John Locke Foundation

spotlight

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Tax Cuts for All

Tax Reform Means Savings to All NC Income Groups

EXECUTIVE SUMMARY

- **The average North Carolina household in every income category received a tax cut from the 2013 tax reform.**
- **In 2015 households earning less than $25,000 will have $79 million in tax savings from the 2013 tax reform. Households earning less than $50,000 will save more than $147 million.**
- **If one takes into account the full effect of tax changes made since 2011, all the result of conservative legislative action, the lowest income earners will save $157 million in 2015. The savings for all households at the bottom end of North Carolina's income distribution, those earning less than $50,000, comes to almost $350 million.**
- **The savings to all lower- and middle-income households in North Carolina earning less than $100,000 a year is more than $682 million.**
- **The 2011 sales tax rate reduction, opposed by Democrats, resulted in middle- and lower-income families receiving more than twice as much in tax relief as those earning more than $100,000 a year.**
- **The average household in every income group is seeing its tax burden reduced from both the 2011 sales tax reduction and the 2013 tax reform package.**
- **Considering both 2011 and 2013 tax changes, the average household in both the lowest and highest income categories is receiving a tax cut of about 1 percent of income.**

for Truth

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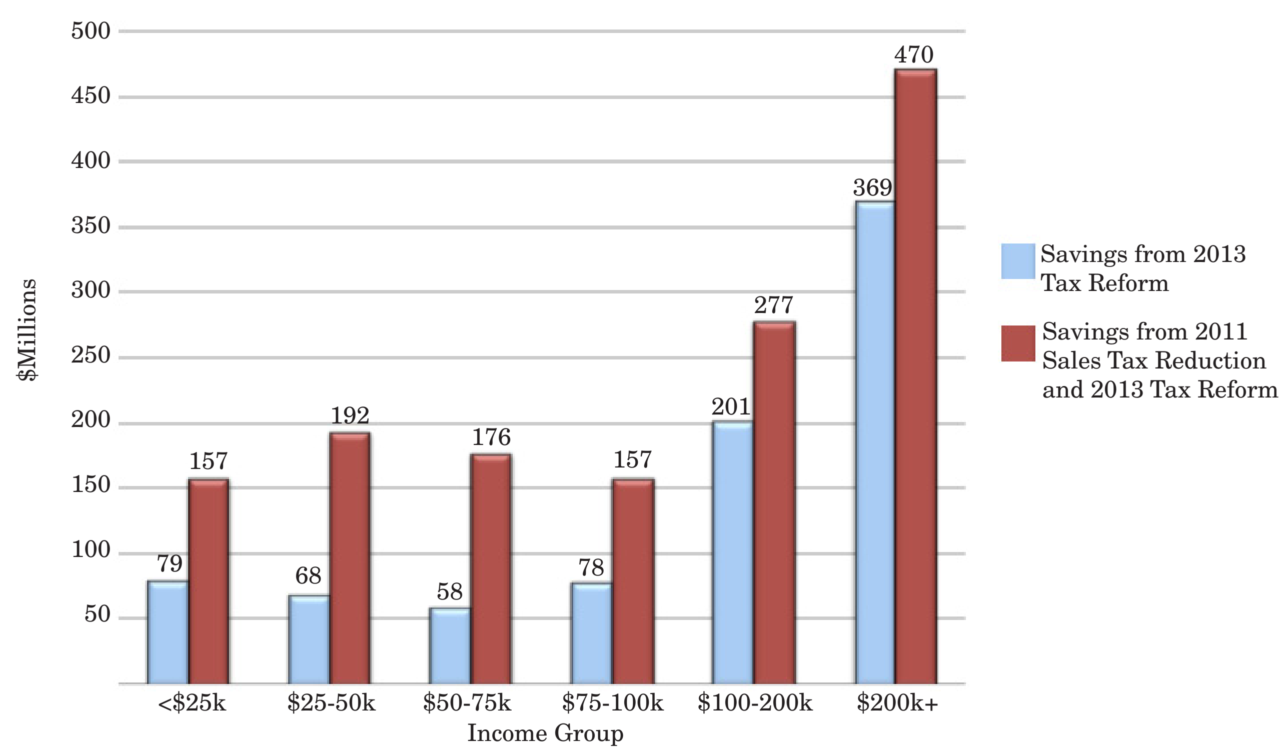
Tax reform passed in 2013, and now going into effect in 2014, will lead to a tax cut for the average North Carolina household in every income category. A new study commissioned by the John Locke Foundation and conducted by economists at Suffolk University's Beacon Hill Institute concludes that, as a result of changes to North Carolina's tax system implemented by North Carolina's Republican legislature, not only are the highest income earners getting a tax cut, a conclusion that has not been in dispute, but the lowest income households and all income groups in between are, too. These results buttress projections made by North Carolina's non-partisan legislative research staff.

