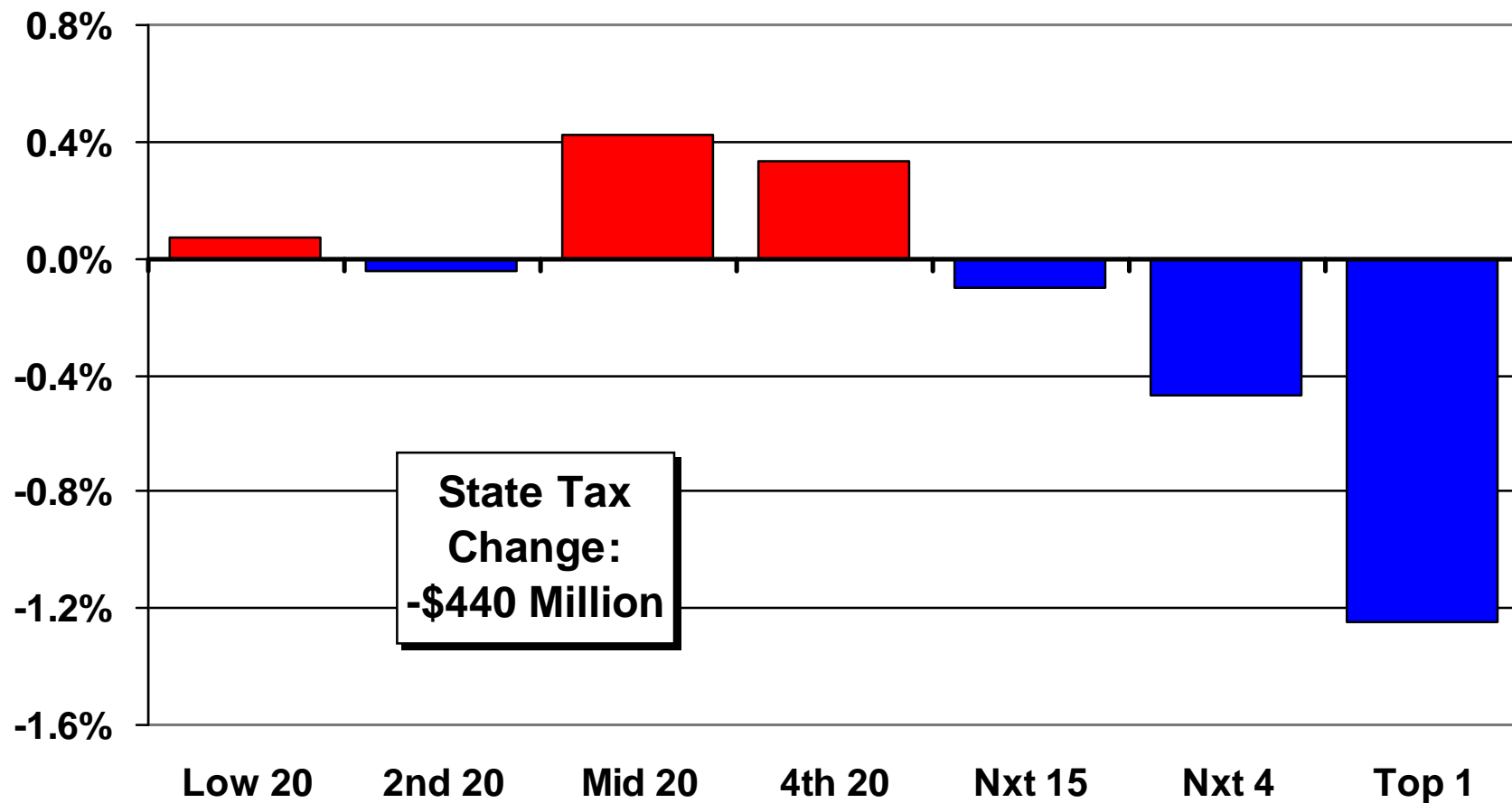


**Combining Rate Cuts With a Broader Base, Take 3:
Base= Federal AGI Minus Mortgage Deduction
Poorest 80% of Income Distribution Sees a Tax Hike**



