



Fiscal Modernization in North Carolina

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Fiscal Modernization

- Over the last decade, a variety of state commissions and other groups have been formed to study and make recommendations to modernize the state tax system
 - **2002 Governor's Commission to Modernize State Finances**
 - **2005-2009 , IEI's "Financing the Future"**
 - **2006 State & Local Fiscal Modernization**
 - **Fall 2009, the House and Senate Finance Committees met to specifically address issues dealing with modernizing the sales tax**

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● ● ● | Fiscal Modernization

“North Carolina needs a tax system that is competitive, stable, adequate and fair if we are to prosper in the 21st Century economy”

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● ● ● | The Argument for Fiscal Modernization

- North Carolina’s tax system was largely set in place in the 1920s and 1930s.
- North Carolina is changing - we are growing bigger, growing older, and becoming more diverse.
- Our economy is no longer dominated by tobacco, textiles and furniture
- These demographic changes and changes in the NC economy have resulted in a “structural deficit” - tax revenues are not able to keep up with a growing economy and basic expenditures.

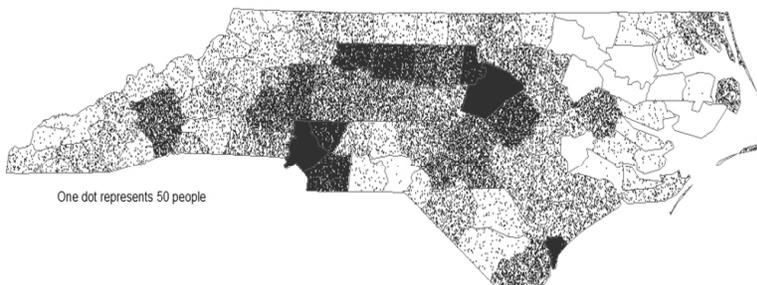
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North Carolina in the Year 2030

Population growth will not be evenly distributed across the state.



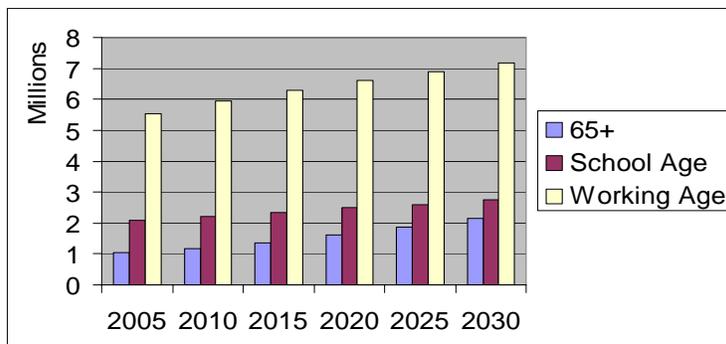
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North Carolina in the Year 2030

The population is aging, especially in rural areas.



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Shift to a Knowledge Economy

% Share of NC's Economy: Old Versus New Sectors

Sectors	1977	2005
Tobacco, Textiles and Apparel	22%	7%
Pharma, Technology, Food, Finance, Auto Parts	10%	17%
Total	32%	24%

Source: *North Carolina in the Connected Age* by Michael Walden (UNC Press, 2008)

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Fiscal Modernization

- Recommendations for broad-based comprehensive tax reform have generally met with a lukewarm response
- Over the last decade, our state lawmakers have enacted several “temporary” tax increases
- In the last budget cycle, the General Assembly dealt with the state’s budget problems with a band aid (a sales tax rate increase and individual and corporate income tax surtax) rather than deal with the real issue -
 - North Carolina’s tax system is out of date and requires basic reform

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● ● ● Problems with the Individual Income Tax

