# The History of State and Local Taxes in North Carolina - Changes in Sources and Burdens


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State and local government in North Carolina provide funds for many critical services including schools and universities, highways and public transportation, healthcare for children and the elderly, public safety, water and sewer services and environmental protection. While the costs of these services continue to grow, the state tax system has largely been unable to keep up with the escalating costs resulting in projected budget shortfalls, significant budget cuts for many programs, and a variety of stop-gap, and temporary tax increases. In order to better understand this inability of the tax system to provide the revenue needed to meet North Carolina's growing budget needs, it is helpful to look back over the last several decades at changes in sources of state and local tax revenue and changes in North Carolina's tax burden.

## Background

The North Carolina state and local tax system as we know it today was largely set in place in the 1920s and early 1930s. In 1921, most state revenue came from the property tax. However, in that year, the General Assembly enacted a state personal income tax, corporate income tax and gas tax, and the property tax became strictly a local-level tax.

As the state assumed or increased responsibility for schools, highways and prisons in the early years of the Great Depression, other sources of revenue were needed. Consequently, in 1933, the state became the second in the nation to enact a retail sales tax.

This basic structure of North Carolina's state tax system remained fairly constant over the next 70 years. Then and now, the primary sources of tax revenue for the state are the individual income tax, corporate income tax and the sales tax. The primary sources of tax revenue for local governments are property taxes and sales taxes.

### *Individual income tax*

North Carolina's individual income tax has been in place since 1921. Before 1989, the state had its own individual income tax system independent of the federal tax. In 1989 the state piggybacked on the federal income tax in that the starting point for calculating North Carolina taxable income was (and is) federal taxable income. From that base, various adjustments are made in calculating North Carolina taxable income. The individual income tax rate is progressive, that is rates increase as income levels increase. In the early years, tax rates ranged from 3% to 7%. In 1989, the rate structure was streamlined to include just two rates - 6% and 7%. In 1991, as the state faced budget difficulties, a third rate of 7.75% was added and in 2001, a fourth bracket of 8.25% was added as a temporary increase. The 8.25% top rate will decline to 8% on January 1, 2007.

### *Corporate income tax*

In contrast to the individual income tax, the corporate income tax is assessed at a flat rate of 6.9% on the income of corporations doing business in North Carolina. The owners of businesses that operate as sole proprietorships (typical of many small businesses) pay tax on business income at individual income tax rates, not corporate rates. Likewise, the owners of businesses that operate as partnerships or limited liability companies typically pay tax on business income at individual tax rates.

***Sales tax***

North Carolina's sales tax is imposed on the retail sale of most tangible personal property in the state. Some items like prescription drugs and groceries (except prepared foods, candy, soft drinks and the like) are exempt from the tax. Most services are not subject to the tax. In 1933, North Carolina had a 3% state-level sales tax. In 1971, the General Assembly allowed local governments to levy a 1% local sales tax. The local tax was increased by .5% in 1983, .5% in 1986, and .5% in 2002. The state-level tax was increased to 4% in 1991 and a temporary increase of .5% was added in 2001. Consequently, today we have a state-level sales tax of 4.5% and a local-level sales tax of 2.5% (3% in Mecklenburg County). The 4.5% state rate will decline to 4.25% on January 1, 2007.

While sales taxes are "flat" in that one rate applies to all taxpayers, the taxes are sometimes criticized as being regressive in nature. Low income taxpayers may consume a higher percentage of their income than high income taxpayers resulting in a higher average tax rate. For example, a taxpayer earning $30,000 per year and spending $25,000 on items subject to a 7% sales tax pays $1,750 in sales tax for an average rate of 5.8% of total income ($1,750 / $30,000). A second taxpayer earning $100,000 per year and spending $70,000 on purchases of products subject to the sales tax pays total sales tax of $4,900. His average tax rate is only 4.9% of total income.