By Household Income Group: Who is Saving What?

In 2015 households earning less than $25,000, the lowest income category, will have a total annual tax saving from the 2013 tax reform of $79 million. Those households earning less than $50,000 per year, that is lower- and lower middle-income households combined, will see an annual tax cut beginning in 2015 of more than $147 million. (See Figure 1) These savings result primarily from cuts in income tax rates to 5.75% and a large increase in the standard deduction. The benefits from these changes more than compensate for any increases in tax payments that are the result of minor expansions of the sales tax base or the elimination of the state's earned income tax credit (EITC) that were implemented under the law.

But this is only part of the story. The Republicans were also responsible for allowing a temporary sales tax increase, implemented by the previous Democrat-controlled legislature, to expire. In 2011, the session after voters granted Republicans control of the General Assembly, Democratic legislators and then Democratic Governor Beverly Perdue favored a continuation of most of the very regressive 5.75% sales-tax rate in effect at the time. Democrats vigorously opposed the full expiration of this increase, so much so that Perdue vetoed the Republican budget that included it. Conservative majorities in both chambers of the legislature overrode Perdue's veto, and the state sales tax was allowed to fall to 4.75%.

Figure 1: Total Savings from North Carolina Tax Reform by Income Group



If one takes into account the full effect of tax changes that can be attributed to the new Republican-led legislature, the state's lowest income earners in 2015 will be saving $157 million. It should be pointed out that about half of that tax savings — more than $78 million that resulted from allowing the the sales tax to fall — was opposed by many of those on the left who are now falsely claiming that lower income people have not benefited from recent tax reform. Combined with lower middle-income households (those earning $25,000 to $50,000 annually) the savings for all households at the bottom end of North Carolina's income scale comes to almost $350 million in 2015. Again, it should be noted that well over half of these savings emanated from the 2011 decline in the sales tax rate opposed by then Governor Perdue.

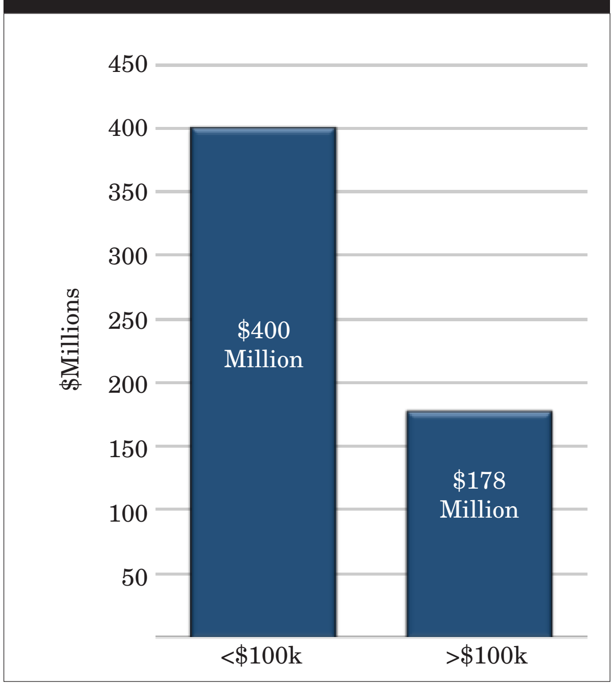
Expanding the income base further, if we tabulate the savings to all lower- and middle-income households in North Carolina earning less than $100,000 a year — that is, excluding upper-middle and high-income households — the total tax savings that can be attributed to actions taken by the Republican led legislature since 2011 is more than $682 million, or slightly less than half the total savings going to all households.

