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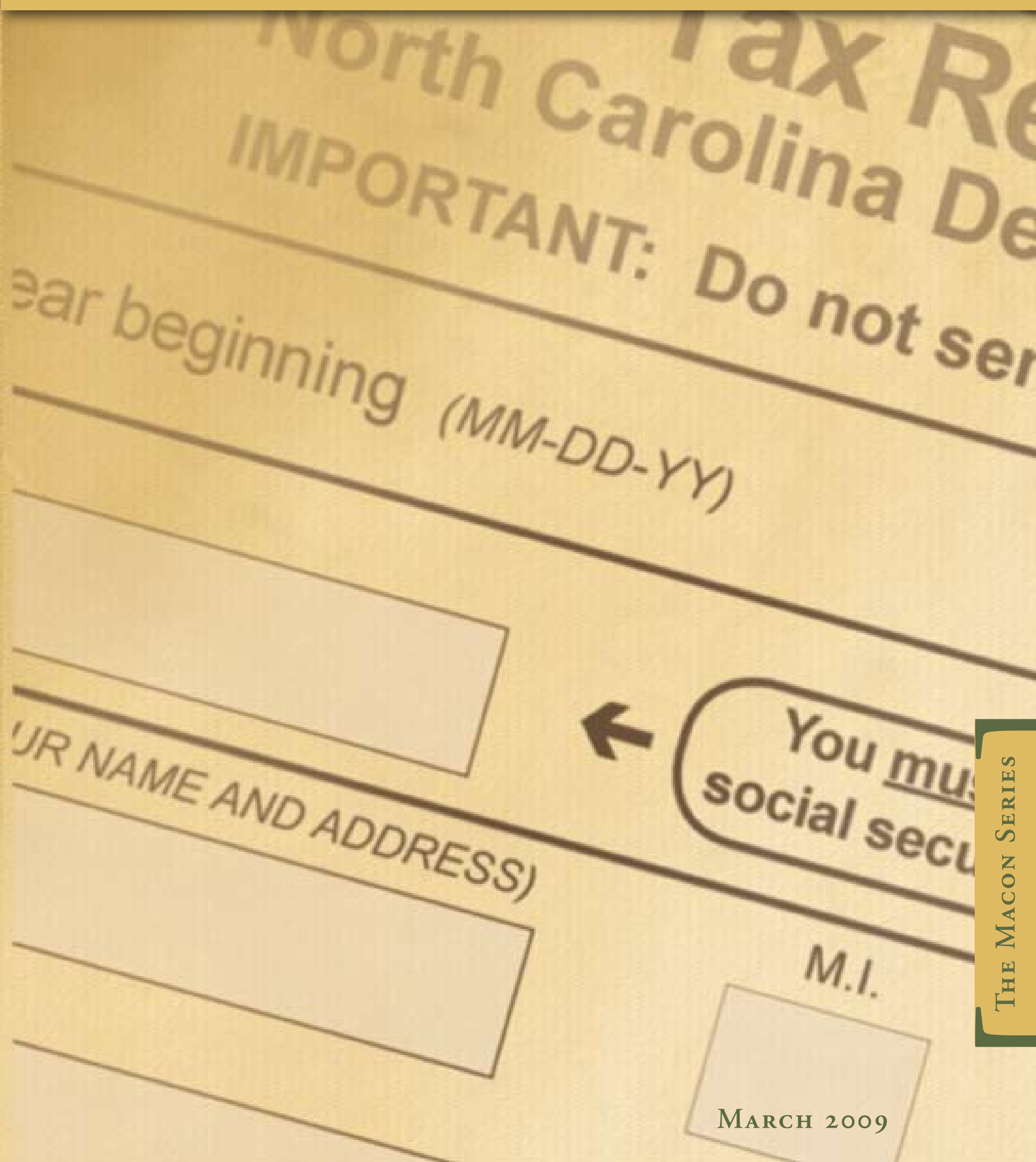
Tax Reform in North Carolina

Dr. Roy Cordato



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This report on tax reform is the fourth in a series of annual research papers from the John Locke Foundation devoted to explaining the principles of free markets and applying them to current controversies in North Carolina. The Nathaniel Macon Research Series was created with the generous financial support of David R.Carr Jr. of Durham, in memory of his friend and business partner George W. Brumley III, who was a strong believer in the crucial role that robust, unfettered markets play in advancing human progress and promoting a free society. The Macon Series will examine closely the fiscal and regulatory policies of the state and whether they help or hinder individuals seeking to create or expand businesses and economic opportunities in North Carolina. The series is named after Nathaniel Macon, a North Carolinian and close political ally of Thomas Jefferson who served as Speaker of the House and U.S. Senator during the first few decades of the American Republic. Macon frequently argued, "That government is best which governs least."

Table of Contents

4 Executive Summary

6 Introduction

7 I. An Overview of North Carolina's Tax System

12 II. Redistributionist Principle vs. Liberty Principle: Tax Reform, and the North Carolina Constitution

14 III. The Economics of Tax Reform: Neutrality and Simplicity

31 IV. Additional Principles for Tax Reform: Transparency and Simplicity

32 Conclusion

34 End Notes

34 Appendix

36 About the Author

Executive Summary

North Carolina's system of taxation aggressively interferes with individual liberty and retards economic growth. It does this by using the tax system to reward some activities and penalize others; by placing multiple layers of taxation on saving, investment, and entrepreneurship; and by promoting forms of taxation, the best example being the corporate income tax, that are completely hidden from those who pay. Because taxation inherently interferes with both personal freedom and economic decision-making, policymakers need to be vigilant about not only how much revenue is being generated but also how those revenues are collected. Some types of taxation are more damaging to freedom and prosperity than others. It is quite clear that our current system has been developed without any attention to this fact and without an understanding of how socially damaging a poorly designed tax system can be.

The cornerstones of North Carolina's tax system are its income tax, which accounts for 54 percent of all taxes going into the state's general fund, and the sales tax, which contributes 26 percent of the general fund revenues. The largest portion of the remaining 20 percent comes from the corporate income tax, which contributes about 7 percent of the total. Other sources of revenue include taxes on alcohol and tobacco, inheritance and gift taxes, insurance taxes, and non-tax revenues such as user fees. While all of these need overhaul and in some cases should be eliminated, the most damaging to North Carolina's economy and to the liberty of its citizens are the personal and corporate income tax.

Policymakers should begin to change the tax system with an eye toward the following long-term goals:

- Replace the current progressive income tax with a flat rate "consumed income tax." This would reduce the tax penalties against economic growth by making all saving and investment tax-deductible and would reduce tax discrimination by abolishing the current "progressive" rate structure.
- Abolish the corporate income tax, which is a hidden tax on workers, consumers, and shareholders.
- Eliminate all special tax breaks for new or existing businesses. The tax code should not subsidize some businesses at the expense of others.
- Eliminate differential sales tax rates and special excise taxes. The state should not be penalizing the choices of some and rewarding the choices of others. Eliminate the sales tax on business purchases.

