John LOCKE FOUNDATION

SPOTLIGHT

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ADJUST THE TAX CODE

State Economy Needs the President's Stimulus

Summary: The state legislature is currently considering the idea of "decoupling" North Carolina's income tax code from the federal tax code in order to avoid implementation of several tax reductions associated with a federal economic-stimulus package. But North Carolina's weakened economy desperately needs the $258 million boost that adjusting state taxes on business and personal investment would provide. Policymakers could offset any revenue loss by reducing spending.

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President George Bush and the U.S. Congress passed a package of tax cuts in Spring 2002 that were meant to stimulate the economy. As the North Carolina economy continues to experience rising unemployment and the most anemic economy in 20 years, the General Assembly is seriously considering the possibility of denying this valuable tax relief to the state's individuals and businesses.

For more than a decade, North Carolina has traditionally conformed its state income tax code to the federal code, thus clarifying such issues as what is deductible, how business expenses are treated, what the limits are on special savings accounts like IRAs, etc. But this is not automatic. If the federal government makes changes the state government must, if it is to continue to conform to the federal code, enact those changes into state law. This is the case with several provisions contained in the president's stimulus package. This raises a question for state lawmakers. Are they more interested in preserving and expanding the current size of government than they are in developing a more prosperous economy?

Stimulating Saving and Investment

The primary purpose of President Bush's tax cut package was to stimulate savings and investment. The plan does this by lowering the tax cost of each.

For businesses the primary provision relates to the rate at which businesses can write off the cost of business expenses and the purchase of business equipment. For individuals the tax savings come from increasing the deductible limits on tax free savings accounts such as IRAs for retirement and education and through the phase out of the inheritance tax. If North Carolina conformed to the federal changes in these areas it

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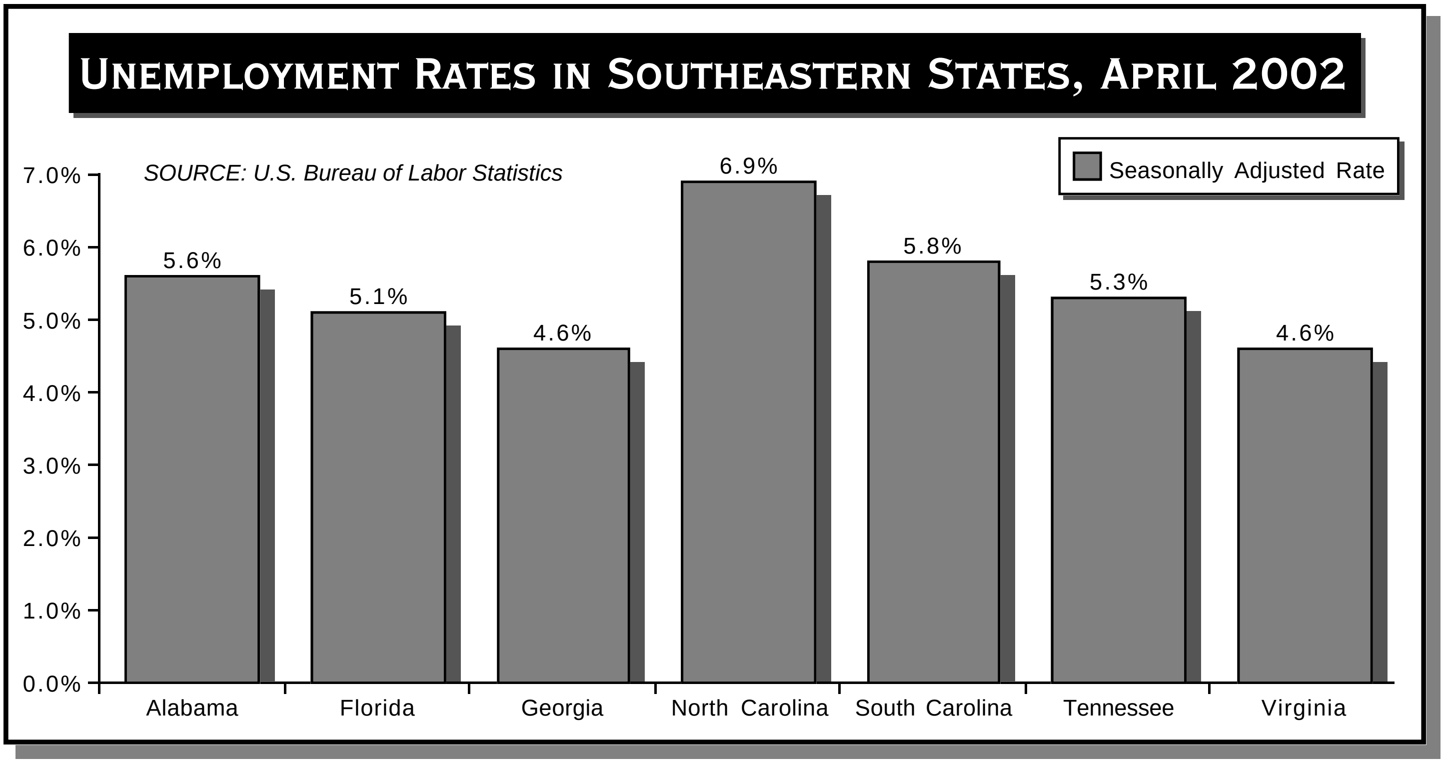


