

**Tax Modernization in
North Carolina —
One Step to Economic Growth
and Fiscal Stability**

Presented to:

**The Tax Policy Subcommittee of
The North Carolina Economic
Development Board**

By

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Economic Growth and Tax Policy in North Carolina

Where are we?

How did we get here?

Where do we go from here?

But First, Many Thanks to:

Brent Lane, Director

UNC Center for Competitive Economies

&

Barry Boardman, Chief Economist

Fiscal Research Division

North Carolina General Assembly

**For providing supporting statistics,
tables and graphs used in this presentation**

Some Sobering Statistics

- NC economy is large, complex and difficult to impact with tax policy, incentives, etc.
- We have the 24th largest economy in the U.S., however....
- While NC has spent billions on economic development over the years through tax credits, incentives, etc., we have not seen per capita income in relation to the U.S. average grow as a result
- Experience shows that “economic development success” isn’t the same as “economic success”---

A Large Economy is Hard to Fix...

- **NC is consistently cited as one of the “Best Business Climates” in the United States according to various publications**
- **NC’s workforce = approximately 4.5M workers**
- **Our capacity to impact the NC economy is limited because of its size and complexity**
- **NC has 500,000+ businesses of various sizes**
- **But direct assistance is possible to only a few thousand companies**
- **Just a 1% gain in employment requires creation of 45,000+ new jobs, which is difficult even in good economic times**

From the Evaluation of NC's Incentive Programs from the UNC Center for Competitive Economies Final Report–2009

- Tax credit incentives are difficult to administer & have not achieved their goal of economic stimulation
- Tax rate reductions are preferred over tax credits by most companies
- Tax credits have higher transaction costs than tax rate reductions
- The majority of tax credits in NC are claimed by companies in less distressed areas
- The majority of tax credits claimed are for new machinery, **not job creation**

NC is Losing Ground in Income Growth

Despite being one of the “Best Business Climates” in the U.S. during the last decade according to *Site Selection Magazine* & other publications, in North Carolina:

- Job creation is not keeping up with the workforce
- Job growth, unemployment, & poverty is worse than the U.S. average

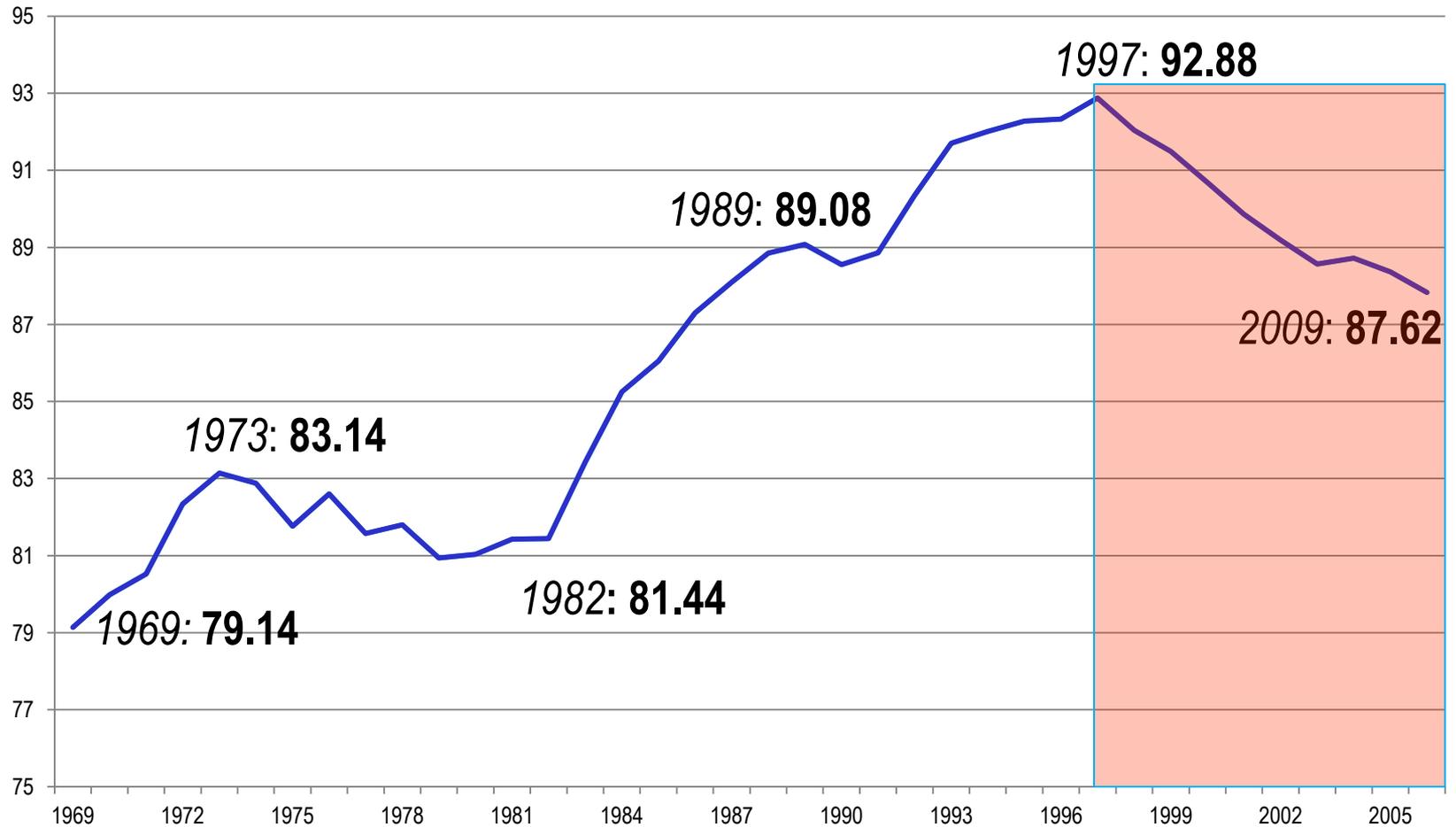
In 2009, North Carolina was 45th in the U.S. in wage and income growth