***Property tax***

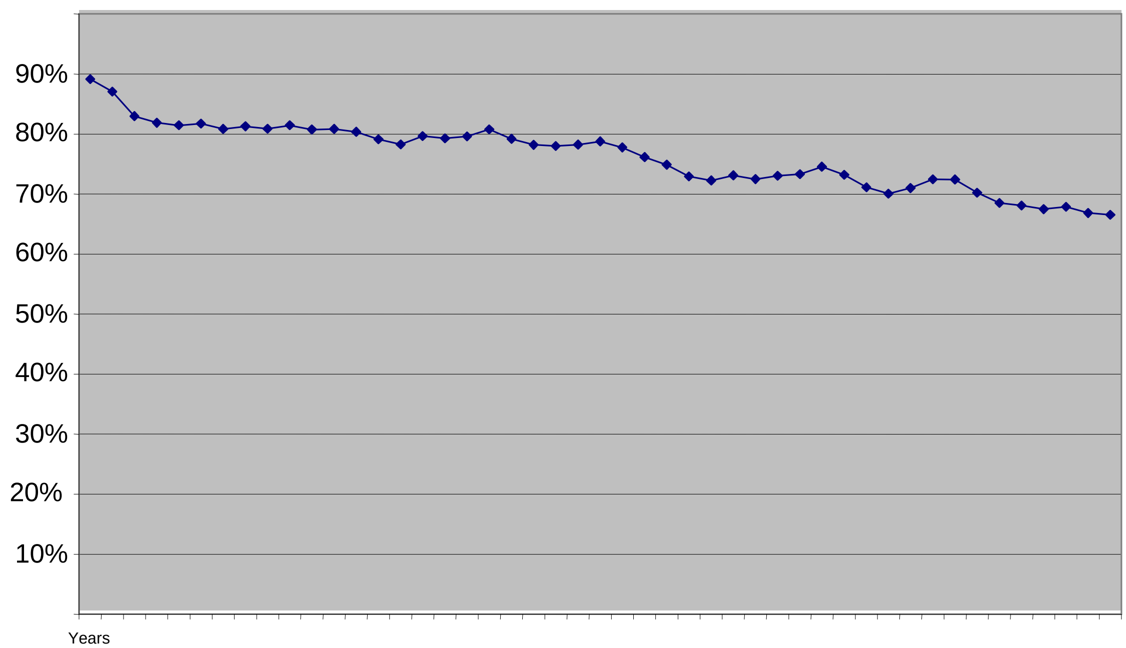
Since 1921, the property tax has been levied and administered by local jurisdictions rather than the state. The tax is imposed on the value of real property (land, buildings and other improvements to the land) and personal property used in a business. Tax rates vary by jurisdiction and can vary widely from one city or county to another. Until 1972, the property tax accounted for over 90% of the total local-level taxes collected in North Carolina. Although its importance at the local government level has declined, the property tax remains the primary source of tax revenue for local governments in North Carolina. In 2002, the property tax accounted for 77% of total local-level tax revenue.

An advantage of the property tax is that it is efficient and generally stable. It is easy to collect and less costly to collect than income or sales taxes. Although economic downturns inevitably are accompanied by declines in property values which cause the tax base to shrink, these downturns are often less volatile than those affecting the income tax or sales tax. In addition, most taxpayers generally consider property taxes to be fair although they can be problematic when increasing real estate prices are not accompanied by increases in wages and other sources of income used to pay the property tax. For example, retirees on fixed incomes may live in homes in which increases in value and property taxes far exceed any increase in income available to pay the tax.

## Changes in Sources of State and Local Tax Revenue in North Carolina

In 1942, almost 90% of the state's general revenue from its own sources (not counting intergovernmental revenue) came from taxes (see Figure 1). The other 10% came from a variety of fees and charges and miscellaneous revenue. Sixty years later, taxes account for only about 66% of the state's own-source general revenue. Of course, the flipside is that fees, charges and miscellaneous revenue have increased to about 34% of general revenue. Fees and charges include a hodgepodge of items such as payments of tuition and fees by students enrolled in North Carolina public colleges and universities, payments made by patients and insurance programs to public hospitals, fees from toll highways, parking facilities, etc. Miscellaneous revenue includes interest earnings, revenue from the sale of property, special assessments, etc.

**Figure 1 - NC Taxes as a percent of General Revenue from own sources**




**Years (1942 – 2002)**

While the relative importance of taxes has declined over the last 60 years as the state and local governments have collected more and more revenue in the form of charges and fees, it is informative to look at increases and decreases in specific types of taxes during that time frame. Due to data limitations, detailed information on the amount of revenue from different taxes is only available since 1957. As shown in Table 1, in that year, 41.4% of total state and local government tax revenue in North Carolina came from sales taxes (both the general sales tax and selective taxes on such items as alcoholic beverages, cigarettes and gasoline). The second largest source of tax was the property tax (26.8%) followed by various license taxes (11%), the individual income tax (10.5%), and the corporate income tax (9.1%).

