

spotlight

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BILLION-DOLLAR TAX HIKE

Legislative Leaders Consider Spend and Tax Mash-Up?

S U M M A R Y : Legislative leaders may be planning a nearly billion-dollar tax hike. The state would take one cent of the sales tax from counties and offer them the option to increase the local sales tax by one cent. To make the trade palatable, legislators would stop charging counties for 15 percent of Medicaid, offer an earned income tax credit for low-income workers, and cut the corporate income tax rate. Counties would also have more responsibility and flexibility in funding school and road construction. Legislators should look for savings in the state budget to pay for schools, roads, and Medicaid before passing the cost to taxpayers.

Legislative leaders may be planning a nearly billion-dollar (\$940 million) tax hike and they hope taxpayers won't notice. The scheme would take one cent from the 2.5-cent local sales tax and give it to the state in exchange for local governments having the option to raise the rate by one cent. The end result would be a penny increase in the sales tax and a new 7.5-cent general sales tax rate for most counties – 8.0 cents in Mecklenburg. Unlike the last sales tax increase in 2001, this increase would *not* be temporary.

On its own, a billion-dollar tax hike stands out, which is why it would be part of a host of spending and tax changes. Each of these possible changes would be aimed at getting support from key groups.

◆ **COUNTIES:** To get counties on board, the state would take over their \$470 million Medicaid burden. With this burden gone, counties could dedicate more of their own money to school and road construction. Some county officials have already endorsed this idea.¹ The apparent scheme could also give counties more flexibility in how they use state funds for schools and roads.

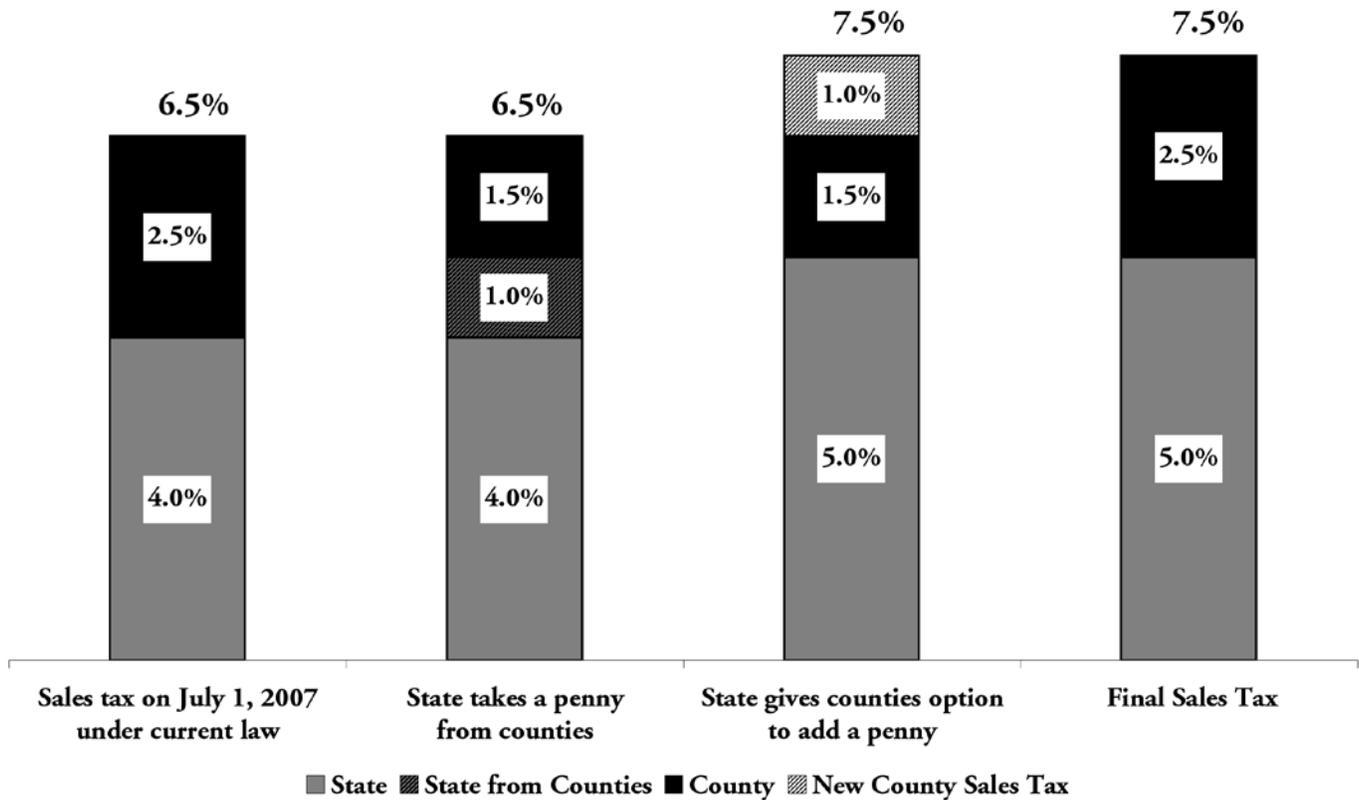
◆ **THE LEFT:** Liberals often complain about the regressive nature of sales taxes. They have also long wanted an earned-income tax credit (EITC) for low-income workers.² A billion dollars of new revenue would provide \$100 million for a credit at 10 percent of the federal level.