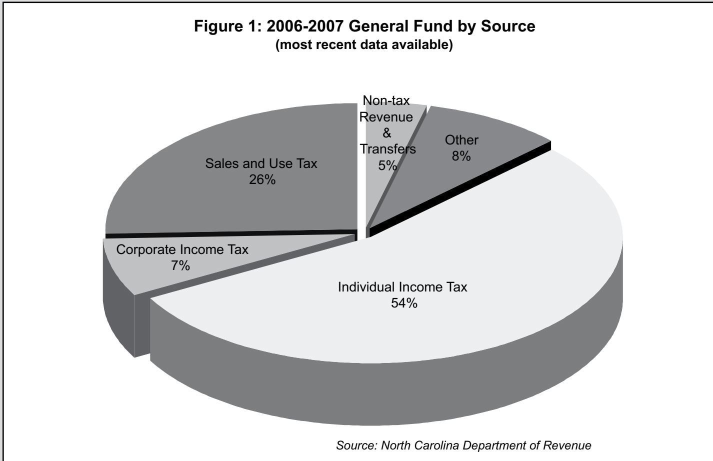
Introduction

Why does North Carolina need to reform its tax system? The short answer is that the state's current system of taxation aggressively interferes with individual liberty and retards economic growth. It does this by using the tax system to reward some activities (tax incentives for economic development) and penalize others (cigarette and alcohol taxes); by placing multiple layers of taxation on certain kinds of economic activities (i.e., taxes on interest, dividends, and capital gains); and by promoting forms of taxation that are completely hidden from those who pay (i.e., the corporate income tax).

The purpose of this paper is to examine North Carolina's tax system in light of the principles of individual liberty, embodied in the state's Constitution, and on basic economic principles for advancing economic prosperity. Because taxation inherently interferes with both personal freedom and economic decision-making, policymakers need to be vigilant about not only how much revenue is being generated, but also how those revenues are collected. Some types of taxation are more damaging to freedom and prosperity than others. It is quite clear that our current system has been developed without any attention to this fact and without an understanding of how socially damaging a poorly designed tax system can be.

In dealing with the tax system, this paper is looking at half of the fiscal policy equation. The purpose of taxation is to fund government spending, and ultimately tax reform needs to be considered within the context of the role of state government. In other words, tax reform should go hand in hand with budget and spending reform. This latter project is beyond the scope of this paper, but it is suggested that the reforms advanced here be considered in conjunction with spending reforms that have been discussed in other reports published by the John Locke Foundation.[1]

Figure 1



I. An Overview of North Carolina's Tax System

The cornerstones of North Carolina's tax system are its income tax, which accounts for 54 percent of all taxes going into the state's general fund, and the sales tax, which contributes 26 percent of the state's general fund revenues. The largest portion of the remaining 20 percent comes from the corporate income tax, which contributes about 7 percent of the total. Other sources of revenue include taxes on alcohol and tobacco, inheritance and gift taxes, insurance taxes, and non-tax revenues such as user fees (see figure 1).

A. Taxes on Income

Since its inception in 1921, North Carolina's income tax has had a graduated or progressive rate structure. The desirability of this will be discussed below. What this means is that as incomes increase, specified increments to income are taxed at increasingly higher rates. For example, in 1924 North Carolina had a relatively straightforward system. With each increment in taxable income

(after deductions) of $2,500 up to $10,000, the rate was increased by 0.75 percent. So the first $2,500 was taxed at 1.25 percent. If a person had $5,000 in taxable income, the first $2,500 was taxed at 1.25 percent and the second was taxed at 2 percent. This was continued up to a taxable income of $10,000. Income above $10,000 was taxed at 4.5 percent.[2] The term "marginal tax rate" refers to the rate that is being paid on the last increment. In the 1924 example, a person earning $10,000 would face a "marginal rate" of 3.5 percent on the last $2,500 increment between $7,500 and $10,000, while a person earning $14,000 would have faced a "marginal rate" of 4.5 percent on the $4,000 above $10,000.

"The current rate structure goes from a bottom rate of 6 percent, twice as high as the top rate when the tax was put in place in 1921, to a top rate of 7.75 percent."

As an aside, $10,000 in 1924 would be equivalent to an income of over $126,000 today, which would be taxed at a marginal rate of 7.75 percent today. It should also be noted that while rates at the federal level have trended downward over the last 40 years, except for the expiration of a statutorily temporary increase in the rates in 2007, there has never been a lowering of the structure of marginal rates for the entire history of the North Carolina income tax. Every change since 1924 that was not instituted specifically as a temporary measure to deal with a transient problem has resulted in a rate increase. (In 2001 a temporary top rate of 8.25 percent was instituted for two years and extended for an additional two years, to deal with a budget deficit caused by excessive spending in the 1990s.) The current rate structure goes from a bottom rate of 6 percent, twice as high as the top rate when the tax was put in place in 1921, to a top rate of 7.75 percent. Except where distinctions are made in the federal code, for example, IRAs and other specially

designated savings accounts, the North Carolina income tax system makes no distinction between different kinds of income. For example, all returns to saving and investment such as capital gains, interest, and dividends are considered to be ordinary income and are taxed at the same rates as other forms of income. This is in part at odds with the federal system, which taxes capital gains, and, with recent changes, dividends at lower rates. I will argue below that by taxing returns to investment and saving, North Carolina introduces double taxation into its tax code and creates a bias against investment activities.

In addition to its personal income tax, which is paid by individuals and all unincorporated businesses, North Carolina also has a corporate income tax. This tax is levied on corporations doing business in the state. Over the years the corporate income tax has varied widely. Between 1921 and 1991 it increased steadily from 3 percent to 7.75 percent. It was then lowered every year between 1997 and 2000, when it fell to its current rate of 6.9 percent. It will be argued below that this tax is completely inconsistent with sound principles of taxation and should ultimately be abolished. It also should be noted that, in the name of economic development, the state has carved out a number of special exemptions and rebate schemes relating to business taxes. These programs effectively use the corporate tax to subsidize some businesses and penalize others.