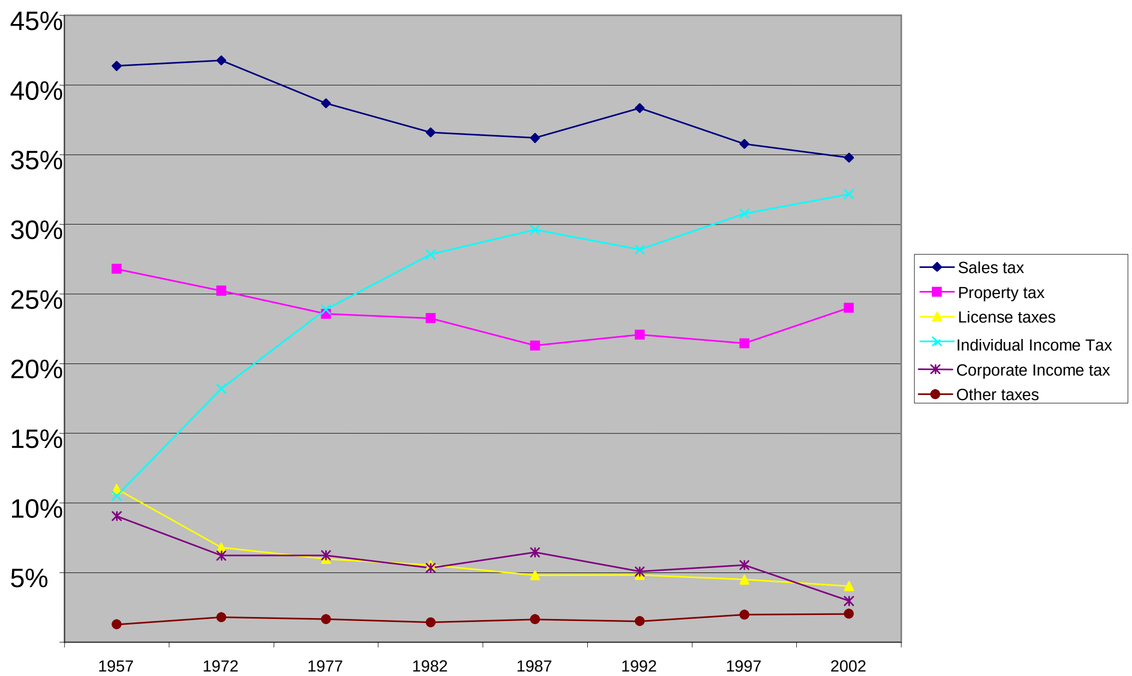
By 2002, the components of total tax revenue had dramatically changed. While the sales tax was still the largest component at 34.8%, the individual income tax accounted for over 32% of total tax revenue while the property tax declined in importance to 24% of total tax revenue and the corporate income tax to only 3%. During this 45 year time span, property taxes, sales taxes, license taxes and corporate income taxes declined in importance. In 1957, these four taxes accounted for 88.3% of total tax revenue. In 2002, these taxes accounted for 65.8% of total tax revenue at the state and local level. During the same time, individual income taxes increased from a modest 10.5% of total taxes to over 32% of total taxes.

**Table 1: Percent of Total NC State and Local Tax Revenue from Various Sources**

| | **1957** | **2002** |
|---|---|---|
| Sales Taxes | 41.4% | 34.8% |
| Property Taxes | 26.8% | 24.0% |
| License Taxes | 11.0% | 4.0% |
| Individual Income Taxes | 10.5% | 32.2% |
| Corporate Income Taxes | 9.1% | 3.0% |
| Other Taxes | 1.2% | 2.0% |

As the trend lines in Figure 2 show, the percent of total taxes from the individual income tax increased rapidly between 1957 and 1987, moderated slightly between 1987 and 1992 and increased again over the ten year period from 1992 to 2002.