**Combining Rate Cuts With a Broader Base, Take 3:
Base= Federal AGI; 20% EITC Allowed
Poorest 80% of Income Distribution Sees a Tax Hike**

**State Tax Impact of Rate Cut, AGI + 20% EITC
All North Carolina Families in 2007**



Fairness = Adequacy

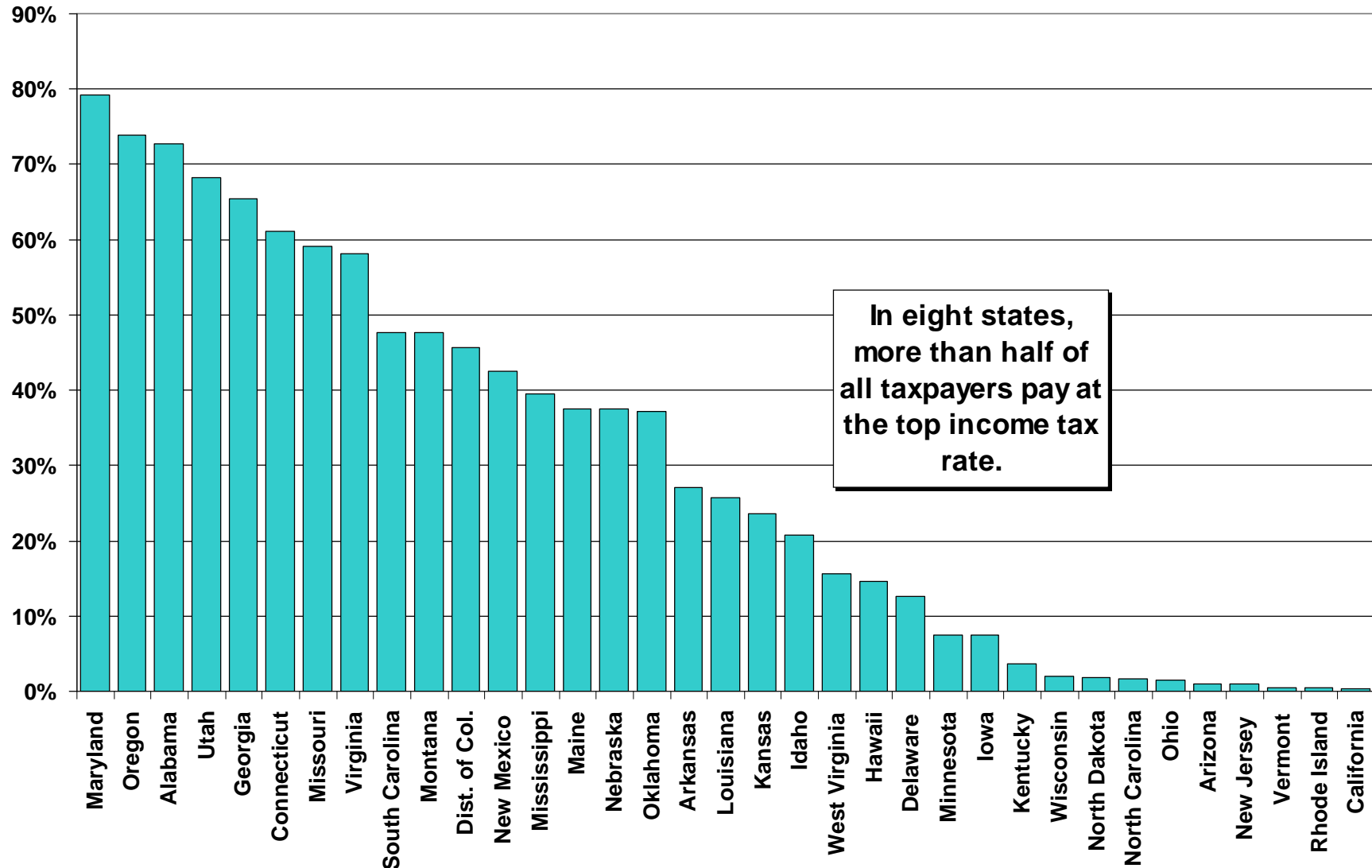
- Potential impact of closing the fairness gap:
- If lawmakers changed the tax system to require that the wealthiest 1% should pay as much of their income as the poorest 20%, the revenue yield would be **\$589 million** in 2006.
- Requiring the top 5% to pay as much as the poorest 20%: **\$1.07 billion**.
- Impose same condition on top 20%: **\$1.6 billion**.
- Simple reason: top 20% has 57% of the income; poorest 20% has 3.6% of the income statewide.