We are Losing Ground on Per Capita Income In North Carolina

- We are falling further behind the U.S. average in per capita income
- Our average per capita income as a percentage of the U.S. average has decreased every year from 1997 to 2009 to where we were in 1986
- **If current trends continue, our average per capita income as a percentage of the U.S. average is on track to drop to 1970 levels by 2020**
- Being one of the “Best Business Climates” in the U.S. has not resulted in income growth in relation to the rest of the U.S.

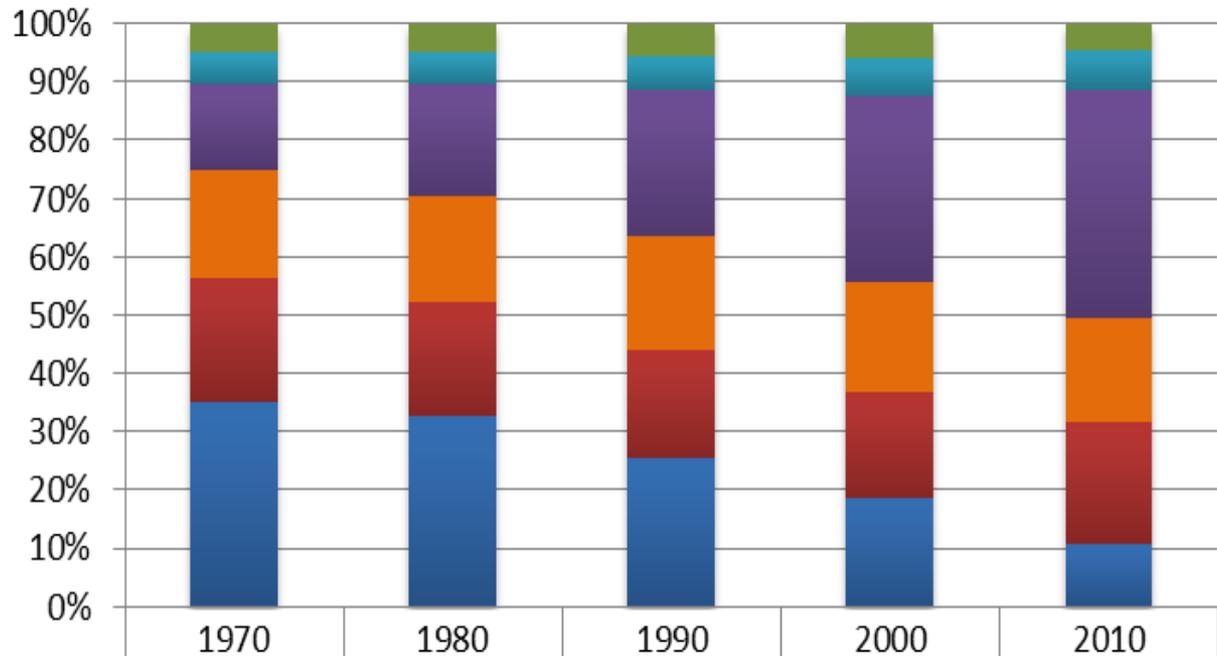
Simultaneous Economic Success and Failure

NC Per Capita Income as % of US



Another Indicator of North Carolina's Changing Economy.....

NC Percent Employment by Industry Sectors



■ Construction, Agriculture & Mining	5.0%	4.9%	5.4%	5.9%	4.5%
■ Financial Activities & Information	5.4%	5.5%	5.8%	6.5%	6.7%
■ Services	14.9%	19.2%	25.2%	32.0%	39.1%
■ Trade, Transportation and Utilities	18.5%	18.1%	19.6%	18.7%	17.8%
■ Government (incl. Military)	21.1%	19.6%	18.5%	18.1%	21.1%
■ Manufacturing	35.2%	32.7%	25.5%	18.8%	10.8%

NC's Workforce has Changed....

The previous slide shows that the composition of North Carolina's workforce has changed considerably over the last 40 years, especially in the Service and Manufacturing sectors

While Manufacturing employment has decreased by approximately 24%, employment in the Service sector has increased by approximately 25% during the same period

What Can Be Done to Reverse the Downward Trend of Average Per Capita Income Growth?

What Can We Do?