◆ **THE BUSINESS LOBBY:** Businesses might not like the idea of a higher sales tax, but reports suggest that legislative leaders hope that a \$100-

200 W. Morgan, #200
Raleigh, NC 27601
phone: 919-828-3876
fax: 919-821-5117
www.johnlocke.org

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Figure 1. Increasing the Sales Tax to Raise Nearly \$1 Billion



million corporate income tax cut, to 6.0 percent from 6.9 percent, would get the Chambers of Commerce to cooperate. This tax cut would be nearly twice the value of what the Senate offered in the 2005 session. Even counting it as an offset to the sales tax hike, the net tax increase would still be \$840 million.

◆ **EVERYBODY ELSE:** The remaining revenue from the tax increase could make it possible for the temporary taxes first passed in 2001 to finally expire, saving taxpayers \$280 million — unless all of the other commitments tied to the scheme were to keep lawmakers from addressing the shortfall they created in the 2006 session.³

Why this? Why now?

Numerous reports and groups in the past year have emphasized the challenges facing state and local governments in transportation, school funding, Medicaid, tax reform,⁴ and the fiscal balance between state and local government.⁵ The scheme outlined above would try to buy off interest groups while giving the appearance of addressing these critical areas.

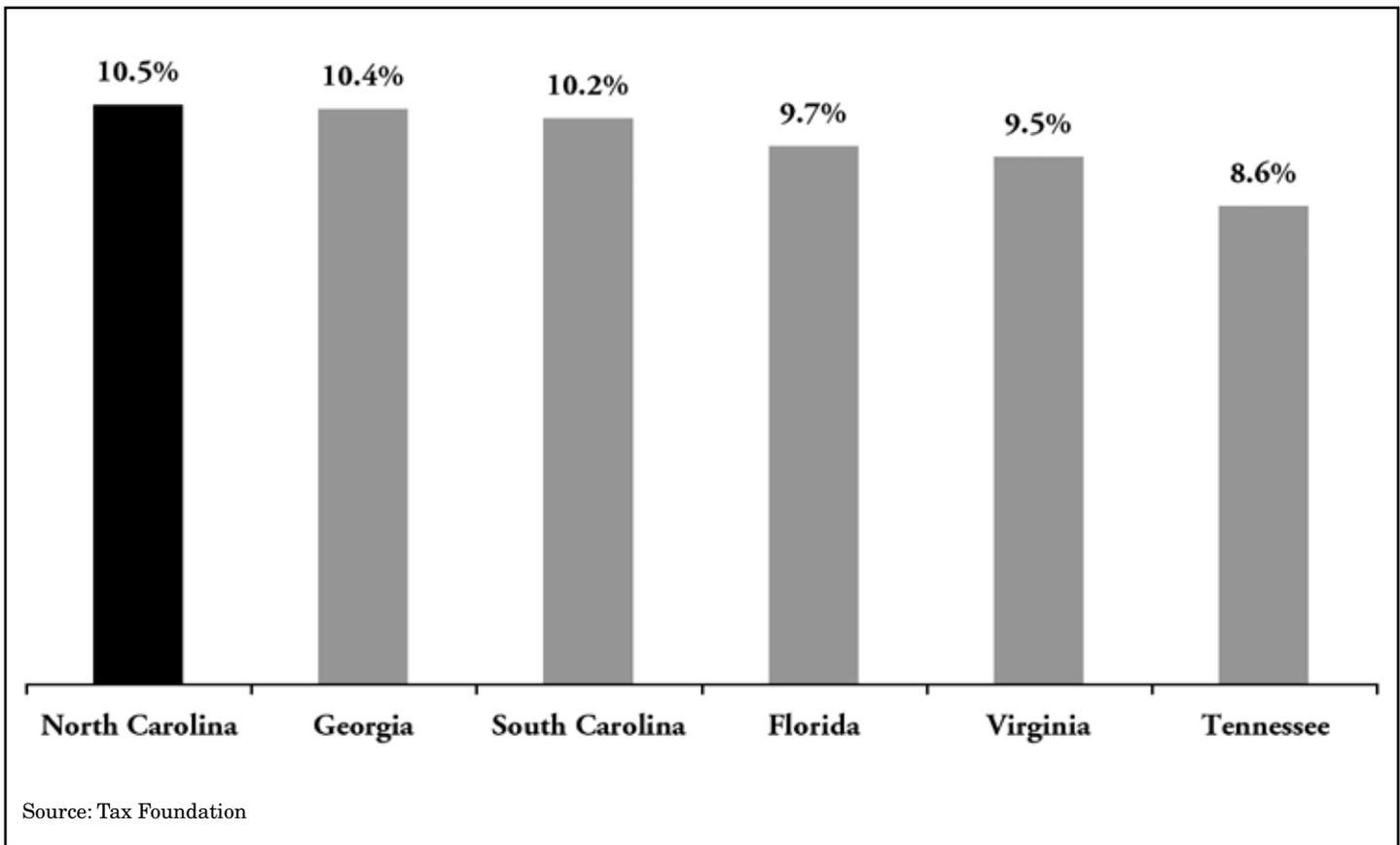
What’s Not to Like?