What about Income Tax Volatility?

- Opponents of income tax hikes argue that states with heavy income tax reliance are susceptible to fiscal shortfalls when capital gains decline. But...
- The good times can be really good. (Google stock options responsible for 1/8 of \$4 billion income tax growth in California last year.)
- Revenues can be put in Rainy Day Funds in growth periods to get through bad times.
- Temporary rather than permanent tax cuts in good times leave base intact in bad times

Many state income taxes are “graduated” in name only.

% of Taxpayers Paying at Top Income Tax Rate, 2005

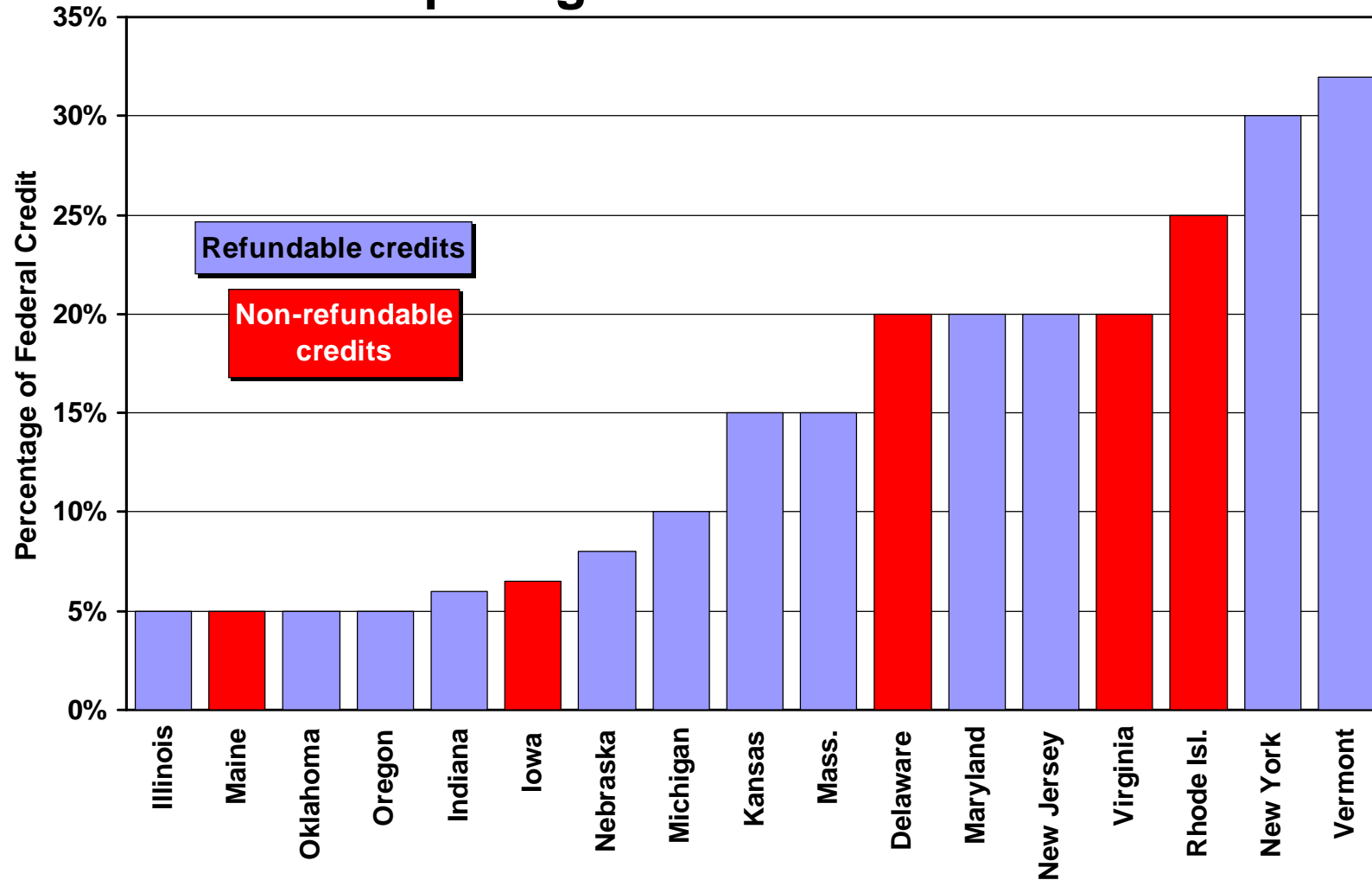


Elderly income tax breaks are usually poorly targeted—and carry a high long-term price tag.

- Many elderly tax breaks benefit pensioners while providing no benefit to wage-earners.
- Most pension tax breaks have no income limits, (Minnesota, Oregon, Virginia impose limits) and some have especially high caps.
- Social Security benefits are completely exempt in most states.
- Rapidly aging population (12.4% over 65 in 2000, almost 20% by 2030) means cost of these breaks will grow rapidly.
- **Poorly-targeted income tax breaks for seniors are a ticking time bomb.**

20 states now have EITC's: but only some are refundable, and some are redundant.