Focus on actions and policies to increase income and grow wealth:

- Tax code modernization & optimization
- Focus on job re-training for economic development and job creation
- Make infrastructure investments with a high impact
- Make quality gains in graduation rates
- Measure education performance & workforce development for 21st Century jobs

Tax Modernization is One Step

Develop new tax policies to enhance job creation, income growth, build wealth and enhance business investment:

- Develop a modern tax code that will better conform to our changing economy & promote income growth, business investment & make our economy more diverse
- Make the tax code simpler, more transparent and easier to understand and administer
- Make NC the best place to conduct business because our tax code & policies foster job creation and income growth
- Tax code changes should be revenue neutral
- Make sure everyone pays their fair share of taxes

A Modern Tax Structure to Enhance Growth and Stability

Some Ideas for Change

Basic Principles of Tax Policy

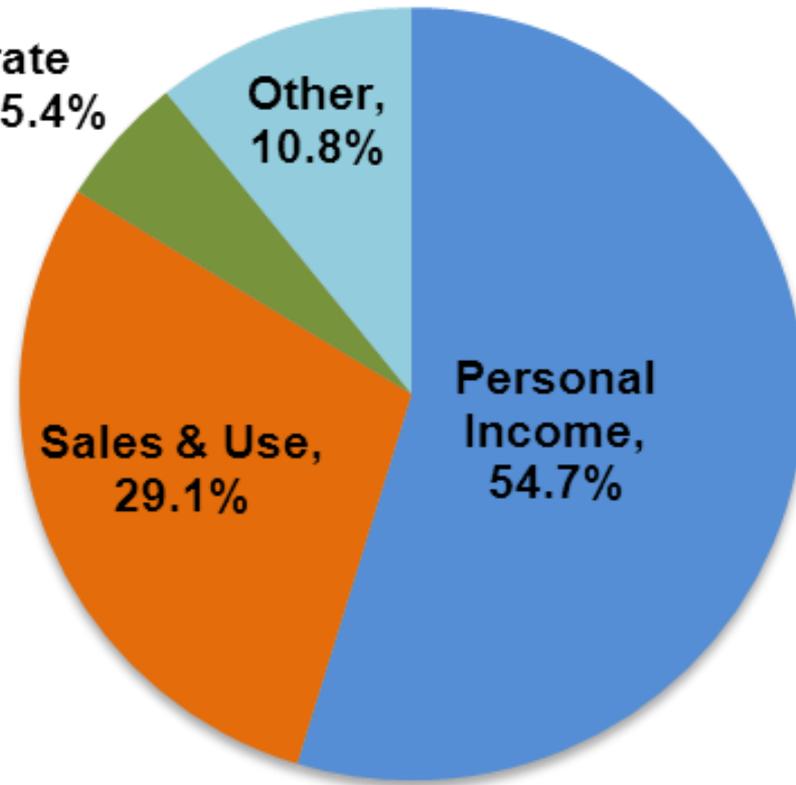
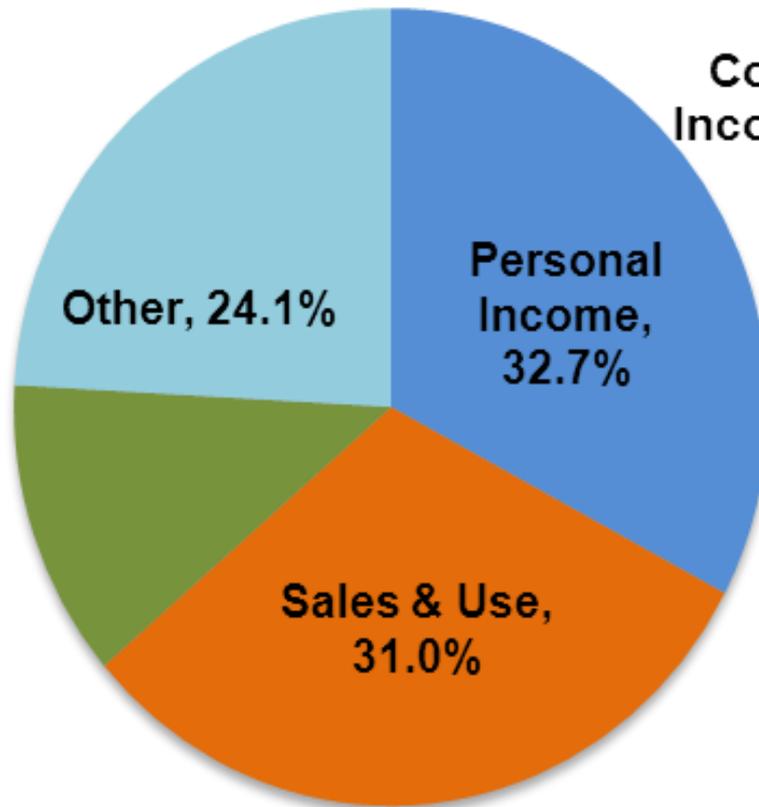
- **Promote equity** – treat similar taxpayers the same, try to eliminate high regressivity or progressivity
- **Simple to comply and administer** – an overly complex tax system creates inefficiency for taxpayers and administrators
- **Minimize economic distortions** – high tax rates influence economic decisions, business-to-business taxes cause pyramiding and higher prices at final demand
- **Reliable revenue stream** – develop a tax system that is not directly tied to the ebbs and flows of the economy, thereby eliminating large budget surpluses and shortfalls