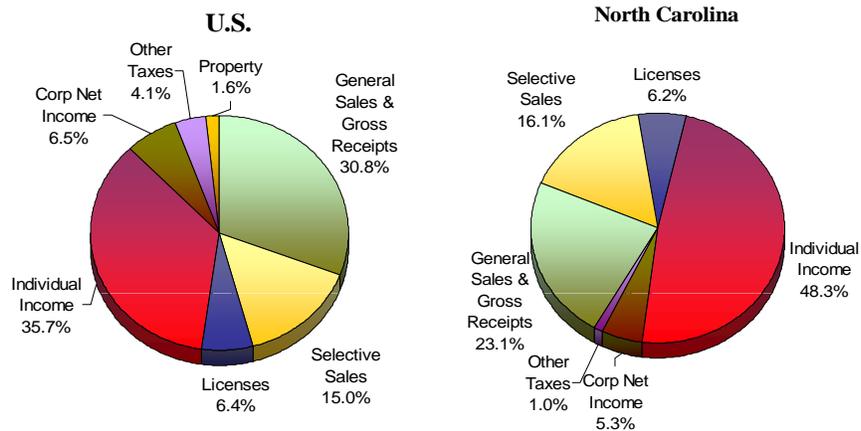
- North Carolina relies more on the income tax than we have in the past and more than most other states
- Depends on “bracket creep”
- Volatile
- Uncompetitive: High rates, paid by small businesses operating as proprietorships and owners of flow through entities as well as individuals

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● ● ● State Tax Collections

North Carolina relies more on the income tax than most states



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● ● ● Problems with the Corporate Income Tax

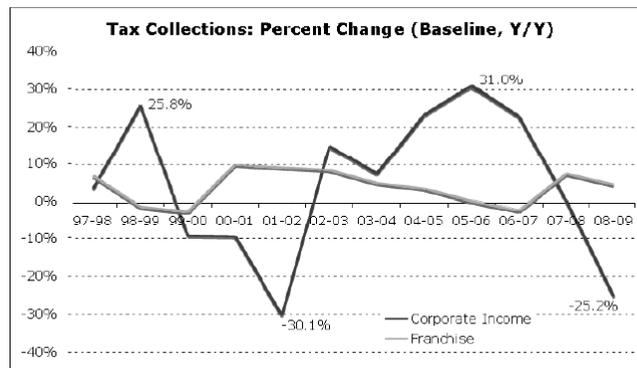
- The most volatile of our state taxes – accounts for between 4% and 8% of general fund revenues
- As a separate entity state, provides opportunities for multi-state corporations to shift income out of state
- Our statutory rate is high although a variety of tax credits are used to reduce the statutory rate

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● ● ● Problems with the Corporate Income Tax - Volatility

State Revenues: Corporate Income Tax



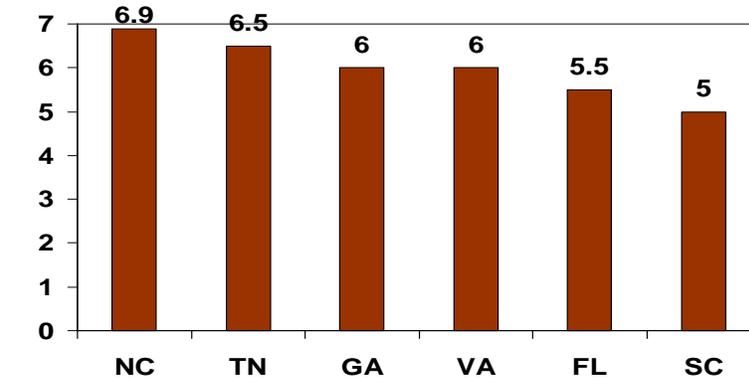
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Corporate Income Tax

Corporate Income Tax Rate (TY 2008)



Source: Federation of Tax Administrators

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The Sales Tax

- In principle, the sales tax is a tax on consumption
- Best features of a consumption tax
 - Taxes what citizens take out (promotes savings)
 - Smoother than Income
 - Grows with the economy
- Ideally, a sales tax should tax:
 - All household purchases
 - All purchases regardless of how obtained
 - All purchases regardless of the vendor
 - No business purchases