Comparing State EITCs in 2006

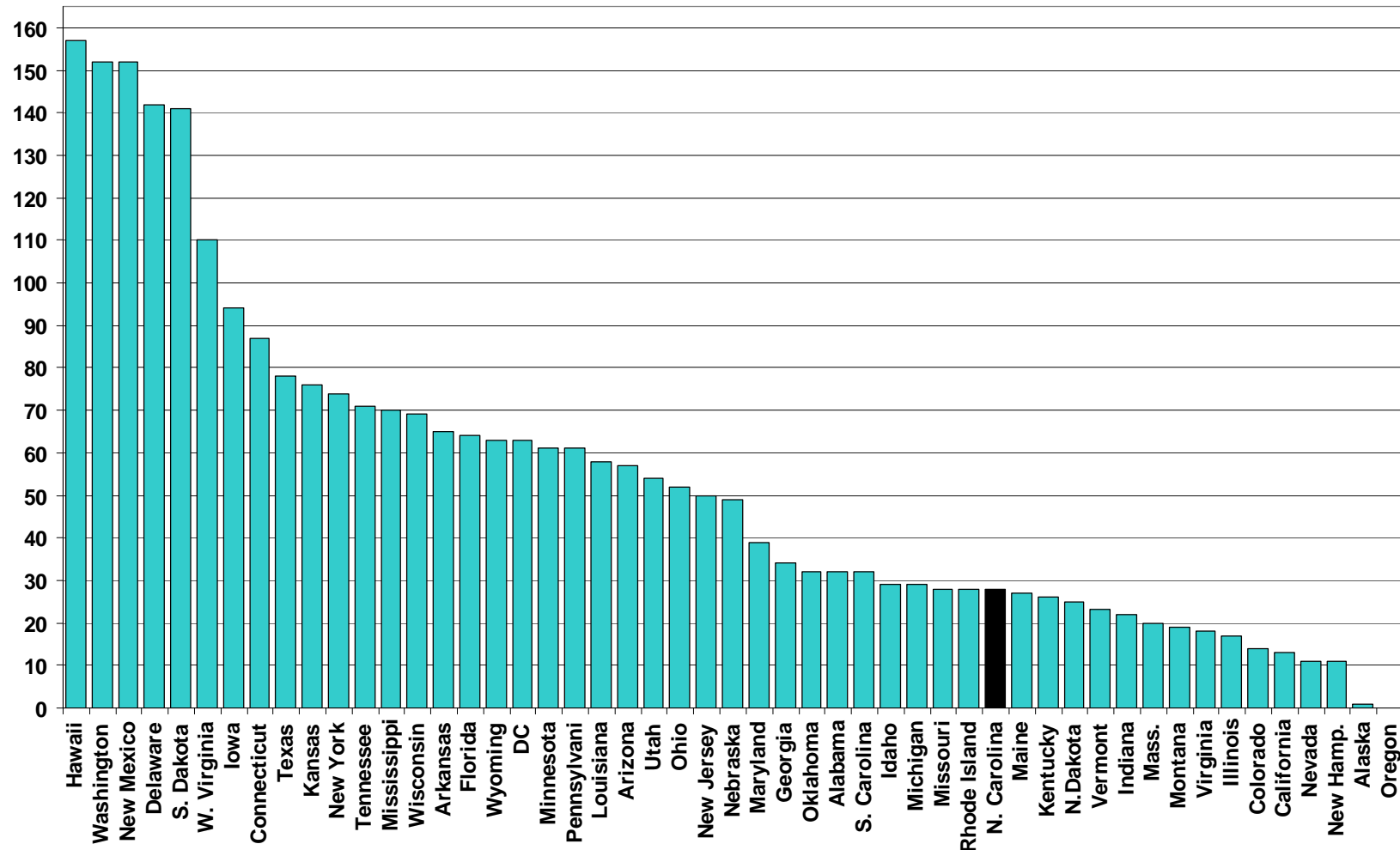


The sales tax: a regressive, but necessary tool for sustainable tax reform

- The most regressive major tax
- *Generally* not deductible on federal income tax returns
- North Carolina exempts many goods and services.
- Services are growing as a share of consumption, while goods are declining—so North Carolina's sales tax is leaking fast.

FTA survey: most states tax less than half of available services.