B. The State Sales Tax

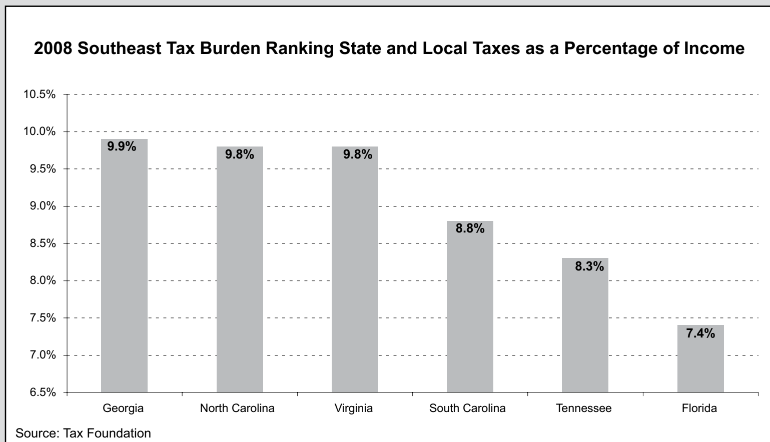
North Carolina's sales tax, which applies to non-food products and no services, is the second largest revenue generator in the state's tax arsenal. It was instituted in July 1933. The story behind the tax is a familiar one. The new tax was set at 3 percent and, of course, was "temporary." It was set to expire in 1935.[3] What should come as no surprise to anyone familiar with new revenue proposals in North Carolina, the original purpose of the tax was "to help fund

education" during the lean years of the Great Depression when local property and income tax revenues were down. After several extensions of this "temporary" tax, it finally was made permanent after extending the expiration date to 1939.[4] The rate stayed at 3 percent until 1991, when it was increased to 4 percent.

Then in 2001 it was raised "temporarily" to 4.5 percent. Not surprisingly, given the history of the tax, when it was about to expire in 2003 it was extended to July 2005. The 4.5 percent increase has since been made permanent. The exemption for food items not eaten on the premises began in 1996, but was eliminated in July 1997. This exemption has been instituted and rescinded many times over the 70 years that the tax has been in place.

While the state has a 4.5 percent sales tax, the total tax in most counties is 6.75 to 7.25 percent due to a local-option sales tax of 2.25 to 2.5 percent. The only exception is Mecklenburg County, which has a 2.75 percent county tax. Food is not exempt from this local-option tax.

Figure 2



C. How Much are North Carolinians Paying?

Each year the Tax Foundation in Washington, D.C., tries to get a sense of the proportion of income that people in each state are paying in state and local taxes, publishing data for all 50 states. The national average is 9.7 percent. That is, on average, 9.7 percent of income is paid in state and local taxes. North Carolina is above the national average, coming in at 9.8 percent, and well above the average for the Southeast region and the states that it competes most closely with for new industry and new investment. The nation's seven Southeastern states have an average tax burden of 9 percent, with North Carolina in almost a three-way tie with Georgia (9.9 percent) and Virginia (9.8 percent) (see figure 2).

Because of the number of different kinds of taxes that the residents of North Carolina pay and the fact that each individual's and family's circumstances are different, it is very difficult to generalize about how much families might be paying over the course of a year. In spite of this, I have attempted to "guesstimate" the total amount of state and local taxes that "typical" middle-class families in North Carolina might be paying. To do this, I have had to make some highly stylized assumptions about the purchases that families make, how often they eat out, the value of the homes that they are living in, local property tax rates, etc. Given all of this, we have come up with some estimates that we consider reasonable (see Appendix). These range from a family of four with $100,000 in pre-tax income paying over $9,400 a year in state and local taxes down to a family of two (one child and one income earner) earning $25,000 in pre-tax income paying about $1,746 a year. This translates into about 11 percent of after-federal-tax income for the former and about 7.7 percent of after-federal-tax (federal income tax plus social security tax) income for the latter. In other words, this is the percentage of family income that is available for paying state and local taxes.

II. Redistributionist Principle vs. Liberty Principle: Tax Reform, and the North Carolina Constitution

Tax reform, while often discussed in terms of economic analysis, is fundamentally a question of justice and morality. There are two diametrically opposed philosophies that typically compete as guiding principles in tax policy debates. These can be defined as the "redistributionist principle," which tends to focus on progressivity in the tax code, and the "liberty principle," which focuses on keeping taxes for everyone as low as possible. Elaine Mejia of the North Carolina Budget and Tax Center expresses the redistributionist approach succinctly. She states that, "the objective of any tax system is to progressively distribute the burden of paying for government services."[5] The more people earn, the greater proportion of their income should be paid in taxes. This is essentially a redistributionist principle because it is based strictly on one's ability to pay and is unrelated to benefits received. Tax revenues should be redistributed from those who can "best afford" to pay the taxes to those who receive the services those revenues provide, regardless of who those people happen to be. Furthermore, there is rarely any suggestion in this literature that any particular level of taxation, on either high- or low-income individuals or families, is ever "too high." The only concern is that the relative burden of taxation be borne most heavily by those earning the highest income. For example, as noted above, the income tax rates today on the lowest income earners are twice as high as they were on the highest income earners in the 1930s, yet evidence shows that this is of no concern from a redistributionist's perspective so long as rates increase as incomes increase.

This is in stark contrast to the liberty principle, which focuses on minimizing the extent to which the tax system interferes with individual freedom, i.e., "the pursuit of happiness," and maximizes the extent to which people can keep what they earn. In North Carolina, the basis for using this principle as the ethical guide

for tax policy can be found in the state's Constitution. Article 1, Section 1, of the Constitution is titled "The Equality and Rights of Persons." It states: "We hold it to be self-evident that all persons are created equal; that they are endowed by their Creator with certain inalienable rights; that among these are life, liberty, the enjoyment of the fruits of their own labor, and the pursuit of happiness."[6]

Note that in addition to the familiar Jeffersonian reference to "life, liberty, and the pursuit of happiness," the N.C. Constitution recognizes the equal right in everyone to "the enjoyment of the fruits of their labor." In reality, it is this right that guarantees all other rights. To the extent that we are denied the right to make use of the fruits of our labor — i.e., our incomes — we are denied our rights to life, liberty, and the pursuit of happiness. We secure an income in order to have the means by which we can sustain our lives and freely pursue happiness.

Taxation, by definition, coercively denies everyone the right to a portion of the fruits of their labor. Therefore, it is inherently inconsistent with one of the most fundamental principles upon which North Carolina's social and political systems are based. The implication for tax reform is clear; North Carolina's tax system should be structured in such a way that it interferes as little as possible with individual decision-making, both personal and economic, and it should strive constantly to keep the burden of taxation as low as possible. In particular, there are some obvious kinds of taxes that should be eliminated; specific excise taxes that are meant to encourage some behaviors and discourage others. This would include taxes

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on tobacco products, alcoholic beverages, rental cars, hotel rooms, restaurant meals, etc. These taxes discourage some behaviors relative to others and therefore penalize some people's preferences with respect to their "pursuit of happiness." They are therefore inconsistent with the concept of equal rights as constitutionally delineated.

It should also be noted that from this perspective there is no room for progressivity in the rate structure of the income tax or in any other tax. Besides penalizing people for being economically successful, a point that we will discuss at length below, progressivity denies equal rights to the fruits of one's labor. The fundamental assumption behind the progressivity mantra of the redistributionists is that the more income you have, the fewer rights to that income you possess. North Carolina's progressive income tax rate structure is not only economically indefensible (see below) but also morally reprehensible.