**Figure 2 - Percent of NC Tax Revenue from Various Sources**



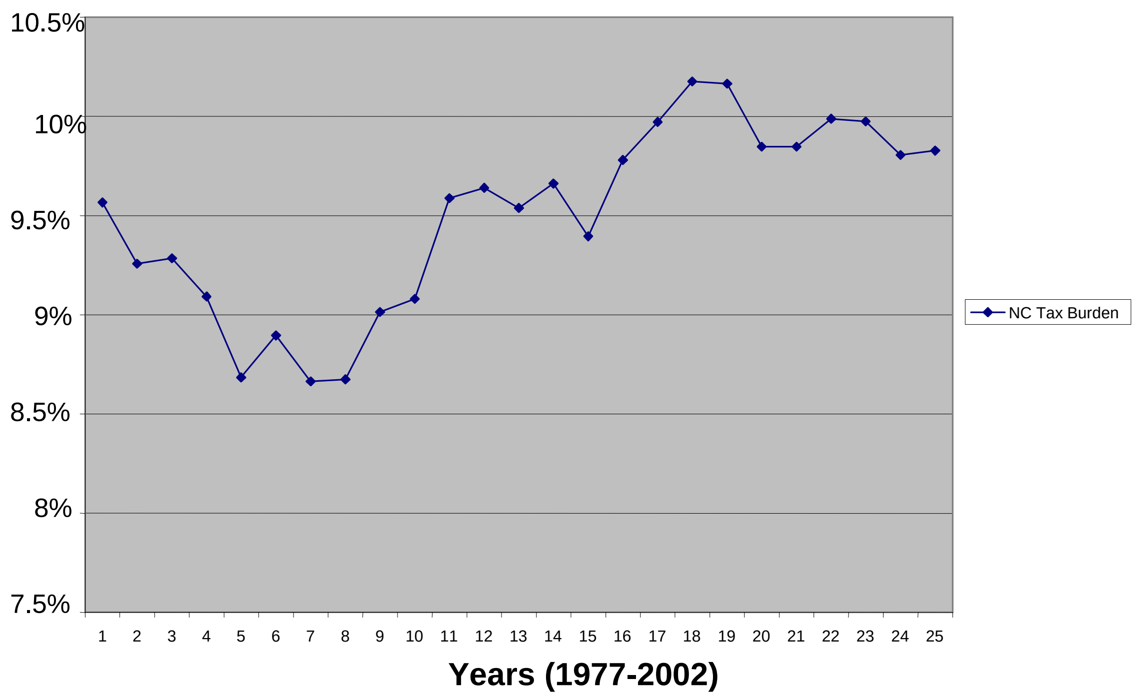

## North Carolina’s Changing Tax Burden

While it is clear that individual income taxes are more important to the state’s tax coffers today than in the past, additional analysis is necessary in order to understand how taxpayer’s state tax burdens have changed over time. A state’s tax burden is measured by calculating taxes paid as a percent of income earned by the state’s residents. Both state and local taxes are typically included in the measure to ensure comparability of burdens across states. For example, some states provide services at the state-level that are provided by counties and other local government units in other states. As a result, the levels of the various taxes assessed at the state and local level frequently vary. While the state-level sales tax in North Carolina and Virginia are close to the same (4% in Virginia compared to 4.5% in North Carolina), North Carolina's local-level sales taxes vary from 2.5% to 3% while Virginia's highest local sales tax is 1%. In a ranking that includes only state-level sales taxes, North Carolina taxpayers appear less taxed in comparison to Virginia taxpayers (4.5% in North Carolina compared to 4% in Virginia) than they actually are (7% in North Carolina compared to 5% in Virginia).

In the following calculations of tax burden, taxes include individual income taxes, corporate income taxes, property taxes, general sales taxes, selective sales taxes such as those on gasoline, tobacco products, and alcoholic beverages, license taxes and other taxes such as estate and gift taxes. Personal income (as defined by the U.S. Census Bureau) is used as a measure of income earned by the state's residents. Personal income is the income that is received by all persons in the state from all sources. It includes not only wage and salary income but also rental income, dividend income, interest income, and income earned by small business proprietors.