Sales Taxation of Services, 1996

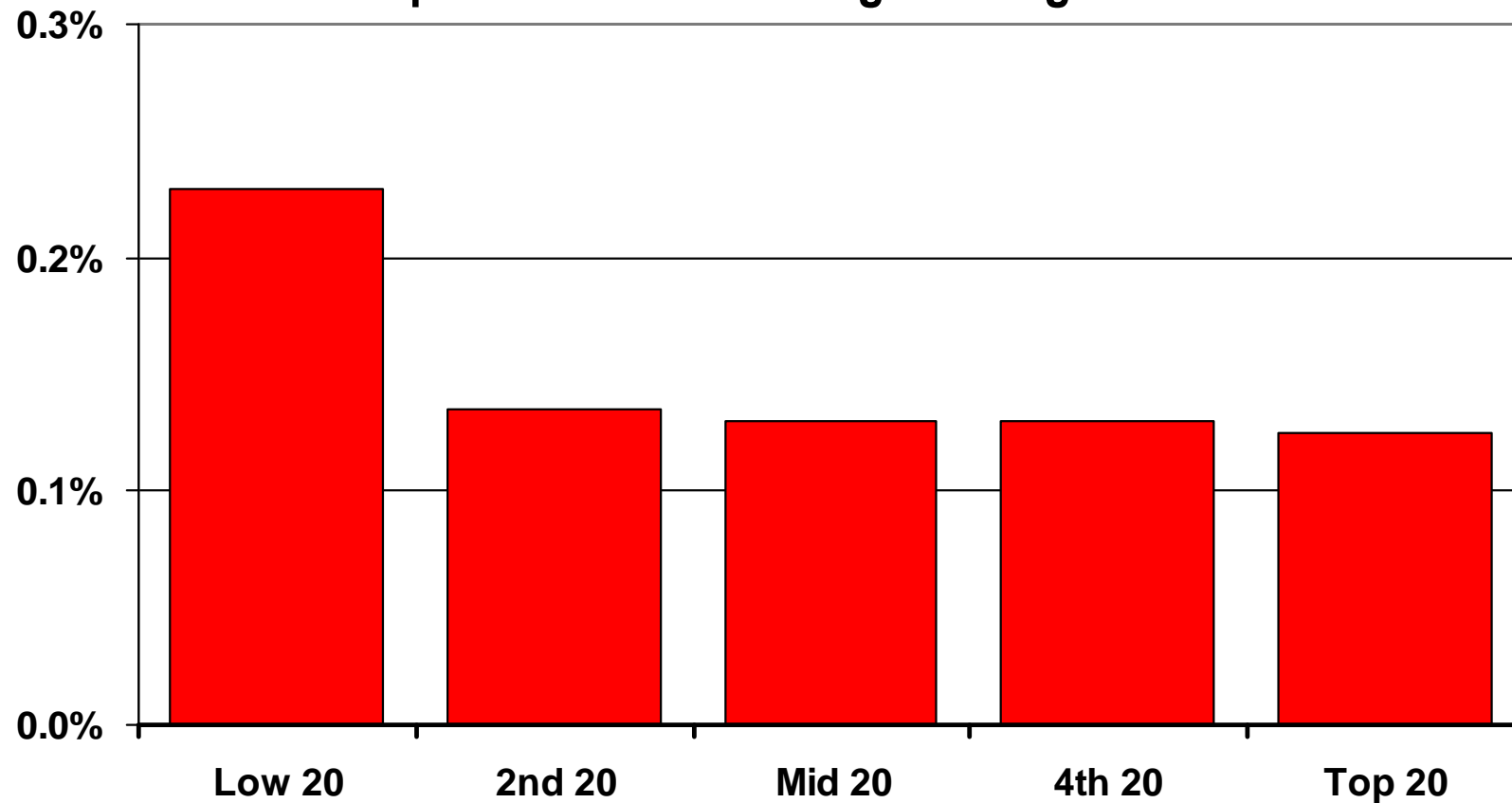


Will Taxing Services Make North Carolina's Sales Tax (More) Progressive?

- Taxing personal services is clearly much less regressive than the current base.
- Taxing some “luxury services” may even be slightly progressive.
- But any substantial base expansion will include services consumed at all income levels— which means comprehensive base expansion is unlikely to make the sales tax much less regressive.
- Taxing business services will likely lead to exporting part of incidence— but in-state portion likely to be regressive.

The best state-specific tax incidence model suggests that taxing business services won't be a progressive move.

Texas Comptroller's Tax Incidence Report: Incidence of Exemptions for Accounting and Legal Services