would have a beneficial effect on the economy and make it easier for citizens of the state to save and invest, especially for their retirement and their children's education.

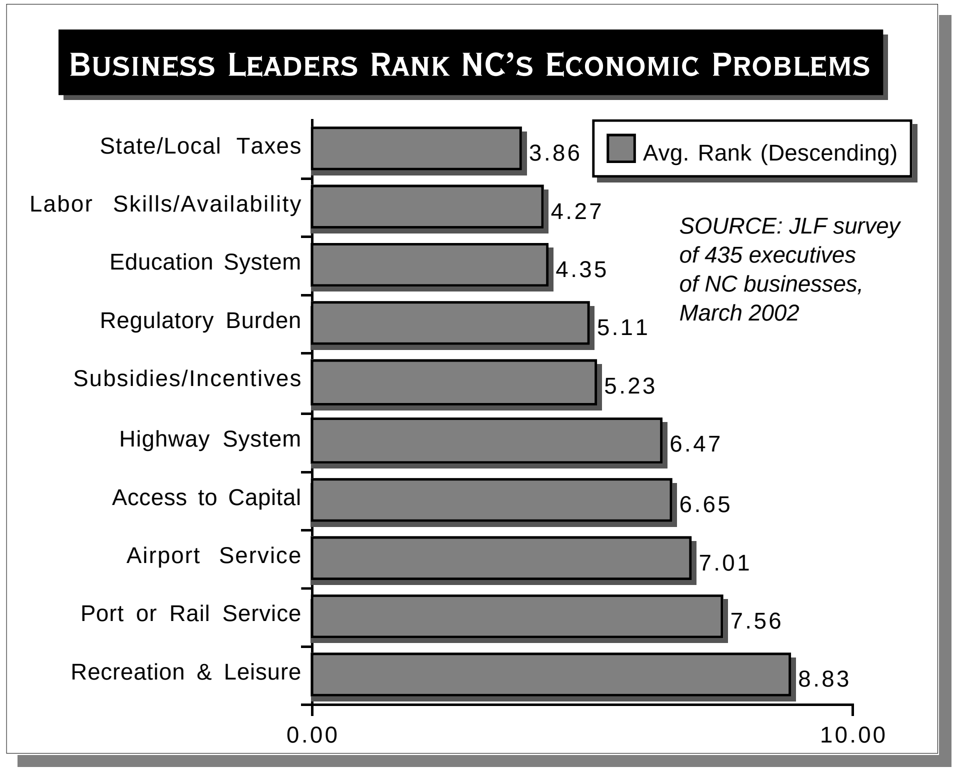
Probably the least appreciated change relates to the deduction of business expenses. The cost of most business equipment can be deducted from taxable income, but it cannot be done all at once in the year that the equipment is purchased. The tax code has assigned periods of "useful life" to different kinds of equipment and investment purchases. The longer the useful life, the longer the tax write-off period. Most investment purchases can be written off over a period of 20 years or less. The exception is real property such as buildings and land. This means that the tax value of the write-off, in real terms, is actually less than the full cost of the investment. This is because of the time value of money. A dollar five years from now is worth less than a dollar today. This is why banks and other lenders require that interest be paid. If someone cannot write off the full cost of a business purchase for 15 or 20 years there is actually a *loss* associated with the tax write-off itself. This loss is reflected by the interest that could have been earned on that money. This is why an economically efficient and fair tax code would allow businesses to expense all of their investment purchases, i.e., they would be allowed to write off the entire expense in the year that it is incurred.