In regards to this comparison, it should be noted that the 2011 sales tax decline resulted in middle- and lower-income families receiving overall savings that were significantly greater, more than twice as much, as those earning over $100,000 a year. Middle- and lower-income households earning less than $100,000 are receiving more than $400 million annually in tax savings from the 2011 tax rate decline, while high-income and upper middle-income households are saving $178 million. (See Figure 2) In other words, these tax savings, by any standard, would have to be considered very progressive. Despite this fact, the liberal establishment in the state opposed this otherwise automatic sales tax rate reduction, suggesting that their professed concern for lower income families under the 2013 reforms may not be completely sincere.

The Typical Household

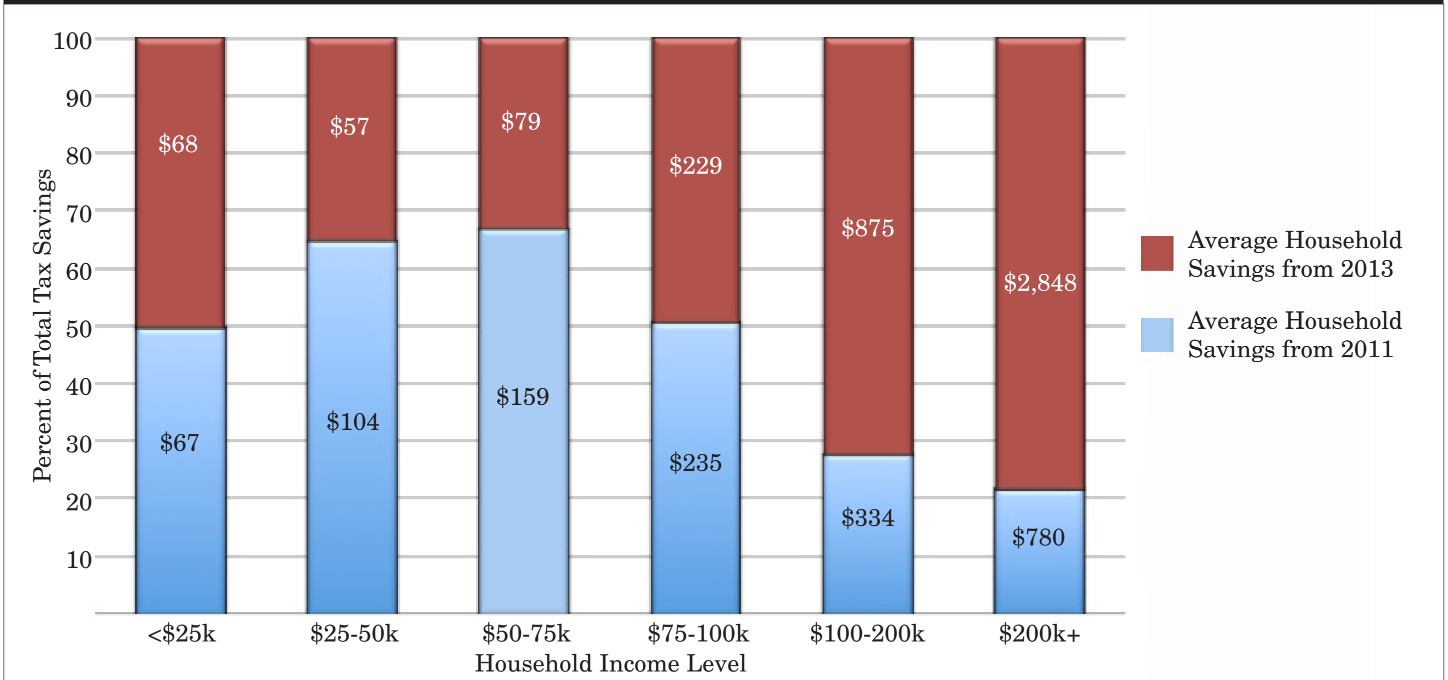
So what does all this mean for typical households in North Carolina? First, the narrative claiming that the recent tax changes in North Carolina reduced the taxes of the well-to-do "on the backs" of lower- and middle-income groups is simply false. The average household in every income group from bottom to top is seeing its tax burden reduced from both the 2011 decline in the sales tax rate and the 2013 tax reform package. As one would expect, for the typical household in each income category, the absolute amount saved goes up as incomes go up. For any given tax cut, those who earn and spend more are always going to save more.