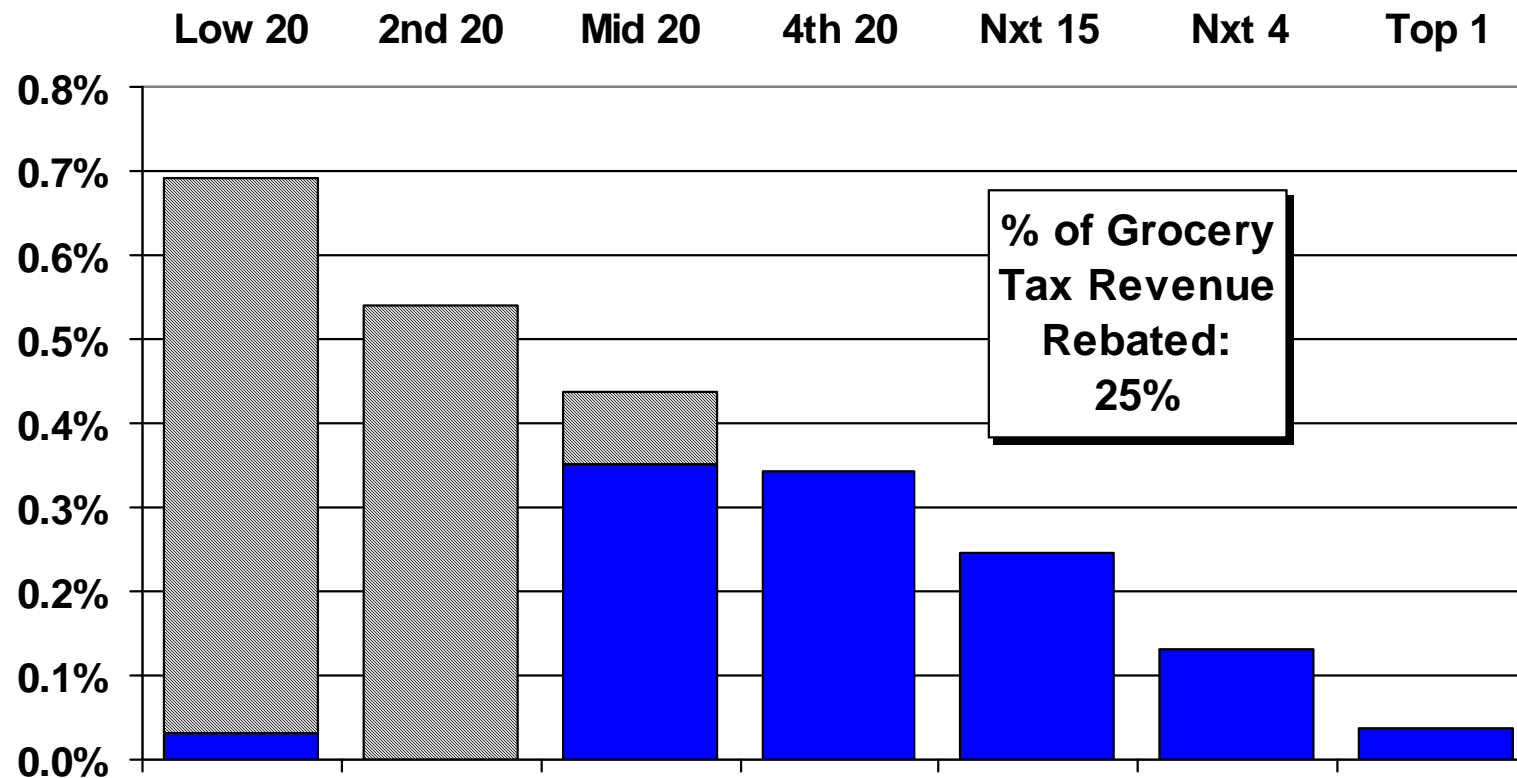


What About Exempting Groceries. Clothing, Utilities?

- Undeniably a progressive tax cut.
- Cutting the food tax is not a partisan issue.
- But it's expensive. Food can be 10 to 20% of a state's sales tax base.
- If it turns out to be unaffordable, long-term impact can be bad for low-income families
- Cheaper alternatives are available.

A “hold-harmless” sales tax credit is a costly proposition.

Holding Low-Income Families Harmless With a "Grocery Tax" Credit: One Approach



Sales tax credits can deliver targeted, low-income sales tax relief at a lower cost than exemptions.

The Kansas Food Sales Tax Refund

Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers are eligible.

Income Level	Refund
\$0 to \$12,500	\$60 per exemption
\$12,501 to \$25,000	\$30 per exemption
\$25,001 or more	no refund

Combined Reporting is the Obvious Corporate Tax Reform Solution– But Disclosure Matters Too

- The SEC requires publicly held corporations to disclose basic information about their federal income tax payments.
- Thanks to these reporting requirements, we know that many of the largest and most profitable corporations have been able to reduce or zero out their tax liability—and we have some ideas about how.
- Most states impose little or no reporting requirements on corporations' state taxes.

Information is Power

- **Disclosure** of corporate tax payments and tax breaks is the gold standard in tax transparency.
- Regular **tax incidence analysis** reminds lawmakers that fairness is lacking.