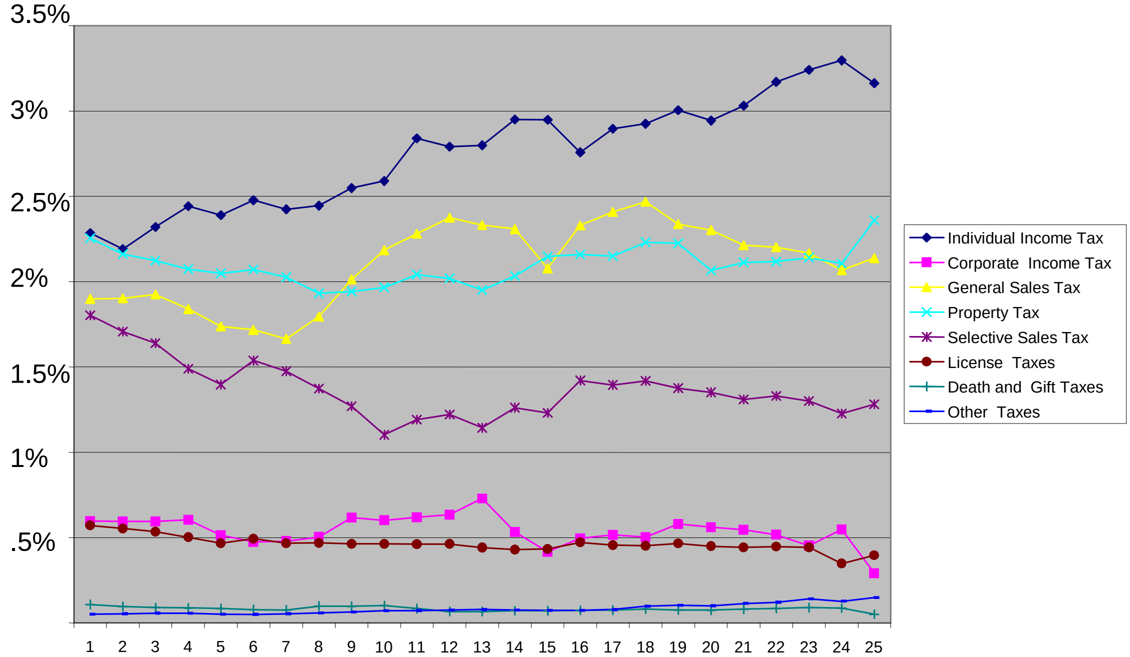
As shown in Figure 3, the tax burden over the last 25 years has ranged from about 8.7% to 10.1% with a generally increasing trend since about 1984.

**Figure 3 - NC State and Local Taxes as a Percent of Personal Income**




More interesting is how different types of taxes contributed to the tax burden during those years. As shown in Figure 4, the individual income tax has contributed a steadily increasing amount to the tax burden over the last 25 years. In 1977, the individual income tax burden was 2.3% of personal income. In the first half of the 1980s, the individual tax burden was relatively stable before starting an increasing trend in 1984. The burden increased steadily between 1984 and 1987 before moderating slightly in 1988 and 1989. After a fairly significant drop between 1991 and 1992, the individual tax burden increased again between 1992 and 1993 – perhaps as a response to the 1991 tax increase - and has increased almost every year since, spiking at 3.3% in 2000 before declining modestly in 2002 to 3.2% of personal income.

**Figure 4 - NC Tax Burden by Type of Tax**




With the exception of 2002, the property tax has remained in a fairly narrow range from 1.9% of personal income to 2.2% of personal income. In 2002, the property tax burden jumped to 2.4%.

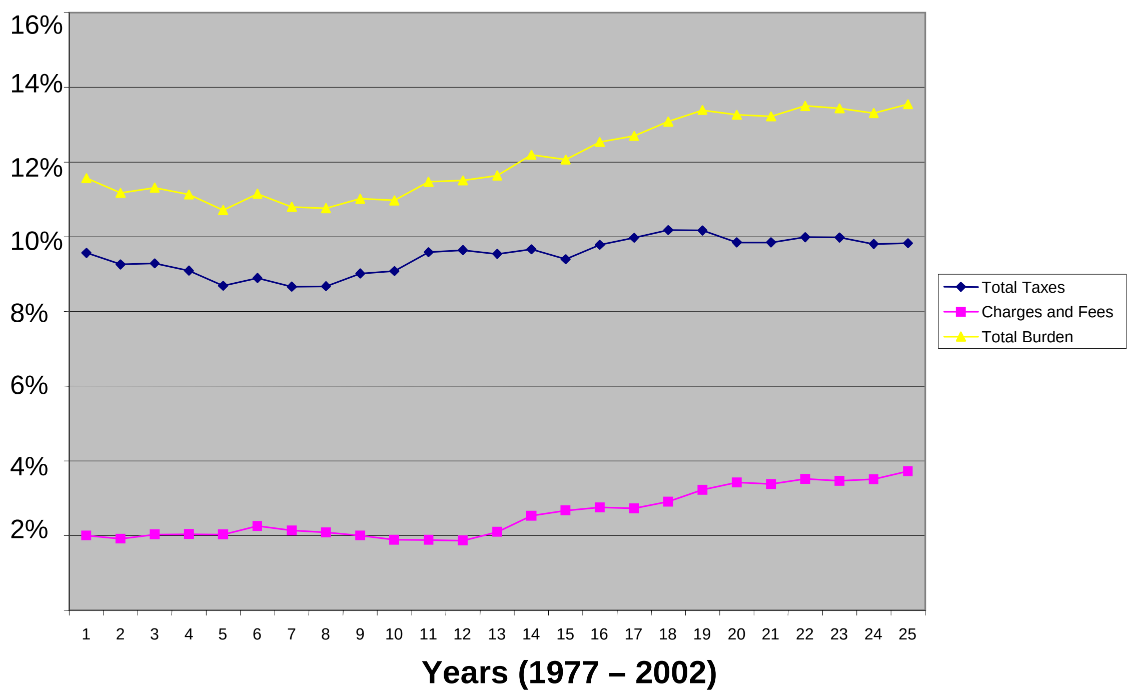
The general sales tax burden has changed over the last 25 years in response to increases in the state and local sales tax rate as well as in response to changing economic conditions. The trend line shows general increases in the sales tax burden from about 1983 to 1990 followed by a large drop in 1991. The state increased the state-level tax from 3% to 4% in that year and the general sales tax burden increased until about 1994. However, the sales tax burden has generally declined since 1994. Possible explanations for this decrease include the growth of electronic commerce and sales on the Internet and the growth of the service economy. Companies that sell products via the Internet are responsible for collecting and remitting sales tax to the state only if the firm has a physical presence in the state. Often times, this is not the case. While buyers have an obligation to pay use tax on these purchases, collection of the use tax from individual buyers is difficult at best. As discussed earlier, most services are not subject to the sales tax.