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● ● ● | Problems with the Sales Tax

- NC relies less on the sales tax than most states
- North Carolina's sales tax base is narrower than most states – services are largely not subject to tax
 - Discriminates against manufacturing
- Relies on a shrinking and volatile base
- Regressive dependence on tangible goods
 - As consumers become wealthier, they consume more services

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● ● ● | Problems with the Sales Tax

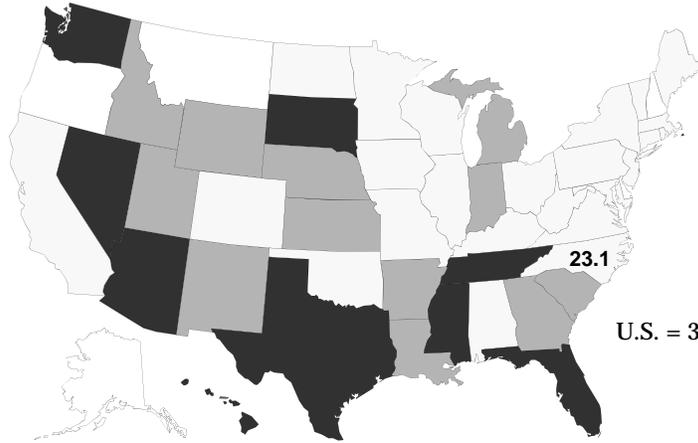
- Due to numerous exemptions, the sales tax can be surprisingly complex for retailers!
 - Sales tax holidays confound the problem – what is exempt and what is not?
 - Food is not subject to sales tax but candy is
 - Is a Twix bar candy or food?
 - Food is not subject to sales tax but soft drinks are
 - Is bottled ice tea a soft drink?

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General Sales Taxes as a % of Total Taxes