III. The Economics of Tax Reform: Neutrality and Simplicity

If there is one thing that the economic analysis of taxation teaches us, it is that all taxes are not created equal. It is important to emphasize that some ways of collecting taxes will cause less damage to the economy than others. It should be made clear that there is no such thing as a form of taxation that is beneficial to the economy, but economic analysis can show what kind of tax policies will do the least amount of damage.

A. Neutrality: Bridging the Gap Between Equal Rights and Sound Economics

As noted in the previous section, an implication of the liberty principle, implied by the North Carolina Constitution, is that taxation should not discourage some kinds of activities and reward

others. This is because the rights that are guaranteed in Article 1, Section 1, quoted on the previous page, are endowed to everyone equally, and to favor some forms of pursuing happiness or some ways of earning an income over others through tax penalties and tax favors is to deny this fundamental equality.

The guiding principle for tax analysis in the economics literature is "neutrality." This principle dovetails with the notion of equal rights. Economic efficiency, and therefore economic growth, will be maximized when market decision-making is left free to reflect the true preferences of consumers and the best insights of entrepreneurs and investors. The implication is that taxation should seek to minimize interference with this process.

Tax policy should strive to be "neutral," i.e., it should neither penalize nor favor particular kinds of decisions regarding how much people work or pursue leisure activities; how much of their income is spent or saved and invested; what kinds of goods and services are purchased; what kinds of investments are made; etc. To the extent that tax or any other government policies skew these decisions away from those that would be made purely based on market conditions of supply and demand, it will harm economic growth and individual well-being.

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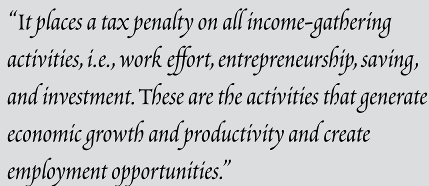
B. The Income Tax: Penalizing Productivity and Economic Growth

With some notable exceptions, primarily the taxation of capital gains, and now dividends, North Carolina's income tax is modeled after the federal income tax. This means that it defines "taxable income" in the same way and by and large "piggy-backs" on the federal tax code when determining what are and what are not deductible expenses. Because of this, our state income tax system suffers the same problems as the federal system in that it is dramatically biased against work effort relative to leisure, and saving and investment relative to consumption spending.



> *"It places a tax penalty on all income-gathering activities, i.e., work effort, entrepreneurship, saving, and investment. These are the activities that generate economic growth and productivity and create employment opportunities."*

The economic biases or "non-neutralities" created by the North Carolina income tax system are generated by both its rate structure and the way it defines taxable income, i.e., its base. As noted previously, North Carolina has a rather steeply progressive tax rate structure that biases against work effort and productivity, and the tax base is defined in such a way that it double, and in some cases, triple taxes the returns on saving and investment.

In the literature on the economics of taxation there is a well-known saying: "people aren't taxed, activities are." The more technical way of saying this is that nearly all taxes have what is called an excise effect. The idea is that taxes are generated by siphoning off revenues that are generated from one form or another of economic activity. Because taxation reduces the rewards or increases the costs associated with these activities, it discourages them. For example, a tax on cigarettes discourages smoking; a tariff discourages

the importation of foreign-made products; a tax on gasoline discourages gasoline consumption; etc.

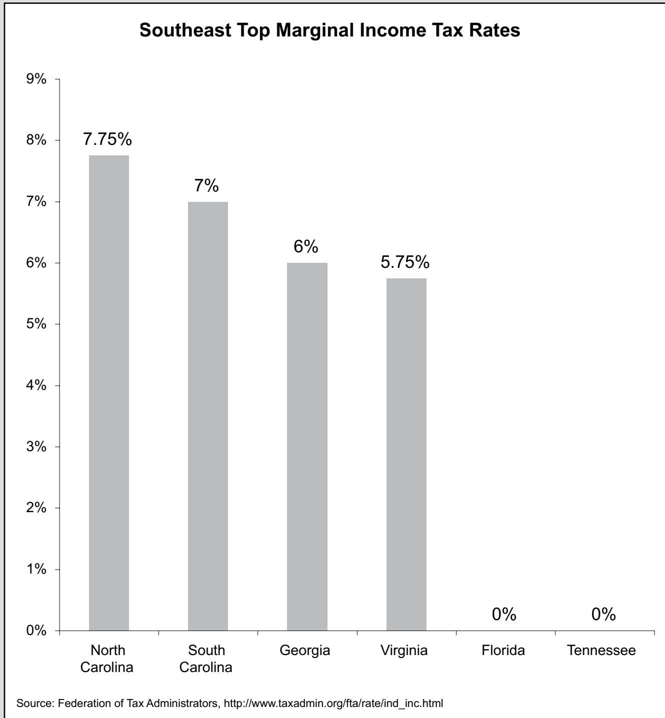
What is often not recognized is that the income tax also has an excise effect. It places a tax penalty on all income-generating activities, i.e., work effort, entrepreneurship, saving, and investment. These are the activities that generate economic growth and productivity and create employment opportunities. The North Carolina income tax is no exception to this, and when compared to many other states, its anti-productivity bias may be particularly egregious.

How North Carolina Penalizes Work Effort

The proposition that all income taxes penalize productivity is simple to demonstrate. As noted above, by reducing the rewards to all income-generating activity — work, saving, and investment — it discourages those activities relative to non-income generating activities — leisure and consumption. People pursue economically productive activities because of the income that it generates. The greater the rewards to these activities, the more likely it is that they will be pursued.

This tax penalty is most easily demonstrated when analyzing how it has an impact on (income-generating) work effort. In any particular instance, when deciding how much they are willing to work, people will weigh the satisfaction that they expect to receive from doing other things, what we will generically call leisure, against the income that they would receive from pursuing the work-related activities. These kinds of decisions are made on a regular basis. When people are deciding to work overtime, to take a second job, or to go "back to school" to get higher degrees or additional training, they assess the additional income that can be gained from these additional efforts and weigh it against the other activities in their lives that they will have to give up.

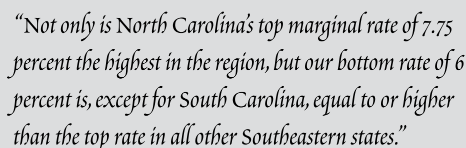
Figure 3



Income taxation distorts this value judgment in favor of these other leisure activities. It reduces the financial return to the work activity while leaving the inherently non-pecuniary rewards to leisure untouched. In the terminology of public finance, income taxation drives a "wedge" between the rewards to work effort and the rewards to non-work activities. The higher the tax rate, the greater the wedge, i.e., the greater the penalty against additional economic productivity, and the more distorting is the tax.