- **Tax expenditure reports.** Lawmakers (and the public) should know where the money is going.

Summing Up: Strategies for a Sustainable and Fair State Tax System

- **Personal income tax:** the gold standard for tax fairness (and sustainability). Allow low-income credits like the EITC.
- **Corporate income tax:** Better disclosure of tax information.
- **Sales taxes:** Do it right: broad base, low-income credits.

Tax Changes in the States, 2002-2007:

Noteworthy legislation

- >25 states increased cigarette taxes
- Massachusetts repealed a capital gains break—and New Mexico created one.
- Major property tax cuts (ID, NE, SC).
- Strengthening corporate income tax (NJ, NY, TX)
- Cutting sales tax on food (NM, UT, WY, SC, WV).
- Income tax rate cuts
- Decoupling from federal tax breaks.
- Continued expansion of EITC

Takeaway Points:

- Fairness-enhancing tax reform can help achieve other worthy tax goals, especially adequacy.
- Income tax cuts are a bad deal for North Carolina– and economic benefits are hard to measure.
- Base-broadening is an important goal, and can be more politically palatable than rate hikes.
- Transparency is an important goal too.
- Recognize the difference between short-term and long-term solutions.
- Taxes and spending are two sides of the same coin.

State Tax Fairness Resources:

- Weekly “Tax Justice Digest.” Best and worst of state (and federal) tax politics and policy. Sign up by emailing ctj@ctj.org
- Our tax policy weblog: www.talkingtaxes.org.
- Our website: www.itepnet.org.
- Center on Budget and Policy Priorities (www.cbpp.org).