Less than 30.8% 30.8% to 40.0% Greater than 40% Not Levied

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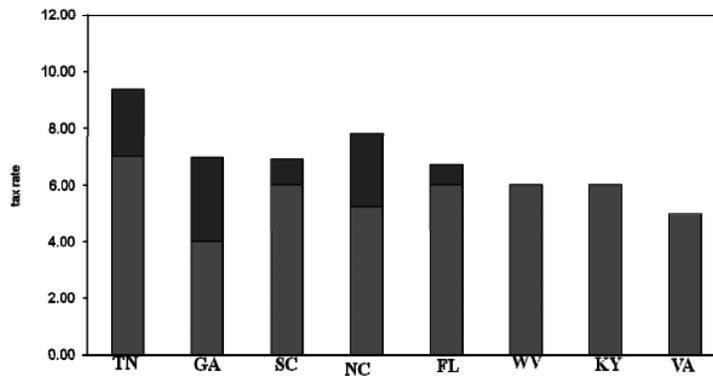
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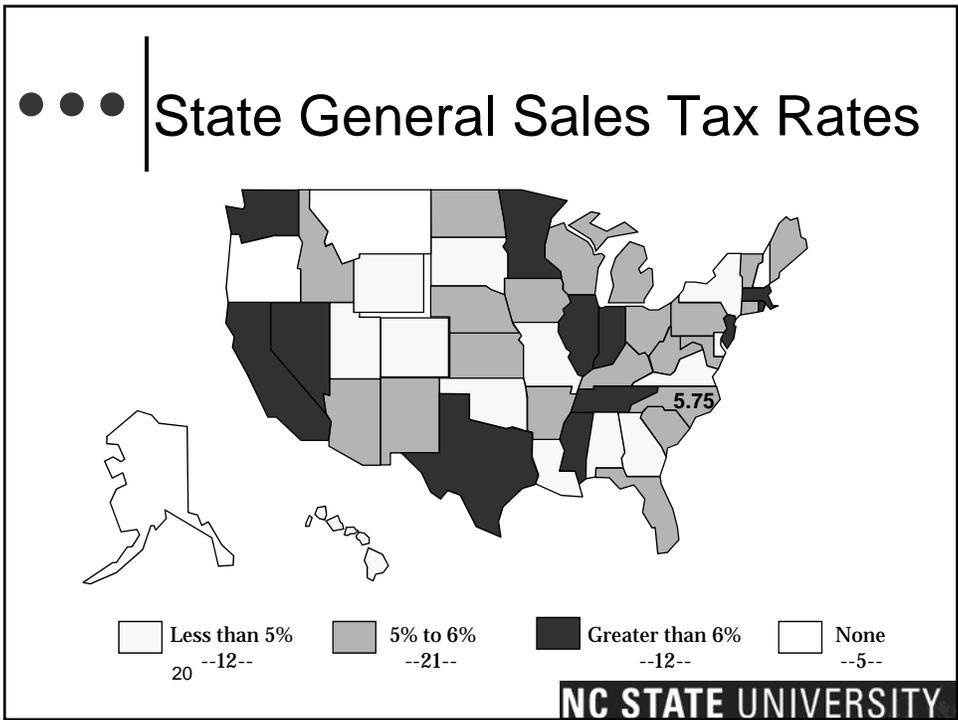
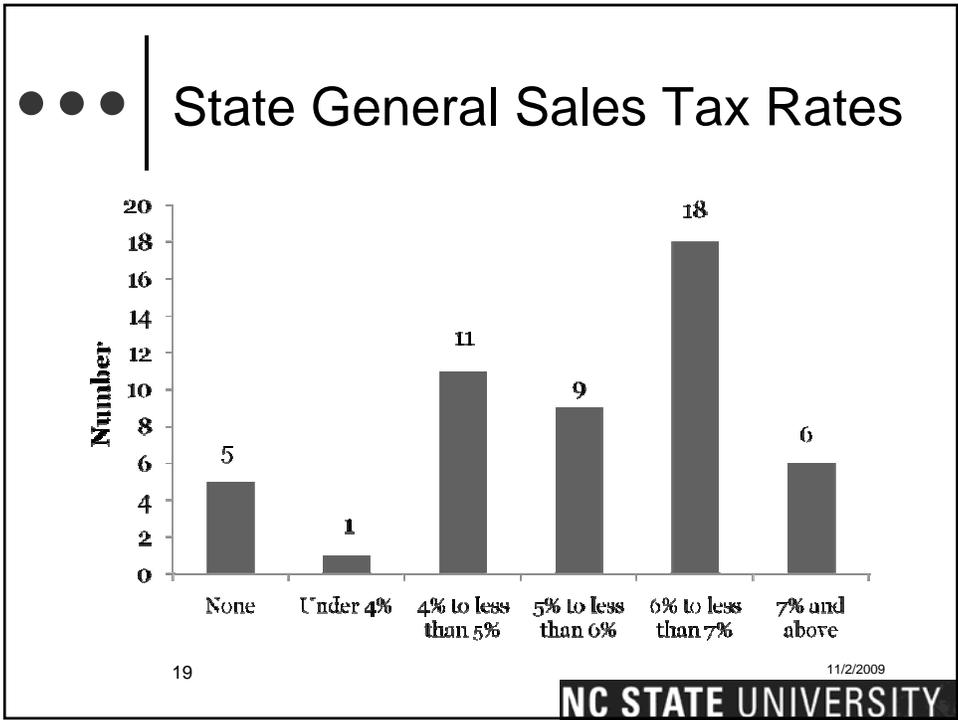
Problems with the Sales Tax

The 2009 increase gives NC one of the highest rates



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North Carolina's sales tax base is narrower than most states

- FTA catalogs 168 separate services
- NC taxes 30 services
- Average services taxed by a state = 56
- 18 states tax fewer services than NC
- 5 states tax over 140 services (Hawaii, New Mexico, Washington, South Dakota and Delaware)

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Common Services Taxed by Other States

- Pet grooming
- Landscaping
- Construction trade services (painting, plumbing)
- Storage services
- Pest exterminating services
- Cleaning services
- Security services
- Automotive services
- Repair services
- Personal services (tanning parlors, health clubs)
- Janitorial services
- Sign construction and installation services
- Warranties

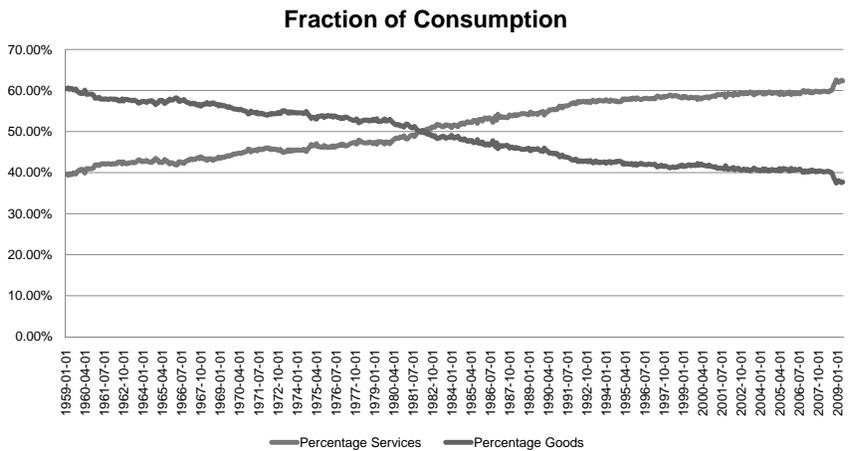
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North Carolina's Tax Base in Shrinking - Consumption Expenditures 1979 and 2009

	<u>1979 Percent</u>	<u>2009 Percent</u>
Total Expenditures	100.0	100.0
Durable Goods	13.4	11.1
Nondurable Goods	39.1	29.2
Services	47.4	59.7

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North Carolina's Tax Base is Shrinking



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Volatility

- Sales of services are less volatile than income
- Sales of durable goods are more volatile than income
 - Durable goods make up a large fraction of the sales tax base

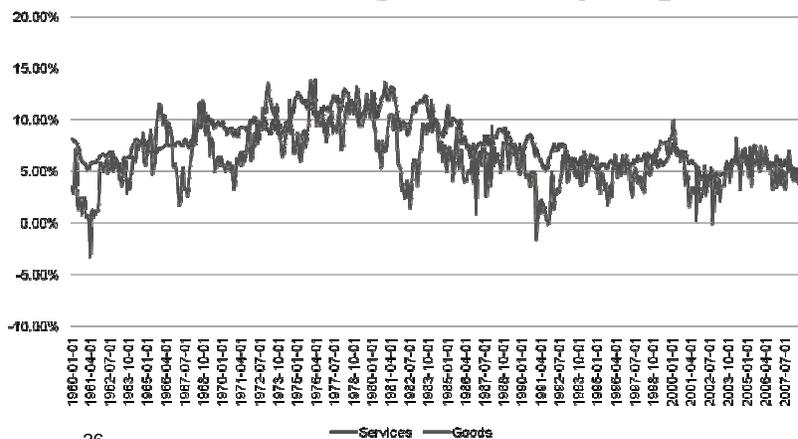
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Sales Tax Volatility

Year over Year Change in Consumer Spending



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● ● ● | Volatility

- Volatility can be just as dangerous on the way up as down
- Cyclically high revenues expose governments to pressure to increase services (spend more) or reduce tax rates
- But if you reduce rates, what happens in a down cycle?

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● ● ● | Financing the Future

- So how should North Carolina go about financing its future?
- The recommendations from the different groups studying the issue have been (for the most part) very consistent.

