Face-off on Tax Policy

As April 15 approaches, taxes are in the news. However, North Carolina state representatives and senators, and legislators in cities, towns, and counties of the state, devote a lot of attention to taxes year-round, in good times and bad.

To help readers gain a better understanding of different philosophies and principles of taxation in North Carolina, we posed six questions to two policy analysts from organizations usually seen as opponents: the John Locke Foundation and the North Carolina Justice Center's Budget and Tax Center. The former is typically labeled "conservative," the latter "liberal."

The side-by-side answers that follow provide illuminating points of agreement, as well as points of disagreement. As North Carolina local and state elected officials consider their views on taxes, an examination of "first principles" of taxation, as well as opinions on some contemporary tax issues, is in order. —Editor

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Question 1.

What are the key principles for guiding state tax policy? Are one or two principles most important?

Cordato: Two kinds of principles should guide tax policy, moral and economic. The moral kind is more important because the entire fabric of the American political system is based on a particular ethic, namely individual liberty. For North Carolina the basic statement of this ethic is found in Section I of the North Carolina Constitution, Declaration of Principles. Following the U.S. Declaration of Independence but expanding on it as indicated by the phrase emphasized by me in the following quotation, the Declaration of Principles states:

> *We hold it to be self evident that all persons 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.*

The difference between the statement in the Declaration of Independence and this statement has the most direct implication for tax policy. In North Carolina the citizens have an explicitly recognized right to "the enjoyment of the fruits of their own labor." This implies that they have a right to use their own income for their own purposes.

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Mejia: In 1988 the National Conference of State Legislatures, in conjunction with the Lincoln Institute of Land Policy, put forth what remains the best set of core tax principles.[1] These five principles follow, along with brief descriptions.

Principle 1: provision of appropriate (that is, adequate) revenues. Taxes are a means to an end, which is to raise revenues to pay for government services, both today and in the future. To provide appropriate resources, a tax system must be *sufficient*, *stable,* and *certain*. This is particularly important for state governments, which, unlike the federal government, may not fund government with deficit spending. A "sufficient" tax policy raises enough revenues to pay for the programs and services that the majority of citizens and lawmakers demand, and remains flexible enough to adapt to a changing economy. A "stable" tax policy favors a diversified and broad-based tax structure. A "certain" tax policy requires that lawmakers avoid constantly changing tax laws except when necessary to reflect changes in economic and political circumstances.

Principle 2: neutrality. This principle recognizes that taxes should not unintentionally distort market decisions.

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Without this right the right to pursue happiness would be meaningless.

Because of its coercive nature, all taxation denies people this fundamental right. Policy makers, therefore, have an obligation to ensure that the North Carolina tax system encroaches on this right as little as necessary. This means that elected officials should not make tradeoffs between higher taxes, which violate a fundamental constitutional right, and government programs that are not constitutionally guaranteed.

Furthermore, the statement makes no distinctions based on income. "All persons" have an equal right to the fruits of their labor. This implies that policy makers have no moral authority to seek "progressivity" in the tax code (that is, taxing of larger incomes at higher rates). By its very nature, progressivity presumes that some people have fewer rights to the fruits of their labor than others.

Economic analysis gives rise to a second, complementary principle for guiding tax policy: policy makers should minimize taxation's negative impact on economic growth. In other words, the tax burden should be kept low. Taxation transfers control of resources from the forces of supply and demand in the private sector to the forces of political decision making in the government. This involves a transfer from an institutional setting where resources are used

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It also requires that the tax base be as broad as possible. Unfortunately the North Carolina tax code is riddled with exemptions, credits, deductions, and the like, introduced to encourage or sometimes discourag3 specific behaviors by businesses and individuals. Although special treatment might be justified in some distinct cases, the tax system generally should not distort economic decisions.

Principle 3: fairness and equity. Tax fairness means different things to different people, but it probably is the reason most often cited for advocating specific changes in tax policies. Tax policy experts agree that tax fairness has two aspects: horizontal equity and vertical equity. "Horizontal equity" requires that similar taxpayers be treated similarly. That is, people with similar income and assets should pay approximately the same amount in taxes. This is far from reality in the current tax code, which gives preferential treatment to specific categories of individuals and businesses. "Vertical equity" demands that a tax system place at least proportional, if not progressive, burdens on taxpayers of varying economic means. At the very least, a tax system should not be "regressive." That is, it should not take a greater share of the income and wealth of low- and moderate-income taxpayers than it takes from wealthier taxpayers. Unfortunately, almost all state tax systems, including North Carolina's, fail this test.

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more efficiently to one where they are used less efficiently, leading to a reduction in economic growth and prosperity.

The principle of economic growth further implies that, to the extent possible, taxation should be neutral with respect to economic decision making. That is, tax policy should not penalize or subsidize some economic choices relative to others. These choices include decisions concerning consumption relative to saving and investment, leisure relative to work, investment in some kinds of industries relative to investment in other kinds, or purchase of certain kinds of goods and services relative to other kinds. The economy operates most efficiently when market forces (producers, consumers, investors, and entrepreneurs), not the tax code, determine resource allocation.

Finally, the tax system should be easy to comply with. This often is called the "principle of simplicity." The diversion of people's time and financial resources to comply with the tax system is itself a tax. It creates what economists call a "dead weight loss" to the economy. In other words, these resources are not contributing to overall productivity, and the economy grows at a slower rate than it would if compliance costs were lower.

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Principle 4: ease and economy of administration. Taxes should be as easy as possible for taxpayers to comply with and the least costly for government to collect. A complicated tax system leads some citizens to engage in aggressive tax planning in order to avoid paying taxes. It also leads to general dissatisfaction among taxpayers.

Principle 5: accountability. Tax collection officials should be efficient in their work and immune to corruption. