John Locke
FOUNDATION

spotlight

No. 444 – September 24, 2013

TAX REFORM 2013

Setting the Stage for Economic Growth

KEY FACTS: **• In 2013, the state of North Carolina implemented fundamental tax reform, replacing a system that imposed burdensome taxation on the many with special exemptions for the privileged few.**

• Changes were made to the personal and corporate income taxes by lowering the rates and broadening the bases.

• Changes to the sales tax were less significant, leaving current rates in place and expanding the base to include some services.

• From the perspective of economic growth, the two most important reforms are those made to the personal and corporate income taxes.

• The plan cuts taxes by about $4.75 billion over five years, assuming the state meets certain revenue triggers and implements the plan fully.

• With the personal income tax, economic distortions have emanated from both its rate structure and its base. With respect to the corporate tax, the problem has been that it has existed at all.

• An income tax is a penalty on productive activity of all kinds—the higher the rate the greater the penalty.

• By flattening the top rate and lowering it to 5.75 percent from 7.75 percent, the latest reforms significantly ameliorate these problems.

• Future reform efforts need to focus on eliminating savings from the tax base.

• Principles of government transparency and economic growth both suggest that the corporate tax should eventually be abolished.

• The good news is that, by lowering the rate, these negative impacts are reduced, and dramatically so if revenue triggers are met and the rate falls to 3 percent.

• The importance of reducing tax revenues is that it transfers resources from political to private sector control, enhancing the overall efficiency of how these resources are used.

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for Truth

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For many years it has been recognized that North Carolina's tax system is in need of a major overhaul. The system has been a model of hodgepodge tax policy, with high marginal rates on personal and corporate incomes and lots of exemptions carved out for the favored few. This has led to a tax system that generally penalizes investment, entrepreneurship, economic growth, and therefore job creation.

The process of bringing this to an end has more than begun with this year's sweeping tax reform, passed by the General Assembly and signed into law by Governor McCrory. The changes that were made, particularly to the personal and corporate income taxes, have set the stage for long-term economic growth. The deliberative process that led to these changes was thoughtful and, in large part, ignored the kind of special interest pleadings that typically plague such reform efforts.

What has changed?

Before examining the potential impact of tax reform on economic growth over the coming years, a summary overview of the plan is in order. Over the course of the 2013 legislative session, North Carolina's General Assembly debated several possible approaches to reforming the tax code. There is no reason to review the alternatives that were discussed other than to note that they all had the same set of goals—to reduce the tax system's general bias against productivity and job creation, to reduce favoritism and special carve outs, to simplify the tax code, and to reduce the overall burden on tax payers. The final version of the bill made significant progress in accomplishing all of these goals.[1]

Generally speaking and without going into all of the details (see chart comparing the new tax structure and the previous system), the reform made sweeping changes to the personal and corporate income taxes by lowering the rates and broadening the bases. The changes to the sales tax were less wide ranging, leaving current rates in place and expanding the base to include some services. The reform also eliminated the estate (aka death) tax.

Overall the plan cuts taxes by about $4.75 billion over five years, assuming the state meets certain revenue triggers and implements the plan fully. That works out to no more than 4 percent of expected General Fund revenue during the period, and probably less if the economy grows as a result.

From the perspective of economic growth, the two most important reforms are those made to the personal and corporate income taxes. On the personal side, North Carolina had a graduated rate that went from 6 to 7.75 percent. For many years it has had the highest top rate in the southeastern United States. Even the bottom rate of 6 percent exceeded the top rate in many other states of the region. Under the adopted reform, the rates will be collapsed, converting the system to a flat rate tax where everyone will be taxed at a single rate of 5.75 percent with large personal exemptions. Most loopholes and deductions are eliminated. The most notable exceptions are charitable deductions and the deductions for mortgage interest and property taxes, which are capped at $20,000 combined.

The 6.9 percent corporate income tax, which has been, like the personal income tax, the highest in the southeast, will initially be lowered to 6 percent in 2014 and then to 5 percent in 2015. Ultimately, assuming that certain trigger revenue targets are met, the rate will drop to 4 percent in 2016 and 3 percent in 2017. Unlike the current corporate income tax, which acts as a negative slush fund where the rate is set high with special breaks given to favored businesses and industries, the new low rates will be applied across the board. Loopholes and giveaways that are embedded in the current system, based on what is essentially a crony capitalist model, are eliminated.

A significant step in the right direction

While the changes that were made in this year's reform do not obtain what economists might call the "ideal" in terms of creating an efficient and unbiased or "neutral" tax system, they do represent a significant step in the right direction. Clearly sound principles of tax reform guided the effort and ultimately were implemented.

	Current Law	New Plan
Personal Income		
Rate	6 percent > $0 7 percent > $12,750 7.75 percent > $60,000	Flat 5.8 percent in 2014, 5.75 percent thereafter
Personal Exemption	All filers receive $2,000 or $2,500 depending on income	Married Filing Jointly - $15,000 Head of Household - $12,000 Single - $7,500
Child Credit	$100 per child for AGI < $60,000	$100 per child for AGI > $40,000 $125 per child for AGI < $40,000
Corporate Income		
Rate	6.9 percent	6% in 2014, 5% in 2015, if revenues hit target then 4% in 2016 and 3% in 2017
Sales and Use		
Non-Profit Refund	-	Cap the sales tax refund allowed to non-profit entities at $45 million (state and local)
Broaden Base	-	Repeal sales tax holidays, bakery items, nutritional supplements, meals served at universities, and newspapers
Other Tax Changes		
Mortgage & Property Tax Reimbursement	Unlimited	Cap at $20,000
Gasoline Tax	No cap	Imposed Cap on rate
Estate Tax		Removed

The most important detriments to economic growth have come from the personal and corporate income taxes. With the personal income tax, economic distortions have emanated from both its rate structure and its base. And with respect to the corporate tax, the problem has been that it has existed at all.