As an extreme example, if the income tax system had one flat rate of 100 percent with no deductions (i.e., both the marginal and average rate were 100 percent) it is obvious that people, at least for

public record-keeping purposes, would put no effort into income-generating activity. As the tax rate fell from 100 percent, the wedge would be reduced, and the mix of leisure and work-related activity would shift. At a tax rate of zero, the wedge would disappear. Given people's true needs and preferences, work effort and productivity would be maximized, and the efficient mix of work and leisure would occur. This mix is guided purely by the interaction of individual preferences and the wages that employers are willing to pay (driven by the value of output produced) as compensation for services rendered.


"Not only is North Carolina's top marginal rate of 7.75 percent the highest in the region, but our bottom rate of 6 percent is, except for South Carolina, equal to or higher than the top rate in all other Southeastern states."

North Carolina's income tax system enhances this tax penalty, both absolutely and relative to other states, in two different ways. First, its income tax rates are high relative to the national average and are particularly high relative to other states in the Southeast with which we are economically most competitive. Not only is North Carolina's top marginal rate of 7.75 percent the highest in the region, but our bottom rate of 6 percent is, except for South Carolina, equal to or higher than the top rate in all other Southeastern states (see figure 3). It should also be noted that Florida and Tennessee have no income tax, which means that the anti-productivity bias does not exist. (This is equivalent to the zero percent rate scenario discussed in the previous paragraph).

Adding to this anti-productivity bias is North Carolina's steeply progressive rate structure. As noted above, progressivity is morally inconsistent with the equal rights protections found in the North Carolina Constitution. But beyond this, it penalizes increased

productivity by taking a greater percentage of people's incomes as they earn more. People climb the economic ladder, in terms of raises and job and career changes, by making themselves more productive. Progressive taxation punishes people for making productivity-enhancing changes in their lives, adding an additional bias against economic growth and wealth creation.

The Tax Penalty on Saving, Investment, and Entrepreneurship

The income tax penalty on savings, investment, and entrepreneurship is analogous to the penalty against work effort. It follows from the fact that the tax is biased against all income-generating activity, which, in a market economy, is the engine of economic growth and prosperity. The easiest way to see this is to note first that the broad choice facing an individual with a certain amount of after-tax income is either to spend that after-tax income or to save and invest it. Like the leisure/work choice discussed previously, the consumption/saving choice is distorted by the income tax. Under the typical income tax system, the returns to saving, for example interest income, are taxed while the rewards to consumption, which relate to personal satisfaction and are non-pecuniary, are not. The tax system, therefore, will penalize saving and investment by reducing the returns to those activities relative to consumption.

An alternative and more useful way of viewing this bias, in terms of identifying approaches to tax reform, is by showing that income taxation, using the traditional terminology, "double taxes" saving relative to consumption. (This terminology is somewhat misleading. More accurately, the tax reduces the returns to saving twice, while reducing the returns to consumption just once.) This can be demonstrated with a simple example. Start with an individual who has $100 of pre-tax income. In the absence of taxation this means that this person has $100 available for either

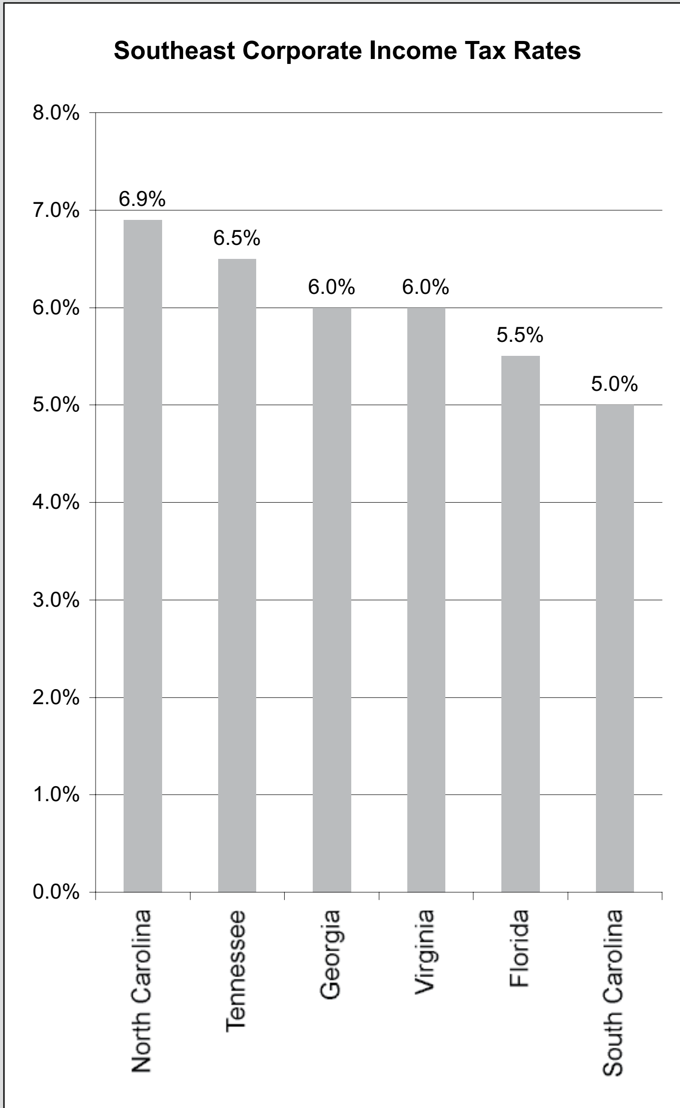
saving or consumption, i.e., the purchases of goods and services. If the interest rate is a simple 10 percent per year, then the person can decide whether he prefers to spend $100 or save the $100 and have $110 available for spending a year from now. The decision will be based on his needs and desires and the needs and desires of those who depend on him.

Now assume that the individual faces a 10 percent income tax. His $100 is reduced to $90. This reduces the amount available for consumption by 10 percent and, likewise, it reduces his returns to saving by 10 percent. If the $90 is saved his interest income is reduced to $9.00. In the absence of further taxation his choice is between spending $90 now or waiting a year and having the opportunity to spend $99. But under an income tax, the returns to saving get hit again. The $9.00 in interest gets taxed by 10 percent also. The return to saving is reduced to $8.10. The tax reduces these returns twice: first, from $10 to $9.00 when the initial $100 is taxed and, second, from $9.00 to $8.10 when the interest is taxed. The return from consumption is reduced only once, from the level of satisfaction that could be obtained with $100 to the level that could be obtained with $90. The tax on interest or other returns to investment, including the taxation of dividends and capital gains, biases the decisions against saving, investment, entrepreneurship, and business expansion and in favor of consumption spending.

"If we apply North Carolina's top marginal rate and look at its actual impact on investment returns, including interest, dividends, and capital gains, we discover that while reducing the rewards to current consumption by 7.75 percent it reduces investment returns by about 15 percent."