Like those email messages from an exiled Nigerian oil minister, this legislative tax scheme counts on the reader being so overwhelmed by the promise of riches that he ignores the costs.

◆ **MEDICAID:** The state should take over the county share of Medicaid. A decade of responsible county administration can be swamped by legislative whim in Raleigh or Washington. Rather than put the burden for this shift on taxpayers, however, lawmakers should first look for savings within Medicaid, a program with better benefits than available in most private insurance plans.⁶

◆ **ROADS:** The state also faces a \$65 billion shortfall to build and maintain roads over the next 25 years,⁷ and \$920 million in just the next three years.⁸ But the shortfall need not be so large. The General Assembly still takes \$250 million a year from the Highway Trust Fund, which was created in 1989 to build a four-lane intrastate arte-

Figure 2. North Carolina Has the Highest State/Local Tax Burden in the Southeast



rial system and urban loop highways in 13 years. Only two-thirds of the work has been completed, and the rest is slow in coming. In addition to criticism of the funding formula, recent research has found that millions of transportation dollars each year are wasted on projects that are not cost-effective.⁹ The state needs a better formula to fund the most worthy projects based on safety, road condition, and congestion relief. Tolls and other user-based funding can pay for some road construction more efficiently, equitably, and simply, and can do so sooner than current formulas otherwise permit. The state should also make more use of other financing devices commonly used in other states.

◆ **SCHOOLS:** Our fastest-growing counties do not have enough seats for all of the students that will be entering their schools in the next ten years. Outside of Forsyth County,¹⁰ however, few school districts have found cost-effective ways to build schools. School buildings themselves are too elaborate, have too many amenities, and are located on too much land.¹¹ Alternatives such as charter schools and public/private partnerships are also rarely considered. Counties should seek ways to limit the cost of building schools before receiving a blank check of new funds. Also, the state should allow more charter schools either by eliminating the cap or by permitting successful charters to create branch campuses.

◆ **WORKING POOR:** An earned income tax credit (EITC) would have been a good policy alternative to this year's minimum-wage increase. Judge Richard Posner has written that the EITC "compensates for low wages without interfering with the labor market."¹² It is a misuse of the EITC to make it offset a regressive tax increase, one that eliminates most of the EITC's benefit.

◆ **TAX REFORM:** North Carolina's reliance on a progressive personal income tax and a regressive sales tax on goods leaves government revenues vulnerable to economic cycles. Tax collections grow faster than income in good years and shrink faster in bad years. Targeted tax incentives and other carve-outs make the tax system more complex. Spending reform would end the boom-and-bust cycle of the state budget.¹³ A consumed-income tax and corporate income tax repeal would produce a simple, efficient, and equitable tax code that spreads a low tax rate

over a broad taxpaying base.¹⁴ Other methods of taxation would accomplish the same goal, but the legislative proposal moves in the opposite direction.

In short, the scheme apparently being hatched would increase the burden on taxpayers with little gain for anyone. North Carolina already has a higher state and local tax burden than any other state in the region¹⁵ (see Figure 2). The sales-tax increase would expand the gap and make for the 12th highest state and local sales tax rate in the country (see Figure 3). More businesses are subject to the eight-percent personal income tax than to the lower corporate income tax rate, which makes the personal income tax more important for economic growth. New county taxes on top of the property tax hikes voters approved when they passed bonds in November will not be popular.