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● ● ● | General Tax Recommendations

1. Tax reform must be comprehensive in order to be successful.
2. Income and sales tax bases should be broadened and tax rates should be reduced so that overall changes at the state level are revenue neutral.
3. To the extent that base broadening results in increased burdens for low-income taxpayers, the State should provide a mechanism to offset this increase.

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● ● ● | Recommendations: Income Tax

- Broaden the individual income tax base, reduce individual rates and eliminate tax filing and payment responsibilities for low income taxpayers
- Reduce or eliminate the corporate income tax, consider changes to the franchise tax and consider other methods of taxing corporations

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Recommendations: Sales Tax

- Broaden sales tax base.
- Lower the sales tax rate.
- Eliminate special rates and exemptions.

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The Current Budget Picture

- The current recession hit North Carolina particularly hard
- While most economists believe the economic recovery is on solid footing, the budget picture is not!
 - As of December 7, Fiscal Research Division estimates a \$3,7 billion budget gap

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The Current Budget Picture

- Revenues through the first 4 months (through October) are \$20 to \$25 million above the \$6.1 billion target
- Note that the “target” was set very low
- Tax revenue is actually \$45 million over target but other non-tax revenue is below target
- Economy based taxes are starting to show signs of recovery- sales tax growth is up and withholding tax collections are improving

Source: Barry Boardman, Fiscal Research Division, North Carolina General Assembly

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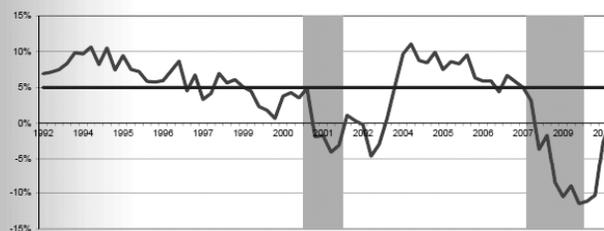


Sales & Use Tax Collections

Key Revenue Collection Trends

Sales and Use Tax Collections (adjusted for tax law changes)

Quarterly Baseline Collections (change over prior year)



Collection losses have ended after two years of significant declines (long run average growth close to 5%).

Source: Barry Boardman, Fiscal Research Division, North Carolina General Assembly

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Personal Income Tax - Withholding Tax Receipts

Key Revenue Collection Trends



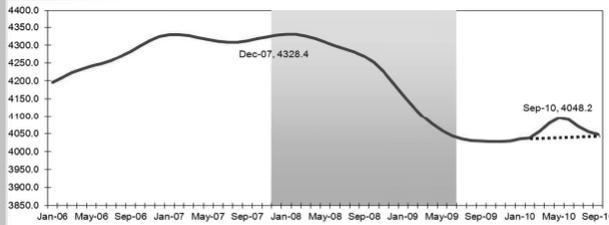
Withholding has started to rebound following a slight increase in employment as well as in the number of hours worked.

35 Source: Barry Boardman, Fiscal Research Division, North Carolina General Assembly

Employment

Key Revenue Collection Trends

Total Employment (thousands)



The trend of monthly net job losses has ended, but there has been little rebound in employment. The temporary uptick from Census jobs can be seen in the early summer (the dotted line is an FRD estimate of total employment without the census uptick).

Source: North Carolina Employment Security Commission

Source: Barry Boardman, Fiscal Research Division, North Carolina General Assembly

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What Can We Expect?

- Today's economic uncertainties and anticipated revenue shortfalls may provide an opportunity for tax modernization that we did not have in the past few years
- But, the need for tax revenue to balance the budget makes revenue-neutral reform unlikely

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What Can We Expect?

- Some base broadening of the sales tax might be expected as an experiment and to raise revenue
- Tax low-hanging fruit – services that are connected to the sale of a tangible good
 - Auto repairs for example

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What Can We Expect?

- Will the Governor support tax modernization?
- Does the new Republican-led General Assembly support tax modernization? If so, who will carry the torch?
- Will the business community support comprehensive reform?

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