If we apply North Carolina's top marginal rate and look at its actual impact on investment returns, including interest, dividends, and

Figure 4



capital gains, we discover that while reducing the rewards to current consumption by 7.75 percent it reduces investment returns by about 15 percent. In other words, North Carolina has an implicit top marginal rate on saving and investment of almost double its statutory rate. By taxing saving and investment, North Carolina has a strong anti-productivity bias in its tax code, which stifles entrepreneurship and ultimately job creation. This anti-growth bias does not exist in states like Florida and Tennessee, which have no income tax.

In addition, the state further punishes investors with its separate corporate income tax. North Carolina's corporate income tax is relatively high. Indeed, as with the personal income tax, the corporate tax is the highest in the Southeast at 6.9 percent (see figure 4).

First, it should be pointed out that the corporate income tax does not tax corporations. A corporation is a legal and accounting entity and as such cannot pay taxes. All taxes "paid" by a corporation must ultimately come out of someone's pocket. These individuals come from one of three groups — the corporate stockholders, who pay in the form of lower dividends or capital gains; the corporation's employees, who pay in the form of lower wages or fewer jobs; or the customers, who pay in the form of higher prices. Corporate taxes will always be paid by a mix of these three groups. What this means is that the North Carolina corporate tax adds a third layer of taxation on stock dividends and capital gains from the sale of stocks. It also adds additional layers of taxation on workers and reduces the purchasing power of shoppers. Corporate taxes are hidden from those who actually pay them and are a particularly dishonest form of taxation.

The hidden nature of corporate taxation also makes the taxes easy to demagogue by those who want to raise taxes while making people think that "someone else"— i.e., greedy corporations — is paying.

C. Reforming North Carolina's Income Tax

Clearly the best option would be to follow the lead of states like Florida and Tennessee and abolish North Carolina's 88-year-old income tax. This would be the surest way to ease the anti-growth, anti-investment, and anti-productivity bias in our current tax structure. This change also would be consistent with the state's constitutionally recognized right to the "enjoyment of the fruits of one's labor." Unfortunately for North Carolina's income earners, this is not, at the present time, a politically feasible option. Given this, there are some steps that can be taken that will help to alleviate the punishing effects that the tax has on the state's workers and producers.

First, policymakers always should be striving to keep rates as low as possible. The lower the rates, the smaller the "tax wedge" that creates biases in favor of leisure over work effort and consumption over saving and investment. Also, the lower the rate, the greater proportion of their income people can keep to "dispose of as they see fit." Second, progressive taxation should be avoided. A tax system that increases marginal rates as incomes increase inherently punishes activities directed toward earning larger incomes. It discourages people from working harder in order to improve their economic condition. It also discourages people from accumulating "human capital," i.e., more education, more work experience, more specialized technical training, etc., in an attempt to increase their future income. Progressive marginal tax rates, therefore, intensify the income tax system's existing bias against work and also against saving and investment.

If progressivity in some form is seen as a political necessity, it should be accomplished with a large "zero tax bracket." This would see to it that the average tax rate would increase as income increases, but the marginal rate would stay the same. What this means is that up to a certain income level no tax would be due. Then, a flat rate of a certain percentage would apply to all income above that

level. For example, let's assume that there is a zero tax bracket for a family of four, up to $20,000, and a flat rate of 5 percent on all income above that level. Families earning less than $20,000 would face an average tax rate of zero percent. A family earning $30,000 would pay nothing on the first $20,000 and 5 percent, or $500, on $10,000 of income. This would be an average tax rate of 1.6 percent. On the other hand, a family earning $100,000 would pay nothing on the first $20,000 of income and 5 percent, or $4,000, on $80,000. This would be an average tax rate of 4 percent.

Under this approach, people aren't penalized for being more productive. A constant rate of 5 percent is taken out of each additional dollar earned, but because of the zero tax bracket, higher income earners are, on average, paying a larger overall percentage of their total income than lower-income earners.

The bias against saving can be mitigated by adjusting the tax base. There are several ways of accomplishing this. The most straightforward is to exempt from taxation all returns from saving, i.e., interest income, capital gains, dividends, etc. This is the approach that has been taken by those who have advocated "the flat tax" at the federal level. From this perspective, saving and consumption are treated symmetrically for tax purposes. Neither the returns from consumption, which are non-pecuniary and realized in the form of the satisfaction gained from the goods and services that we consume, nor the returns to saving and investment — interest, dividends, etc. — are taxed.

"The idea would be to treat all savings and investment in the same way that IRAs and 401K retirement investment plans are treated, except that there would be no penalties for withdrawing funds before any legally specified length of time."

An alternative way of eliminating this bias is by eliminating all

saved income in the current time period from the tax base, only taxing it when it is withdrawn for consumption purposes. A tax that deals with the bias against saving in this way is called a "consumed income tax." The idea would be to treat all savings and investment in the same way that IRAs and 401K retirement investment plans are treated, except that there would be no penalties for withdrawing funds before any legally specified length of time. In reference to the example on page 20, in which the tax and interest rates are 10 percent, if the person decided to spend his $100 in pre-tax income, he would be subject to the 10 percent tax immediately and would have $90 available for consumption purposes.

If instead, he decided to save or invest the $100 for a year, he would not be taxed on it until it was taken out of savings and used for consumption. At the end of a year, if he chose to withdraw the money from savings or to cash in his investment, the original $100 and the return of $10 would be taxed at a rate of 10 percent. This would leave him with $99 for consumption purposes, or the equivalent of a full 10 percent return on $90. The point here is that only income that is used for consumption purposes is taxed, hence the name "consumed income tax." It should also be noted that this gives the same result as the "flat tax" proposal, which exempts the interest income from the tax base. The individual would save $90 ($100 minus the 10 percent tax) and earn $9.00 in interest.

The "consumed income tax" approach to dealing with the anti-saving bias suggests that all expenses that are incurred to generate future income, which is the definition of investment, should be eliminated from the tax base. This has implications for both wage earners and businesses. For working men and women, this implies that all work-related expenses, i.e., commuting expenses, educational expenses incurred for the purpose of enhancing future income,[7] day care expenses, etc., should not be included in taxable income. In terms of analyzing the bias against saving, i.e., non-

consumed income, these expenses are analytically equivalent to saved income. They represent foregone current consumption in an attempt to generate future income.

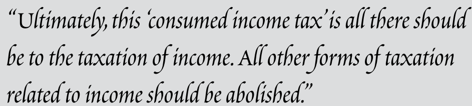
This is also true of business expenses, none of which should be included in the tax base so long as business income is being taxed. It should be pointed out that, not only should all business costs be eliminated from the taxable income base, but they also should be "expensed." That is, they should be deducted in the year that they are incurred, not amortized or depreciated over an extended period of time.