Conclusion

Increasing taxes nearly a billion dollars and distributing the spoils is not good fiscal policy. County budgets are straining under the burden of Medicaid, leaving local governments with few options to pay for schools and roads. The General Assembly should take over the county share of Medicaid, but not at the expense of raising the sales tax.

The deal sweeteners, including the earned income tax credit and corporate tax cut are transparent attempts to gain support from groups but, without being part of meaningful tax reform, will do little to improve the lot of working people or spur economic growth.

Joseph Coletti is Fiscal Policy Analyst for the John Locke Foundation.

Notes

1. "Revenue remains the No. 1 issue," *Hickory Daily Record*, December 3, 2006, tinyurl.com/y3r8f2 www.hickoryrecord.com/servlet/Satellite?pagename=HDR%2FMGArticle%2FHDR_BasicArticle&c=MGArticle&cid=1149191978351&path=/features/lopinion.
2. "North Carolina," State EITC Online, accessed December 5, 2005, www.stateeitc.com/states/north_carolina.asp.
3. Elaine Mejia, "The Final State Budget Agreement," N.C. Budget and Tax Center, August 7, 2006, www.ncjustice.org/media/library/791_btcrptaug72006.pdf.
4. For example, the Emerging Issues Forum focused on taxes in February 2006; see www.ncsu.edu/iei/projects/financing.html.
5. The State and Local Fiscal Modernization Study Commission began meeting November 28, 2006; see www.ncleg.net/gascripts/DocumentSites/browseDocSite.asp?nID=8.
6. Joseph Coletti, "Carve the Medicaid Turkey: State Should Eliminate County Share of Medicaid in Five Years," John Locke Foundation *Spotlight* No. 272, November 21, 2006, www.johnlocke.org/spotlights/display_story.html?id=119.
7. Bruce Sicheloff, "State \$65 billion short on road needs," *The News & Observer* (Raleigh), October 5, 2006; accessed December 5, 2006, www.newsobserver.com/102/v-print/story/494689.html.
8. Bruce Sicheloff, "Money woes create project gridlock," *The News & Observer*, June 27, 2006; accessed December 5, 2006, www.newsobserver.com/248/story/455022.html.
9. David Hartgen, *Policy versus Performance: Directions for North Carolina's Largest Transit Systems*, John Locke Foundation Policy Report, May 4, 2006, www.johnlocke.org/policy_reports/display_story.html?id=71.
10. Terry Stoops, "The Forsyth Formula: Other School Districts Should Learn These Construction Principles," John Locke Foundation *Spotlight* No. 282, www.johnlocke.org/spotlights/display_story.html?id=129.
11. Terry Stoops, *Feng Shui Schools: Wake County's Unenlightened School Building Program*, John Locke Foundation Policy Report, October 23, 2006, www.johnlocke.org/policy_reports/display_story.html?id=76.
12. Richard Posner, "Should Congress Raise the Federal Minimum Wage?" www.becker-posner-blog.com/archives/2006/11/should_congress.html.
13. Joseph Coletti, *Spend and Tax: A History of General Fund Crises in N.C. and How to Prevent Them*, John Locke Foundation Policy Report, September 14, 2006, www.johnlocke.org/policy_reports/display_story.html?id=75.
14. Roy Cordato, *Liberty and Economic Growth: Principles for Reforming North Carolina's Tax System*, John Locke Foundation Policy Report, January 4, 2005, www.johnlocke.org/policy_reports/display_story.html?id=52.
15. "State and Local Tax Burdens Compared to Other U.S. States, 1970-2006," Tax Foundation, April 12, 2006; accessed December 6, 2006, www.taxfoundation.org/taxdata/show/336.html.

Figure 3. Highest Average State & Local Sales Tax Rates in the Nation

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|--------------------|--------------|
| 1. Tennessee | 9.40 percent |
| 2. Louisiana | 8.65 percent |
| 3. Washington | 8.45 percent |
| 4. New York | 8.25 percent |
| 5. Oklahoma | 8.15 percent |
| 6. Alabama | 8.00 percent |
| 7. Arkansas | 8.00 percent |
| 8. California | 7.95 percent |
| 9. Texas | 7.95 percent |
| 10. Arizona | 7.80 percent |
| 11. Illinois | 7.60 percent |
| 12. North Carolina | 7.55 percent |
| 13. Nevada | 7.50 percent |

Sources: Sales Tax Clearinghouse