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Tax Reform in North Carolina: Simple, Neutral, Pro-Growth

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Chairman Rabon and Chairman Rucho, Members of the Committee:

My name is Scott Drenkard, and I'm an economist at the Tax Foundation. For those unfamiliar with the Tax Foundation, we are a non-partisan, non-profit organization that has monitored fiscal policy at all levels of government since 1937. We have produced the Facts & Figures handbook since 1941, we calculate Tax Freedom Day each year, and have a wealth of data, rankings, and other information at our website, www.TaxFoundation.org.

I'm pleased to have the opportunity to speak today with regard to the Senate Finance Committee Substitute to H.B. 998, a comprehensive bill to restructure North Carolina's tax code. While we take no position on the bill, I hope to give some perspective based on our research.

In January of this year, my colleague Joe Henchman and I released a book titled *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform*. In it, we detail reform recommendations in line with the principles of sound tax policy: simplicity, neutrality, transparency and stability.

The focus of my testimony today is that tax structures matter just as much as tax collections. In other words, *how* North Carolina collects taxes can have fundamental impacts on economic growth and deadweight loss. With careful consideration, the Tar Heel state can collect the revenue it needs for necessary government services without stalling the engine of economic growth.

Taxes and Economic Growth

Rarely does empirical economic literature speak so strongly in unison as it does about the effect of taxes on economic growth. In 2012, my colleague Will McBride conducted a comprehensive study of peer-reviewed literature on economic growth and tax levels. He found that of the 26 studies written on the topic, 23 find that raising taxes hurts economic growth.

The three studies that disagree had statistically insignificant results, and all studies published in the last 15 years find that raising taxes hurts growth. This last fact is especially convincing, as these more recent articles address statistical problems with early studies on the topic.

The bill before the committee cuts taxes to the tune of $1.4 billion, and keeping that money in the private sector will create economic growth immediately and in the long run.

The Corporate Income Tax

A central element of this bill is the elimination of the corporate income tax by the year 2017, a move that would make North Carolina one of just four states without a corporate income tax or gross receipts tax. This reform is beneficial for a few reasons. First, corporate income taxes are generally considered to be the most economically destructive. Of the economic literature that distinguishes between types of taxes, the consensus is that corporate income taxes hurt economic growth most, followed by personal income taxes, then sales taxes, and finally property taxes least.

Add to this the fact that corporate income taxes represented just 4 percent of statewide state and local collections in 2010, and in many ways corporate tax elimination is a high "bang-for-your buck" option to increasing growth. As opposed to simply cutting tax rates, elimination of an entire tax also reaps benefits in compliance costs.

Each year, corporate entities spend millions on attorneys, accountants, and tax consultants to comply with the corporate income tax, carefully structuring their income to achieve lower tax bills through the use of special credits even if doing so doesn't make business sense otherwise. Elimination of the tax entirely removes these costs and allows businesses to spend that money on other resources that better serve the economy.