**But First We Need to
Understand What the
Problem Is!**

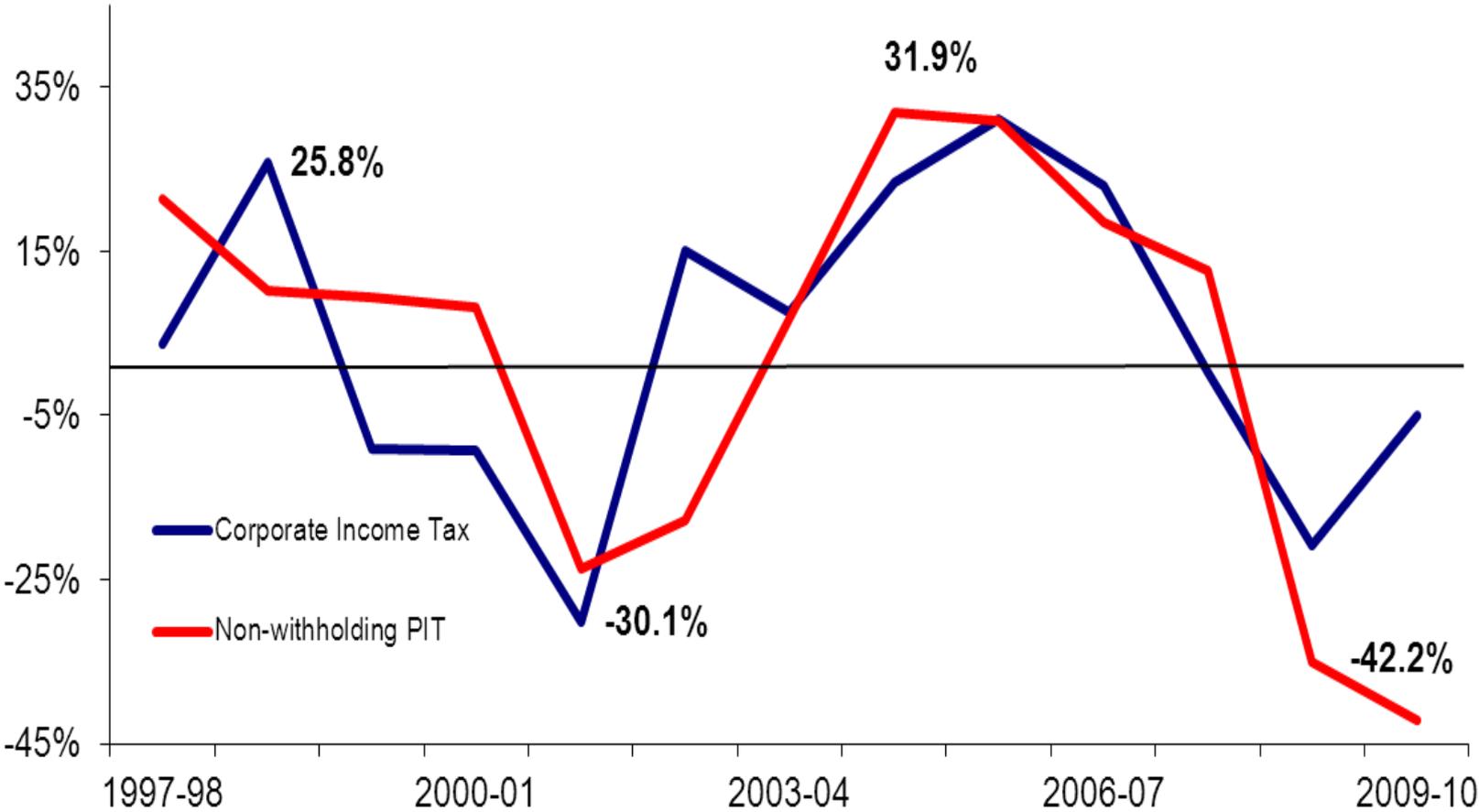
State Tax Structure

FY 1970-71

FY 2011-1012



Growth & Stability



20% of General Fund revenue comes from these two volatile sources.

Does NC Have a Structural Budget Deficiency?

- FY 1990-1991
 - 8.1% shortfall
 - \$600 million expenditure cuts
 - \$600 million tax increase
- FY 2001-02, 2005-06
 - 10.8% shortfall
 - Temporary sales tax increase
 - Temporary income tax increase
- FY 2008-09
 - 15.2% shortfall
 - Increase 'sin' taxes
 - Temporary sales & income tax increase
- A structural imbalance is not sustainable
 - "Change is gonna come"
 - *Ad hoc* changes
 - Change in budget and tax structure

Ad hoc Tax Changes: Last 20 years

Tax Increases

- 1991: Sales, CIT, PIT
- 2001:
 - Temporary 4th PIT bracket
 - Temporary sales tax
- 2003: *Temporary taxes extended*
- 2005: *Temporary taxes extended; cigarette tax*
- 2010: Temporary tax increases; “sin” taxes

Tax Decreases

- 1996 – 1999
 - CIT rate reduction
 - Phase-out State sales tax on food
 - Dozens of credits, refunds, and exemptions
- 2001: Sales tax holiday
- 2004 & 2005: Sales tax exemptions
- 2006 & 2007:
 - CIT & PIT credits, exemptions
 - Temporary taxes expired

The Logical Conclusion?

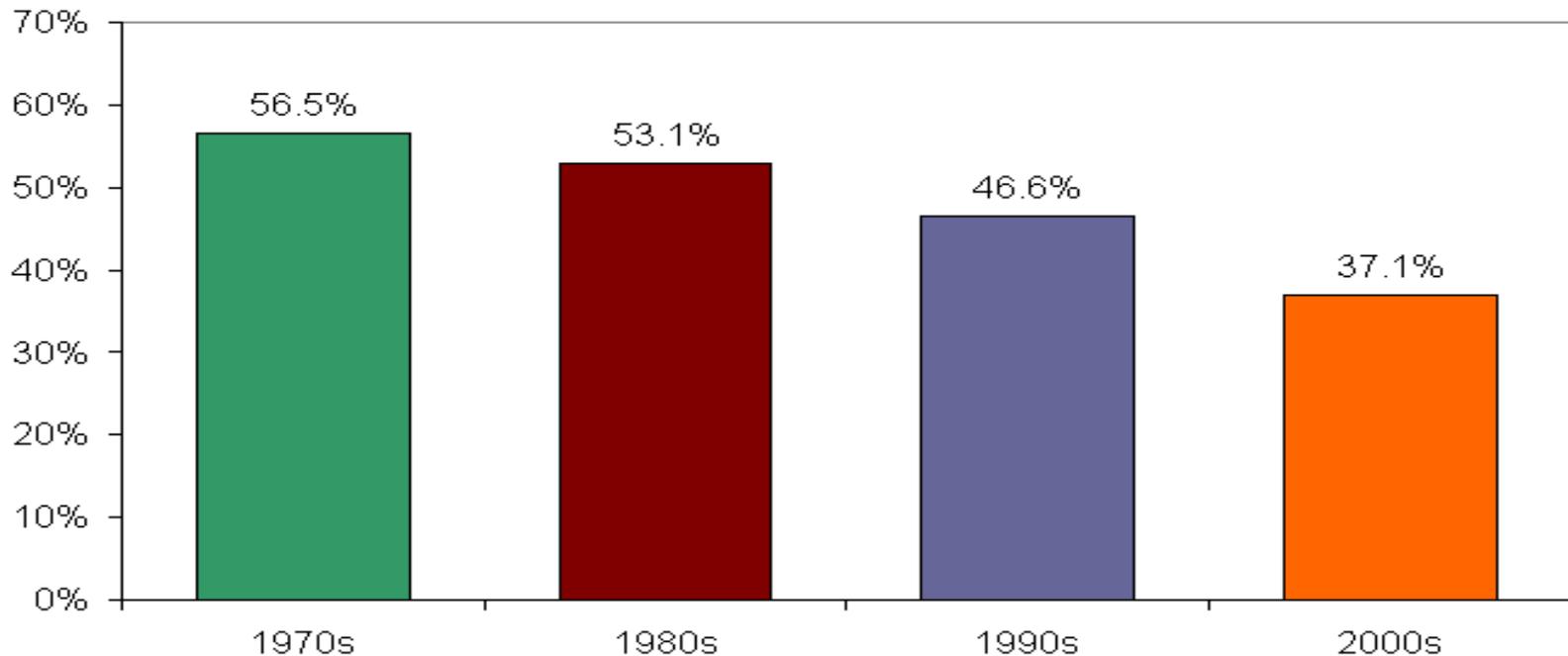
- Income taxes do not represent a predictable and stable source of income for the State because they are subject to significant volatility
- The ad hoc changes to North Carolina's tax code over the last 20 years have been responses to the volatility that is inherent in the current system, which suffers from a **structural imbalance**
- Despite calls to modernize NC's tax code from several independent study groups over many years, we have the same basic tax code as we did in the 1930's, **when Roosevelt was President**

Sales Tax

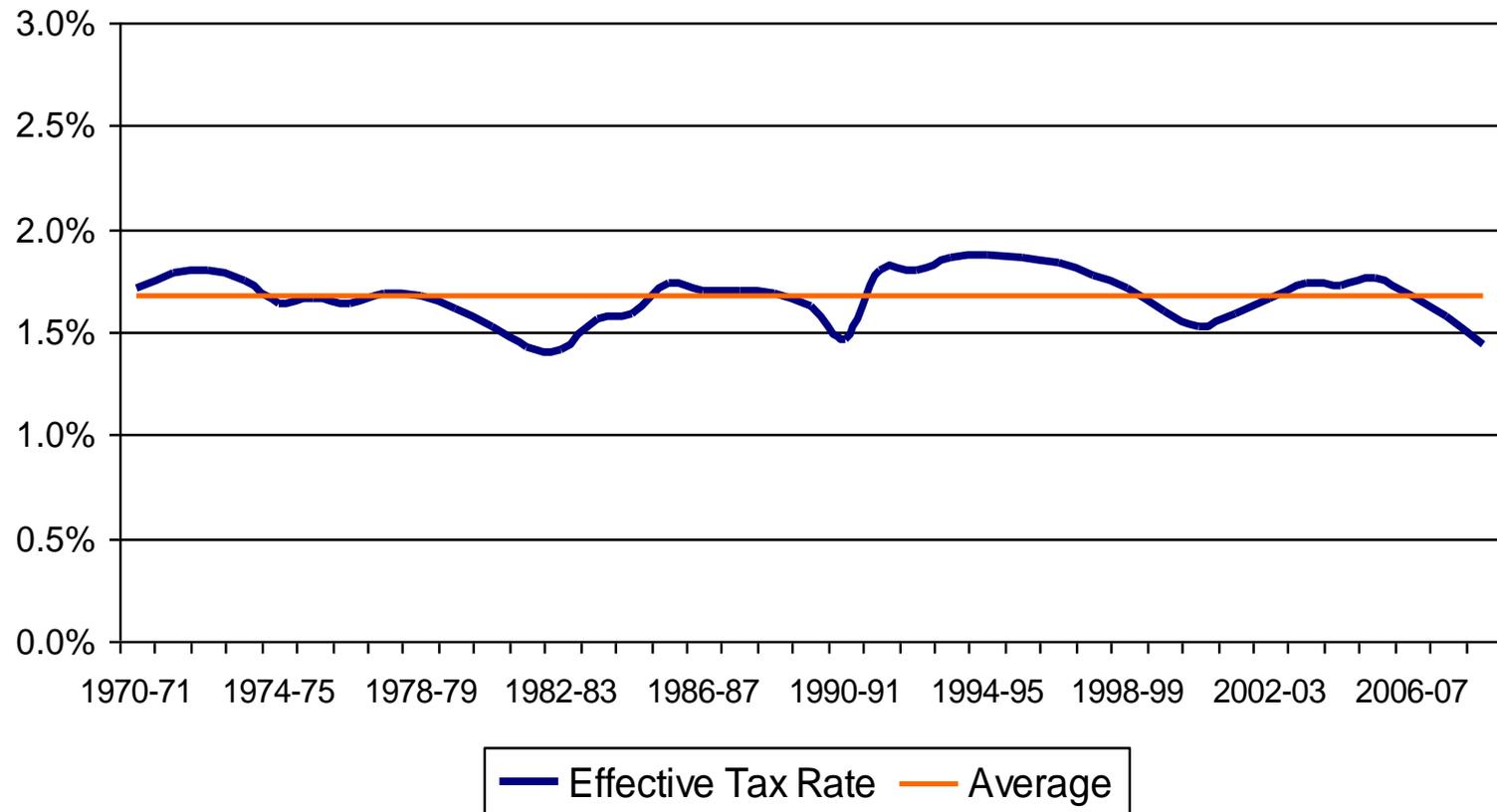
A Shrinking Sales Tax Base & Increasing Sales Tax Rates in North Carolina

The Sales Tax Base

- The tax base has narrowed
 - The bar graphs below indicate how North Carolinians spend \$100 of their income as a % of items subject to sales tax
 - We spend a smaller % of our income on items subject to sales tax now than in the 1970's & more on services not subject to sales tax