Figure 2: Savings from the 2011 Sales Tax Reduction, Income Over and Under $100k



It is interesting, though, to compare households at opposite ends of the income spectrum. (See Figure 3) A typical household in the lowest income group earning about $12,500 a year will have its North Carolina state tax burden reduced in 2015 by $135 with roughly equal amounts of saving coming from the 2011 and the 2013 tax changes. At the opposite end of the spectrum, a household earning $288,000 will see an annual tax saving of $3600 in 2015. In terms of tax dollars saved, this is the widest difference between income groups. But when looked at as a percentage of household income, the tax saving in both categories is about the same: one percent. The savings seen by the average households in the middle-income groups range from about one-half to one percent of income.

Figure 3: Savings per Average Household due to 2011 and 2013 Tax Changes



Household Income Group	Under $25k	$25-50k	$50-75k	$75-100k	$100-200k	$200k+
Average Income	$12,521	$36,055	$62,133	$87,334	$134,675	$288,364

Conclusion: What We Are Not Claiming

It is not being claimed that every household in every income group will see its taxes go down as a result of these changes. This would be an extremely unlikely result for any set of tax reforms. Depending on particular circumstances, there are households in every income category that will end up paying more as a result of recent changes. Clearly, someone could construct particular household scenarios that would demonstrate that result. And dishonest politicos could and will use these scenarios to imply that special cases are typical. But in fact, if they were typical, one could not reach the overall conclusion of this study, namely that, in the aggregate, every income group, from the lowest to the highest, will end up with lower bills at the cash register and increased take-home pay. Those positive outcomes are the result of actions taken by conservative legislators who took control of the North Carolina General Assembly in 2011 and continued to enact reforms in 2013.

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Appendix: The Distributional Effects of H.B. 998, S.L. 2013-316: The Tax Simplification and Reduction Act Methodology

The Beacon Hill Institute at Suffolk University

January 14, 2014

Sales and Franchise Tax

To determine the amount of sales tax paid by a household income group, we referred to detailed state reports and data from IMPLAN. However, we do not use the IMPLAN model itself to conduct any of the analysis. We simply use databases supplied by the IMPLAN group.

First, we gathered information on how much sales tax was paid by type of business for Fiscal Year (FY) 2011, the year before the one percent sales tax reduction.[1] We then distributed each state defined category into one of 27 sectors that the Beacon Hill Institute uses for modeling related to IMPLAN. The results allowed us to identify the amount of taxes paid by each of these 27 sectors which also allowed us to observe how taxes were distributed by income group. This was made possible by 2011 IMPLAN data, the most recent year available, which provide for the amount of purchases of each of these 27 sectors that each household income group makes.[2] Based on this information, we calculated the share of the tax revenue, by sector, which each household income group was responsible for. For example, if households with less than $25,000 of income accounted for 10 percent of retail purchases, then we assumed that they also accounted for 10 percent of the sales tax paid on retail goods.