In this regard I am referring to the system of depreciation for tax purposes that is part of the federal tax code and has been adopted by North Carolina as part of its state income tax. Different types of physical asset, plant, and equipment purchases are put into different categories and allowed to be deducted for tax purposes (amortized) over shorter or longer periods of time depending on the kind of asset. The amortization of business expenses, regardless of how long the assets last in a physical sense, creates a bias of its own. It makes investment in capital equipment that wears out over a relatively longer period of time, "longer-lived capital," less attractive than "shorter-lived capital," everything else equal.

It is often argued that the cost of assets should be deducted from taxable income only as the asset generates income, i.e., over the useful life of the asset. This approach will exacerbate the efficiency problems of taxation. As noted, the full cost of any business expenditure, in this case a physical asset, should be deducted from taxable income. The closest approximation of the full cost of an asset is the market price of that asset.

If the tax code forces the purchaser of an asset to delay the deduction, the real value of the deduction will be for less than the full cost. This is simply because a dollar is worth more to someone now than it is a year from now, or at any time in the future.

Evidence is, people must be paid interest in order to be induced to save. If a farmer builds a warehouse on his property for $100,000 this year, immediate expensing will ensure that the full cost is being deducted. If that deduction cannot be taken fully for ten years, which is the write-off period under the current tax code, then it will be worth less than its full value when it is actually realized. The longer the depreciation period is, the greater the difference between the asset's actual value and the value of the tax deduction. In a system in which asset costs are depreciated for tax purposes, rather than expensed, an incentive will be created for substituting, where possible, shorter-lived assets for longer-lived assets. Also, the system creates a bias against entrepreneurial investments that use relatively longer-lived capital. For example, if an entrepreneur were considering alternative investments in either a fleet of buses to provide commercial charter services or an office building complex, both of which would yield the same before-tax return on investment, it is likely that he would choose the fleet of buses with a five-year depreciation period over the office complex which has a 29-year depreciation period. This is because the difference between the value of the tax deduction and the full value of the asset becomes smaller as the depreciation period is reduced.



"Ultimately, this 'consumed income tax' is all there should be to the taxation of income. All other forms of taxation related to income should be abolished."

Ultimately, this "consumed income tax" is all there should be to the taxation of income. All other forms of taxation related to income should be abolished. While this would include relatively small taxes, such as the state's self-employment tax, the most significant would be the corporate income tax. As noted above, this tax adds to the bias against productive activity by further penalizing investment. But just as importantly, because the burden of the tax is completely hidden from those who pay it, it is inconsistent with honest government.

D. The Sales Tax

From the perspective of economic neutrality, the sales tax is functionally equivalent to the consumed income tax described above.[8] The idea behind both taxes is to tax income used for consumption while exempting income used for saving and investment. With a sales tax, all income is taxed only once, when it is used for consumption purposes. As such, even though both of these kinds of tax mechanisms are referred to as "consumption taxes," they are actually neutral between an income earner's decision to use his or her money for consumption or saving/investment. The primary difference is how the taxes are collected. While a consumed income tax is collected in the same way as typical income tax and paid either through withholding or periodically through the year, a sales tax is collected at the point of sale.

From the perspective of economic efficiency and growth, North Carolina's sales tax is much more sound and needs much less "tweaking" than the income tax. As noted earlier, an implication of the state's constitutional right to use our income as we see fit is that alternative consumption decisions should be on an equal footing and the state should not be in the position of using excise taxes to penalize the consumption of some products relative to others. What this implies is that separate sales taxes for products such as restaurant meals, alcoholic beverages, soft drinks, and tobacco products should be repealed, and these products should be treated the same as other consumption alternatives.

"There is also an element of double taxation in how the sales tax treats business purchases...businesses should not pay sales taxes on any purchases related to the provision or production of their products."

There is also an element of double taxation in how the sales tax treats business purchases that should be eliminated. With the

exception of the purchases made by service providers (see below), businesses should not pay sales taxes on any purchases related to the provision or production of their products. There are two reasons for this. First, like the deduction for plant and equipment for business owners under a consumed income tax, these purchases are investment expenditures that will yield future income, i.e., when the final product is sold in the market. The value of these purchases will be included in the purchase price of the final product and will be taxed at that point.

To tax the purchase when it is made by the business is to add an element of double taxation. For example, if a bookstore purchases a cash register, the value of that cash register to the store's output is incorporated in the price of the books that are sold. The value that the cash register adds to the bookstore's business is therefore taxed when the book is purchased and the retail sales tax is paid. If the cash register is also taxed when it is purchased by the bookstore, it is in essence being double taxed. By taxing a product at retail, you are in essence taxing the value added to that product by all of the inputs that went into providing it. Eliminating the sales tax on productive inputs purchased by businesses will eliminate this double taxation.

The exception would be for service industries that sell their services directly to consumers — this might include hair salons or lawn service companies. At the present time the state does not tax these services directly, but this does not mean that these services escape the tax entirely. For example, if a hair stylist is charged a sales tax when purchasing clippers, combs, styling chairs, mirrors, etc., as is currently the case, the tax is captured in the final price of the hair styling services. Many have argued that under North Carolina's current system, customers of services escape paying a sales tax. This is not accurate. The final price of the services includes the sales tax that has been paid on all of the equipment that adds to the value of the product.

By not taxing services directly, the only aspect of the service that is not captured by the sales tax is the value added by the labor involved. It should also be noted that the largest segment of the service industry does not involve retail sales and therefore should not be taxed in any case. This would include most lawyers' services, accountants, bookkeepers, investment counselors, etc.

Apart from adjusting the tax base to ameliorate the problem of double taxation, the main policy goal with respect to the sales tax should be to lower the rates.

IV. Additional Principles for Tax Reform: Transparency and Simplicity

While this report has focused on what I consider to be the two foundational principles for reforming North Carolina's tax system, there are two others that should be kept in mind as policymakers consider changes to the current system. One of the two is mostly beyond the power of North Carolina's policymakers. The first relates to transparency and hidden taxes. The tax system should serve the function of making it clear to people how much the services their government is providing are costing them. As noted above, this is one of the primary reasons why the corporate income tax should be eliminated. Virtually none of the people who actually pay it are aware of the fact, and they certainly do not know how much the tax is costing them.

"The tax system should serve the function of making it clear to people how much the services their government is providing is costing them."

On this basis the state also should consider eliminating income tax withholding, which also obfuscates the costs of government.

This is because, outside of the self-employed, very few people ever explicitly pay their income taxes by writing a check. Most people are unaware of how much they are paying in income tax each year. Indeed there are many who, because they may get a refund check from the state, believe that they are paying no tax at all. This is another reason to eliminate sales taxes paid by business on products they use to provide the goods that they sell or produce. Sales taxes on business purchases are paid by consumers in the prices of the products that they buy, but they are never made explicit. The point is that good government and an informed citizenry require that taxation be transparent and noticed by those who pay it.