The corporate income tax has been a relatively unimportant source of income tax revenue for the state for the last 45years, never amounting to over 10% of the total tax revenue collected by the state over that period of time. After trending upward in the mid 1980s to a peak of .73% in 1989, the corporate income tax burden has fallen to a historic low of .3% in 2002. License taxes, death

and gift taxes and other taxes have remained relatively stable since 1977 and are responsible for only a small portion of the overall state and local tax burden.
Although fees and charges are not considered taxes, they nevertheless contribute to the total burden borne by North Carolina taxpayers. As discussed earlier, fees and charges include payments of tuition and fees by students enrolled in North Carolina public colleges and universities, payments made by patients and insurance programs to public hospitals, fees from toll highways, parking facilities, etc. In addition to changes in the tax burden, it is important to see how the burden from these fees and charges has changed over time. Due to political pressures to reduce taxes (or at least not raise taxes), fees and charges are sometimes increased as a way to increase revenue when it is politically difficult to raise taxes.

In Figure 5, the overall burden is broken down into its components – the tax burden and the burden from fees and charges.

**Figure 5 - Total Burden**




As shown above, the total burden (consisting of taxes, fees and charges) and the tax burden decreased between 1977 and 1981 while the burden from fees and charges remained flat. However, the trend has been upward since 1981. Over the last two decades, the overall burden from fees, charges and taxes increased from 10.7% to 13.5%, with the burden from fees and charges increasing from 2.0% to 3.7% and the burden from taxes increasing from 8.7% to 9.8%. The increasing tax burden was primarily a result of increases in the burden from individual income taxes which increased from 2.4% in 1981 to 3.2% in 2002.

## Conclusion

North Carolina's basic state and local tax structure has changed little since the 1930s. Today, the state and local governments rely (as they did in the 1930s) on the individual income tax, sales tax, property tax, corporate income tax and various license taxes to generate a large portion of the state's revenue. However, the relative importance of taxes has declined as the state and local governments in North Carolina have increasingly relied on fees and charges instead of taxes to finance government spending. In addition, the individual income tax has grown in importance as a source of revenue for the state. In 1957, sales taxes were the primary source of revenue, accounting for over 41% of total tax revenue while the individual income tax accounted for 10.5% of total state and local tax revenue. In 2002, the individual income tax accounted for over 32% of total tax revenue.

The state's increasing reliance on fees and charges and individual income taxes is also apparent when examining changes in the state's tax burden and overall burden. These changes are important to recognize as they may impact the distribution of the tax burden and the equity of the overall tax system in North Carolina. While the individual income tax is progressive, fees and charges are typically regressive resulting in a greater burden on low income taxpayers in the state. In addition, a state's tax burden can be an important factor in business location decisions. Increases in the overall burden and the tax burden may adversely impact the ability of the state to compete with other states for new businesses.