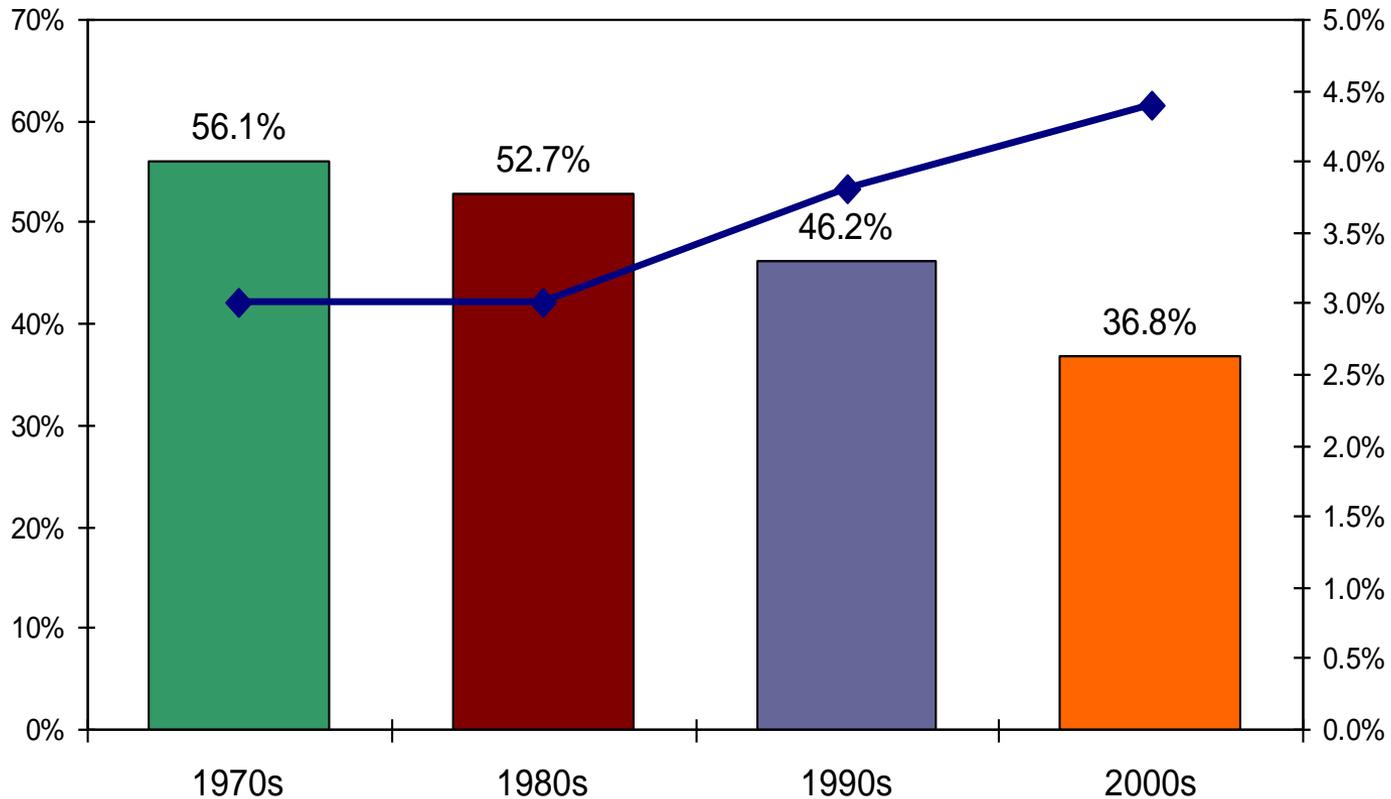


The Sales Tax Base



The effective tax rate (collections/income) has been stable despite a declining tax base. **But how was this achieved?**

The Sales Tax Base



To keep up with a declining tax base, State rates have been increased from 3% to 4.75% since 1991. Thus, the effective rate has remained steady.

Major Sales Tax Exemptions (\$ In Millions)

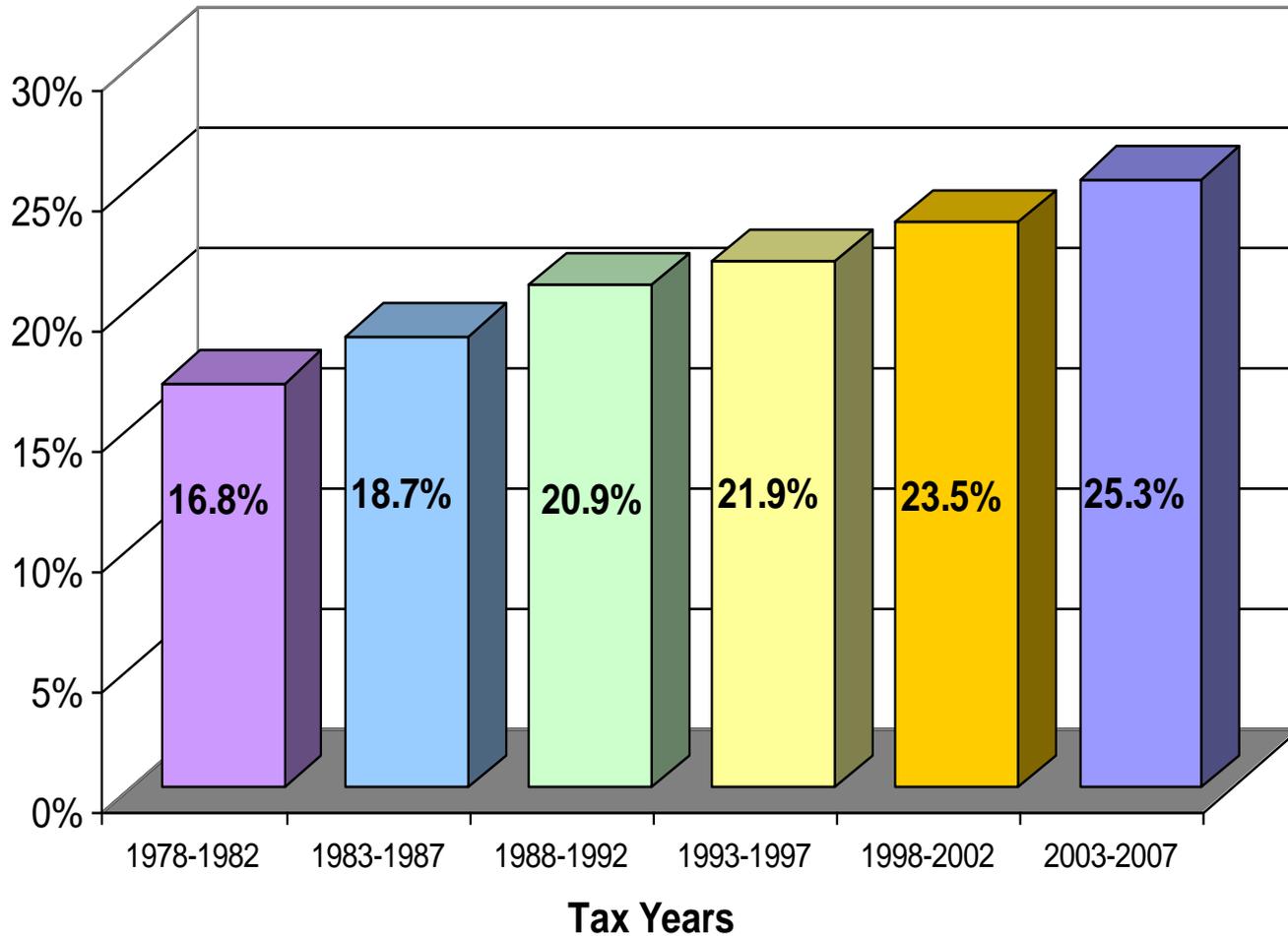
• Food for Home Consumption	\$622.1
• Sales and Use Tax Holiday	\$14.5
• Goods Sold Through Vending Machines	\$10.9
• Aircraft and Boats	\$10.0
• Manufactured Homes	\$6.9
• Modular Homes	\$2.9
• Energy Star Sales Tax Holiday	\$1.7
<hr/>	
• Total: Selected Consumer to Business Exmpt.	\$669.0
• Total: Business to Business Exmpt.	\$1,109.9
• Total: Other Exmpt.	\$1,310.4
<hr/>	
Total: All Exemptions	\$3,089.3