The result of the above calculations leads to the amount of Sales and Use tax paid by sector and by household income group. We summed the amount of tax paid across sectors, and then divided by the number of households in each income group to obtain the desired metric, sales tax paid per household by income group. The above calculations were repeated using the FY 2012 version of the state report, which is updated to reflect the new revenue collections, by type of business, with the lower sales tax rate. [3] We then grew the result to 2015 using annual growth rate between the reports.

Case 3 (the 2013 tax reform package) was calculated based on the Legislative Fiscal Note.[4] We again mapped each of the line items of the sales and privilege license taxes to one of the 27 sectors. In addition, we included changes to the excise tax, franchise tax and eliminations of the wholesaler's discount. With tax changes by sector in hand, we followed the above methodology to distribute the taxes by sector to households.

Individual Income Tax

The North Carolina Department of Revenue provides few details about state individual income tax. We utilized the legislative fiscal note to obtain revenue estimates for each tax change. Since many of the income tax changes lack a revenue estimate, we used the 2011 North Carolina Biennial Tax Expenditure Report to supply revenue estimates.[5] The values were inflated to 2015 using the historical growth rates from previous reports.

Next, we used IRS Statistics of Income data for North Carolina as a proxy for North Carolina state income tax data.[6] Since the North Carolina tax system piggybacks on federal tax law, the data is quite accurate. For the personal exemption and standard deduction and tax rate changes, we used the IRS data directly.

To isolate the effect of each income tax change we assumed that the flat tax rate of 5.75% would be in effect.

For example, we multiplied the total number of exemptions in each income bracket by $2500 to estimate the amount that adjusted gross income would increase for the elimination of the personal exemption. This result was then multiplied by the new flat tax rate of 5.75%.

For the standard deduction change, we subtracted the number of returns that itemized from the total returns for income group. We then allocated the total returns that took the standard deduction to tax returns categorized as married filing jointly, married filing separately, head-of-household and single using national IRS data.[7] We multiplied the number of returns by the increase in the standard deduction for each filing status, then by the tax rate. We divided the total by the number households in each group.

For the tax rate change, we simply multiplied the federal taxable income by the old tax rate and by the new tax rate. We subtracted the two results and divided the total by the number of households in each group.

For the tax changes for which the federal tax law is not as neatly aligned to the state system, we used the estimated tax revenue change from either the Legislative Fiscal Note or the Biennial Tax Expenditure Report. We distributed the total tax revenue change to the different income groups using the ratio of the number of tax returns for each income group to the total number of returns for all groups using the IRS line item the represents the closest proxy in the federal data. This method was used for the $50k small business exemption, private and non-Bailey government pension exemption, charitable giving credit for non-itemizers, the itemizing limit for property taxes and mortgage interest, earned income tax credit, and all other tax credits.

For example, the tax expenditure report indicates that the charitable giving credit for non-itemizers cost North Carolina $36.8 million 2011. We distributed this figure to the income groups based on the number of non-itemizing tax returns for each group, and divided this figure by the number of households in each group.

Corporate Income and Estate Taxes

In the absence of any state specific, or other reliable data, on the distribution of corporate income and estate taxes, we used the Beacon Hill Institute's STAMP model to simulate the tax revenue changes and report the results on the change in real disposable income.

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3. North Carolina Department of Revenue. State Sales and Use Tax Statistics for Fiscal Year 2011-2012. Table 2: Total State Sales and Use Tax Gross Collations and Taxable Sales by Types of Business. Internet, available at www.dornc.com/publications/fy11-12salesusestats.pdf.
4. General Assembly of North Carolina. Legislative Fiscal Note, House Bill 998 (fifth Edition). http://www.ncleg.net/fiscalresearch/budget_legislation/budget_legislation_pdfs/2013/conference/2013%20Finance%20Charts%20for%20Web.pdf
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6. IRS, SOI, Table 2. Individual Income and Tax Data, by State And Size of Adjusted Gross Income, Tax Year 2011, http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2
7. IRS, SOI Table 1.2 All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2011, http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income