The second principle is simplicity. Taxpayers should not have to expend a great deal of resources, either time or money, in order to comply with the tax code. Ideally, there is no reason why a typical taxpayer should have to hire a professional to fill out tax forms. Unfortunately, most of the complexities in the North Carolina system stem from the federal code, and there is probably little that can be done at the state level to simplify the tax preparation process significantly. Even if the state were to adopt a straightforward consumed income tax with a flat rate, so long as the taxpayer had to continue to file federal taxes, the primary complexities in the system would still exist.

Conclusion

North Carolina's tax system needs radical reform. The purpose of this paper has not been to provide a blow-by-blow description of how reform should proceed, rather to provide a roadmap for reform with ideal destinations toward which policymakers should aim. The two most important concerns for lawmakers when designing tax policy should be to minimize the extent to which taxation intrudes on people's liberty – in particular, their right to use their income to pursue happiness however they define it – and to maximize prosperity and economic growth.

While this paper has outlined some sweeping changes that would bring North Carolina's tax code into better conformity with these goals, there are steps that can be taken short of complete adoption of a flat-rate consumed income tax or a traditional flat tax, which would help move the state in the right direction. As discussed, one way to eliminate the bias against saving and investment is to exempt interest from taxation. This is something that could be done in a piecemeal fashion by creating "special niche," tax-free savings and investment accounts for things like primary and secondary education, health care, home ownership, etc. The idea would be OK to move the tax code systematically toward a more neutral stance.

Furthermore, the state can move toward lowering rates for all forms of existing taxation or even eliminating the tax on capital gains and corporate income. The state also should eliminate special subsidies and tax breaks to businesses that are now part of the state's so-called economic development program. All specific business and industry subsidies, whether in the form of tax "incentives" or direct subsidies, should be abolished while using these saved revenues to make the tax code more neutral and growth-friendly for all.

Unfortunately, North Carolina lawmakers rarely have given any consideration to the basic principles of tax policy outlined here. Clearly, over the decades it seems that tax policy changes have been implemented for all the wrong reasons — either to reward or penalize favored activities or to identify and take advantage of new sources of revenue. As a result, the state's tax system is an incoherent hodgepodge of penalties and subsidies that unnecessarily infringes on personal liberty and causes the state to be much less prosperous than it otherwise could be.

End Notes

(1) See Joe Coletti, "Back to Basics Budget," Spotlight, John Locke Foundation, March 16, 2009, found at http://www.johnlocke.org/spotlights/display-story.html?id=221.

(2) Historical information provided by the N.C. Department of Revenue.

(3) Robert Murray Haig and Carl Shoup, *The Sales Tax in America*, (New York: Columbia University Press) 1934, pp. 186-193.

(4) Neil Jacoby, *Retail Sales Taxation*, (New York: Commerce Clearing House) 1938.

(5) "Face-off on Tax Policy," *Popular Government*, Vol. 69, No. 2, Winter 2004, p. 4.

(6) Found at http://statelibrary.dcr.state.nc.us/nc/stgovt/preamble.htm#1.

(7) Some educational expenses are incurred for consumption purposes, i.e., in pursuit of a hobby or simply to enhance one's knowledge of a subject. These expenses should not be tax-exempt.

(8) Michael Schuyler, *Consumption Taxes: Problems and Promises*, (Washington, D.C.: The Institute for Research on the Economics of Taxation) 1984.

Appendix

Tax Estimates for Hypothetical North Carolina Families at Alternative Incomes

A family of four (two children and two income earners) making $100,000 in wages and $1,000 in interest:

	FAMILY A	FAMILY B
Total Income	$101,000	$101,000
standard deduction or itemized	STANDARD DEDUCTION	ITEMIZED
Total Federal Taxes		
(Income, FICA, Gasoline)	$19,273	$17,373
State Income Tax	$5,524	$5,172
Property Tax (House)	-	$1,735
Property Tax (Cars)	$250	$250
Gasoline Tax (500 gal/car)	$242	$242

Sales Tax	$1,988	$2,034
Total State Taxes	$8,004	$9,433
After-Tax Income	$73,723	$74,194

A family of four (two children and two income earners) making $50,000 in wages and $500 in interest:

	FAMILY C	**FAMILY D**
Total Income	$50,500	$50,500
standard deduction	STANDARD	ITEMIZED
or itemized	DEDUCTION	
Total Federal Taxes		
(Income, FICA, Gasoline)	$5,633	$5,558
State Income Tax	$1,989	$1,907
Property Tax (House)	-	$1,157
Property Tax (Cars)	$250	$250
Gasoline Tax (500 gal/car)	$242	$242
Sales Tax	$1,313	$1,316
Total State Taxes	$3,794	$4,872
After-Tax Income	$41,073	$40,070

A family of two (one child and one income earner) making $25,000 in wages:

	FAMILY E
Total Income	$25,000
standard deduction	STANDARD
or itemized	DEDUCTION
Total Federal Taxes	
(Income, FICA, Gasoline)	$2,294
State Income Tax	$860
Property Tax (House)	-
Property Tax (Cars)	$100
Gasoline Tax (500 gal/car)	$121
Sales Tax	$665
Total State Taxes	$1,746
After-Tax Income	$20,960

About the Author

Roy Cordato is Vice President for Research and resident scholar at the John Locke Foundation. From 1993-2000 he served as the Lundy Professor of Business Philosophy at Campbell University in Buies Creek, N.C. From 1987-1993 he was Senior Economist at the Institute for Research on the Economics of Taxation (IRET) in Washington, D.C. He has served as full-time economics faculty at the University of Hartford and at Auburn University and as adjunct faculty at Johns Hopkins University.

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In 2000 he received the Freedoms Foundation's Leavey Award in Free Enterprise Education. He is also a member of the Mont Pelerin Society and former executive board member of The Association of Private Enterprise Education. Cordato holds an M.A. in urban and regional economics from the University of Hartford and a Ph.D. in economics from George Mason University. He also holds a Bachelor's of Music Education from the Hartt School of Music.

About the John Locke Foundation

The John Locke Foundation is a nonprofit, nonpartisan public policy institute based in Raleigh. Its mission is to develop and promote solutions to North Carolina's most critical challenges. The Locke Foundation seeks to transform state and local government through the principles of competition, innovation, personal freedom, and personal responsibility in order to strike a better balance between the public sector and private institutions of family, faith, community, and enterprise.

To pursue these goals, the Locke Foundation operates a number of programs and services to provide information and observations to legislators, policymakers, business executives, citizen activists, civic and community leaders, and the news media. These include the foundation's monthly newspaper, *Carolina Journal*; its daily online news service, *CarolinaJournal.com;* the *Locke Letter*, a quarterly newsletter for donors; regular events and conferences on important public policy issues; and research reports of varying lengths on topics facing state and local governments.

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