Personal and Corporate Income Tax

Personal Income Tax Facts

- 3+ million tax returns filed yearly
 - representing approximately 4.5 million taxpayers
- 3% or about 150,000 taxpayers pay 33% of total PIT (personal income tax)
- 22% or about 1 million taxpayers pay 63% of total PIT

Average Share of Total Personal Income Tax: Non-Withholding



Personal Income Tax

Individual Income Tax Expenditures (\$ millions)

**FY 2012
Estimate**

Standard or Itemized Deduction	2,296.0
Personal Exemption	1,228.2
Government Retirement Income under Baily Settlement	428.8
Social Security Benefits in Excess of Federal Limit	362.9
Credit for Children	151.0
Business Income Deduction	131.6
Earned Income Tax Credit	102.5
Private Retirement Plans and Government Pensions	89.2
Credit for Child Care and Certain Employment-Related Expenses	51.2
Charitable Contributions by Non-itemizers	36.8
Carry-Over provisions	24.0
Severance Wages	23.3
Blind and Elderly Taxpayers	22.1
Other (28 other expenditures)	64.7

Total

5,012.3

Corporate Income Tax Facts

- 65% of returns had no net taxable income
- Less than 8% of all C-corporations have net taxable income over \$100,000
- 217 corporations paid 56.5% of net corporate income tax revenue (after credits)
- 464 corporations paid nearly 70% of net corporate income tax revenue (**after credits**)

Corporate Franchise Tax

- The corporate franchise tax is imposed on corporations and some LLC's and is based on the highest of the capital stock base or the two personal property bases
- The franchise tax is payable whether the corporation is profitable or not
- The franchise tax is not imposed on sole proprietorships, partnerships or most LLC's

Income Taxes v. Sales Taxes---

Policy Considerations

Tax Policy Considerations :

Income Tax

- **Equity and Fairness**

- Income tax often viewed as less regressive when compared to the sales tax
- Tax planning to reduce income taxes is common and difficult to prevent

- **Administration**

State tax departments expend considerable resources administering income taxes

The complexity and uncertainty of tax statutes can confuse tax departments and taxpayers alike

Tax Policy Considerations :

Income Tax

- **Economic Competitiveness**

- North Carolina has extensively used income tax credit incentives as a business development tool, but a UNC study suggests this has not had the desired effect for various reasons
- Surrounding states generally have lower income tax rates than North Carolina
- Compliance costs for companies that must file income tax returns here must be considered
- Businesses want certainty and simplicity for income tax statutes

Tax Policy Considerations: Sales Tax

- **Certainty** –What is and is not subject to the sales tax
 - The more complex the tax system the greater the uncertainty and difficulty of administration
- **Low Compliance Costs**
 - Simplicity lowers compliance and administration
 - Administration cost rise with the number of exemptions to the tax
 - Uniformity across taxing jurisdictions lowers costs

What Are Other States Doing?

- Despite dire forecasts that eliminating state income taxes will negatively impact education, public safety and assistance programs, the experiences of states like **Florida, New Hampshire, Tennessee and Texas** indicate otherwise
- These states still fund more than adequate public services and their schools are generally no worse than in high-income tax states like California, New Jersey and New York.
- The states with no income taxes have also recorded faster revenue growth to pay for government services over the past two decades than states with income taxes because growth in the economy from attracting jobs and capital has meant greater tax collections despite lower rates-----**from the Wall Street Journal, 2/7/12**

What Are Other States Doing?

- States with current plans to eliminate or significantly reduce their income taxes include:

South Carolina, Oklahoma, Kansas, Indiana,
Nebraska, Idaho, Maine, New Jersey, Ohio

- “States like New York, California, Illinois and Maryland that have high and rising tax rates also tend to be those that have growing welfare states, heavy regulation, dominant public unions, and budgets that are subject to boom and bust because they rely so heavily on a relatively few rich taxpayers.” **From the Wall Street Journal, 2/7/12**

From the Wall Street Journal–2/7/12

Comparing High- and Low-Tax States

Percentage average growth by category for nine states without personal income taxes and nine states with the highest personal tax rates, 2001-2010

	No income tax	Highest rate
Population	13.7	5.5
State product	58.5	42.1
Employment	5.4	-1.7

Note: States without a personal income tax are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming. The states with the highest rates are California, Hawaii, Maine, Maryland, New Jersey, New York, Ohio, Oregon and Vermont.

Source: American Legislative Exchange Council, 2011

Next Steps?

- Tax Reform Study Group currently working to develop various ideas for tax modernization and to seek input from business, economists, government agencies, academics, etc.
- Time to heed the call of the numerous independent study groups which have advocated major changes to NC's tax code over the last several years, suggesting broadening tax bases and lowering tax rates

Next Steps?

- **North Carolina can no longer ignore the antiquated tax code elephant in the room**
- **Our tax code must be modernized to recognize that the economy has changed significantly over the last 80 years**
- **Failure to act will force North Carolina to continue with “ad hoc tax fixes” to balance the budget every year**
- **Failure to act will leave North Carolina behind other states as they implement modernization in their tax codes**

Thank You!!

QUESTIONS?

COMMENTS?

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