Under the changes made in the Bush stimulus plan, 30 percent of the plant and equipment costs with a 20 year or less write-off period is allowed to be deducted in the first year. Unfortunately this is only a temporary measure, applying to purchases made for a three-year period that began on September 10, 2001. But it will provide important tax relief and encourage new business investment, at least in the short run. It might also encourage investments that are being postponed to be made sooner. For the North Carolina legislature not to adopt this provision would be a disservice to the state's businesses and workers. New capital investment typically leads to new labor investment. This is especially true for manufacturing industries that have been suffering the most in the recent recession. Also, to the extent that other states fall in line with the federal government and North Carolina does not, businesses that have operations both in and out of our state would tend to allocate new investments to the states with more favorable tax environments. In other words, failure to enact these tax changes could put North Carolina at a competitive disadvantage — and, as the above chart shows, we can scarcely afford such a choice.

Building Family Nest-Eggs

The second pillar of the tax changes instituted by the federal government relates to personal savings. These involve increasing the allowable pre-tax contributions to so-called education IRAs from $500 to $2000 a year; to regular IRAs from $2000 to $3000 and to $3500 for people over 50; and to phase in an increase in allowable annual 401K contributions from $10,500 to $15,000 by 2006. The first increase to $11,000 would be in 2002.

There is also a phase out of the estate tax. In addition to being a double tax (wealth left in an estate is taxed initially as income when it is earned) the estate tax is also a tax on saving. It discourages people from saving now in order to make their children better off in the future — which is a strong motivation for saving, investing, and the accumulation of wealth.



All of these changes have both social and economic benefits. The changes in retirement savings accounts will allow a greater portion of the population to be self-sufficient in their elderly years, taking a burden off of social programs such as Social Security, Medicare, and Medicaid.

Also, the increase in education IRA limits will alleviate some of the pressure faced by parents who are trying to plan for their children's college education. This would seem to be particularly important as major increases in tuition in the state university system are being contemplated. From an economic perspective, saving is the backbone of economic growth. All future economic expansion comes from capital that is accumulated through saving today. The lower today's savings rates the slower the future rate of economic growth.

For all of these reasons, it is important that North Carolina adopt the tax changes that were passed by Congress last year. The state's economy needs the stimulus that these changes are meant to provide even more than the national economy. Unemployment in North Carolina continues to be well above the national rate and is highest in the Southeast. Furthermore, the increase in N.C. unemployment during this recent recession was the third worst in the country.

The State Budget Impact

Unfortunately the primary concern of the General Assembly in adjusting the state tax code to federal tax changes has not been the state economy or making the lives of taxpayers a little easier. Instead, it has been preserving state government's spending promises. According to the state's Department of Revenue, making the above changes would result in a loss to the state treasury (and a savings to taxpayers) of about $258 million in FY 2002-03. This is probably an overstated number. This is because it does not take into account any of the increase in economic activity that these tax changes would encourage. If these changes lead to faster economic growth then the state revenue impact would be reduced.

But even if the figures offered by the department are taken at face value, there are ways of compensating for this loss through reduced spending. The John Locke Foundation has offered an alternative balanced-budget, which includes adoption of all of the federal tax changes in addition to repeal of the tax increases adopted by the legislature last fall. In this budget over $1.2 billion in net spending cuts have been identified.[1] These include direct subsidies to favored businesses and advocacy groups and reductions in the state's Medicaid program, which state treasurer Richard Moore referred to in a recent television interview as "the Cadillac" of Medicaid programs.[2] In addition the proposal includes the elimination of the Golden Leaf Foundation, transferring nearly $100 million a year to the General Fund, and the liquidation of unspent Hurricane Floyd relief money, which amounts to a one time transfer of over $350 million to the General Fund.

The point is that the $258 million that the legislature is concerned about "sacrificing" from the state treasury in order to provide much-needed stimulus to the state's economy can be compensated for in the budget. All it takes is a little willingness to give up some pet projects or say no to some special interests.

— Dr. Roy Cordato, Vice President for Research

Notes

[1] John Hood, Don Carrington, and Roy Cordato, "Changing Course V: An Updated Alternative Budget for NC," *Spotlight*, No. 217, May 6, 2002, found at www.JohnLocke.org.

[2] *Solutions*, February 11, 2002, ABC Channel 11, Raleigh, NC.