The Personal Income Tax

Until now, North Carolina has had a multi-tiered income tax rate structure with a high top rate. An income tax is in essence a penalty on productive activity of all kinds—the higher the rate, the greater the penalty. Furthermore, a progressive rate structure has the effect of penalizing people for earning higher incomes and becoming more productive. By flattening the rate and lowering it to 5.75 percent (from 7.75 percent), below the lowest rate under the previous tax regime, the latest reforms significantly ameliorate these problems.

Future reform efforts need to focus on the income tax base. The current system double taxes all returns to investment. It does this by taxing income that is saved and invested, which simultaneously reduces the returns to that investment (interest, dividends, capital gains) by the same rate. If the government taxes $100 dollars of income that is used for saving by 6 percent, it also reduces the returns to that saved income by 6 percent. On top of that, those returns are reduced a second time when they are taxed as earnings.[2] This amounts to a tax penalty on all forms of investment. This year's tax reform efforts did not address this problem. But the problem can be fixed by removing either the principle or the interest from the tax base.[3] In our proposals, the John Locke Foundation suggested the former.[4] We proposed that the state allow saving and investing institutions to set up "universal savings accounts" (USAs) which would exempt all deposits from taxable income while taxing any withdrawals. These would work essentially like

Individual Retirement Accounts (IRAs) at the federal level except that withdrawals would be allowed at any time.[5] A much more timid but still valuable first step would be to either eliminate the tax on capital gains or, if the legislature wanted to be even more cautious, apply a lower rate to capital gains, as is the case in federal law.

The corporate income tax

Principles of government transparency and economic growth both suggest that the corporate tax should eventually be abolished. First, it is a completely hidden tax. While it is called a corporate tax, it is a well-known principle of taxation that all taxes ultimately must come from real people, not legal business forms. What this means is that the corporate tax is born by workers in the form of lower wages, consumers in the form of higher prices, and shareholders in the form of reduced returns on their investments. If citizens are going to make informed decisions at the ballot box, they need to know what their government is costing them. Because of this, all forms of hidden taxation, like the corporate income tax, should be abolished.

Apart from the issues of good governance and transparency, the corporate tax is a drag on the state's economy. This is because it places an additional layer of taxation on investment, which, as discussed, is already double taxed by the personal income tax system. The good news is that, by lowering the rate, these negative impacts are reduced, and dramatically so if revenue triggers are met and the rate falls to 3 percent.

Future reform efforts should focus on abolishing the corporate tax. This should be done by repealing the legislation that enables the state to tax corporate income at all and not simply by reducing the rate to zero while keeping the authority to have a corporate tax in place. This would make it much more difficult for future legislatures to reinstate it.

The importance of revenue reduction

Lastly, we should not ignore the fact that this reform package reduces taxes overall. In a best case scenario where the corporate tax falls to 3 percent, taxes are cut by about $4.75 billion over five years. The importance of reducing not only tax rates but also tax revenues is that it transfers resources from political control to control by market participants, i.e., consumers and entrepreneurs in the private sector. This will enhance the overall efficiency with which these resources are used. When resources are used more efficiently, they generate more useful output and therefore greater economic growth and prosperity.

Conclusion

While this year's tax reform in North Carolina has removed a number of obstacles to economic growth, it should not be viewed as a stimulus package. This kind of tax reform, particularly at the state level, is never going to act as an abrupt shot in the arm for the state's economy. There is no single reform or law change of any kind that would be likely to accomplish this result. Most of North Carolina's weak recovery can be attributed to the same factors that are affecting the national economy—Obamacare, intense new environmental regulations, government spending and debt, and expansive new taxes.

What North Carolina's tax reform will do is help set the stage for long-term economic growth by removing some important systemic obstacles to that growth. There is no reason for North Carolina's government to be adding additional burdens on our state's economy on top of those that are being thrust upon us by Washington. In light of this, North Carolina's legislature deserves praise. It has helped level the playing field for taxpayers and eliminated some important roadblocks to prosperity.

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End notes

1. The legislation that was agreed upon was most similar to one of two plans (plan B) proposed by the John Locke Foundation in it's book *First in Freedom: Transforming Ideas Into Consequesnces for North Carolina*, published at the outset of the legislative session in early 2013, p. 29. *johnlockestore.com/First-In-Freedom-03.htm*.
2. For a more detailed discussion of how this double taxation takes place see Roy Cordato, "The Consumed Income Tax: Efficient and Fair Tax Reform for North Carolina," John Locke Foundation, April 2012. *johnlocke.org/research/show/spotlights/271*.
3. *Ibid*.
4. Op. cit. note 1.
5. See John Hood, "FAQs on State Tax Reform," Carolina Journal Daily Journal, *carolinajournal.com/daily_journal/display.html?id=9840*.