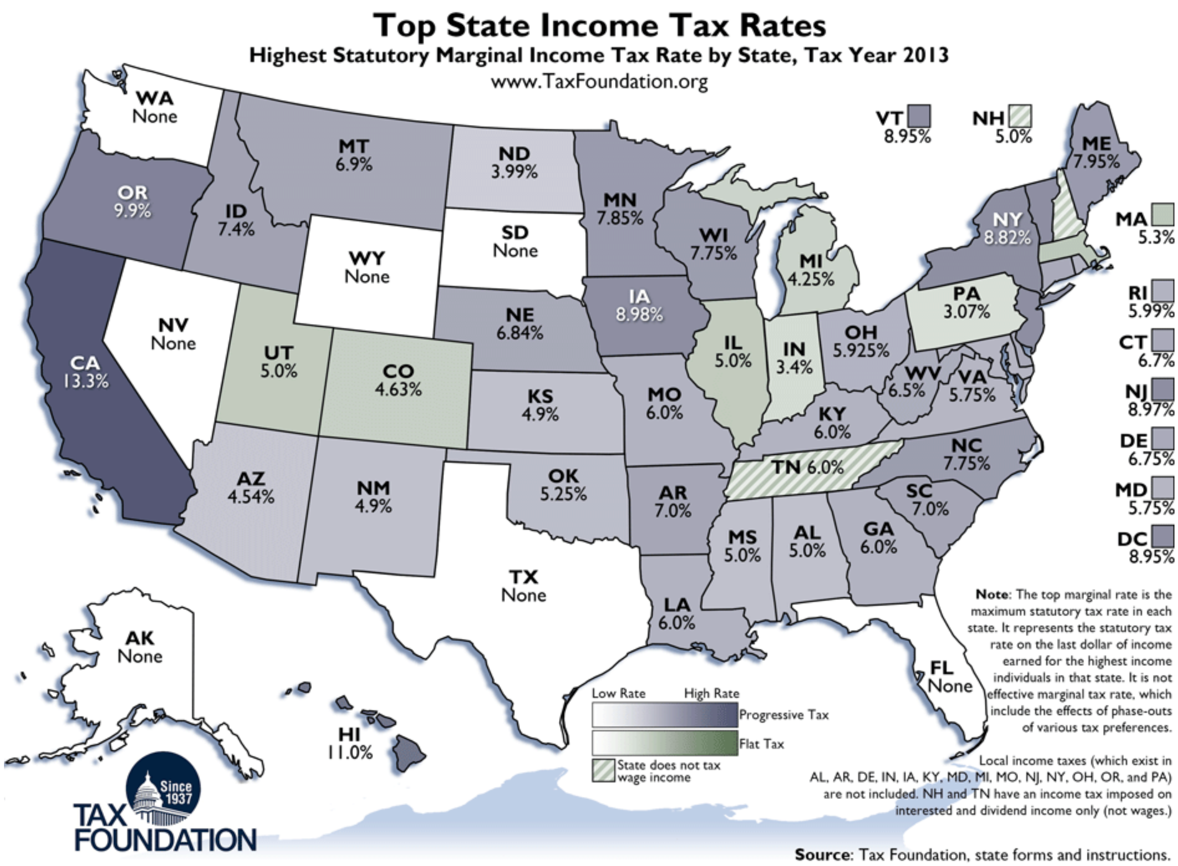
Finally, economists agree that corporate income taxes are not even borne by corporations themselves. They are passed on in one of three ways: to consumers in the form of higher prices, to workers in the form of lower wages, and to shareholders in the form of lower dividends. To review, state corporate income taxes are the most damaging tax to growth, they don't collect very much revenue, they have large compliance costs, and they are ultimately passed on.

Cutting and Flattening the Income Tax

North Carolina's individual income tax, first enacted in 1921, has a graduated rate structure, meaning that taxable income above each threshold (after subtracting deductions and exemptions) is taxed at progressively higher percentages.

North Carolina's top income tax rate is the highest in the region, and the other lower rates are still relatively high and kick in at low levels of income (see Figure 1). As North Carolina grows its finance sector, many prospective employees will have income levels above the top bracket, so the comparison to other states in the region (and other finance centers) is important for relocation decisions.

Figure 1: Top State Income Tax Rates, Tax Year 2013



Excessive taxes on income are also generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive summary of international econometric tax studies, an OECD study found that personal income taxes are among the most destructive to growth, being outdone only by corporate income taxes. The authors found that consumption and property taxes are the least harmful.

The economic literature on progressive income taxes is especially unkind. For example, the OECD study finds that reductions in the top marginal rate of income taxes would be beneficial to long term growth. Examining the period 1969-1986, Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the principle of broad bases and low rates.

For these reasons, I'm pleased to see that this bill and several of the other bills being considered in North Carolina are pushing for a flat income tax.

Estate Tax Repeal

While estate taxes are often a polarizing issue, a 2009 poll by the Tax Foundation found that they are viewed as the most “unfair” of all federal taxes. Though our poll didn’t ask, I think this is largely because of the posthumous nature of the tax and the fact that it taxes income that has already been taxed once.

While these elements make the tax unfair, they also hurt the economy. As pointed out by the Joint Economic Committee in a 2012 report, the federal estate tax has since its inception decreased capital stock by $1.1 trillion due to discouragement of savings and the taxing of intergenerational transfers, which are perhaps the largest source of aggregate capital in the economy. The estate tax discourages savings by promoting a “die broke” mentality, as untaxed consumption becomes relatively cheaper than savings for those who intend to build wealth and bequeath a gift to inheritors, such as children or grandchildren.

Further, the tax is among the most complex taxes; some estimates show that the compliance costs of collecting the tax (estate and gift planning) actually exceed the amount the tax brings in. State estate taxes just add to the complexity.

Reforming the Sales Tax: Taxing Business Inputs Distorts the Economy

North Carolina is not alone in needing to modernize its sales tax. In the 1930s, when sales taxes were first created, they were placed on sales of “tangible personal property,” or goods. Services have not been traditionally subject to sales taxes. This base worked well for a time, as goods represented about two-thirds of the economy. But today, the U.S. economy is fundamentally service-based, with goods representing only one-third of trade and services comprising the other two-thirds.

The result is that instead of expanding the base of the sales tax to services as the economy has changed, states have just raised rates on the existing base defined back in the 1930s, meaning states tax goods at very high rates, while services largely pay no sales tax. For the sales tax to remain a viable revenue source in the next two decades, services will have to be included sooner or later in all states that rely on the sales tax.

The bill introduced today is different than other bills the Senate and House have considered in that it doesn’t include expansion to services. My hope is that if that this legislative body is not able to make room for that reform in this session that they will flag that reform for future examination.

But another equally important sales tax reform is the exemption of business-to-business transactions from the sales tax. Business inputs should be exempt not because businesses deserve special treatment, but because failure to do so results in “tax pyramiding,” the process whereby taxes stack on top of each other as raw goods move through the production process.

As an example, if one were to build a car under a sales tax regime that taxes business-to business transactions, the rubber of the tire would be taxed once when it was sold from the rubber producers to the tire company, then taxed again when the tire is sold to the car company, then taxed a final time when the finished car is sold to the end consumer. This practice inordinately burdens industries with long production lines.

Finally, taxing business-to-business transactions reduces tax transparency, because while a statutory rate paid by the consumer at the point of final sale may be low, the business-to-business taxes are already embedded in the price of the product.

Many states try to avoid these problems by engaging in the laborious task of picking products that are frequently used as business inputs and individually carving out exemptions for them in the sales tax code. This approach is a step in the right direction but does not and cannot ever comprehensively address all the items that businesses use in the production process and should therefore not pay sales taxes on.

In the materials I've been able to obtain on the current bill before the committee, it seems to be moving in the opposite direction, with some of the new expansions to the sales tax falling on business-to-business transactions.

I'd like to hold out the sales tax treatment laid out in an earlier version of S.B. 677 as a straightforward solution to this problem. That bill expressly excludes businesses from paying sales taxes on products that are used in production with the following language included in the exemption section:

> Sales of capital equipment purchased by a business subject to the franchise tax under Article 3 of this Chapter or to a farmer for use by the farmer in the planting, cultivating, harvesting, or curing of farm crops or in the production of dairy products, eggs, or animals.
>
> A service taxable under G.S. 105-164.4(b)(13) through (25) that is provided to a business subject to the franchise tax under Article 3 of this Chapter for use in that business.

The State Business Climate Index

As an informational tool, I've run the various plans through our State Business Tax Climate Index. As you can see, the new Senate plan scores the best on our Index, and the score is driven mainly by the elimination of the corporate income tax. The Rucho and Rabon bill scores very well in the sales tax component of the Index, mainly for its correct treatment of business input exemptions.

Figure 2: State Business Tax Climate Index Rankings

	Current Law	H.B. 998 (Lewis et. al.)	S.B. 677 (Rucho & Rabon)	S.B. 394 (Clodfelter & Hartsell)	H.B. 998 Substitute
Overall	44	19	13	22	6
Corporate	29	20	25	25	1
Individual	43	17	13	17	16
Sales	47	48	16	47	47
Unemployment Insurance	5	5	5	5	5
Property	36	27	27	36	26

Conclusion

In closing, this session represents a unique opportunity for North Carolina to enact serious, growth-maximizing tax reform. I'm excited to see so many good ideas on the table, and I look forward to your questions.

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One of the oldest think tanks in the United States, the Tax Foundation is a non-profit, non-partisan organization that provides research and analysis on tax policy issues and the size of the tax burden at all levels of government. Based in Washington, D.C., our work advances the principles of simplicity, neutrality, transparency, and stability.

About the Center for State Fiscal Policy at the Tax Foundation

The Tax Foundation's Center for State Fiscal Policy produces timely, high-quality, and user-friendly research and analysis for policymakers and the public, shaping the state policy debate toward economically principled tax policies.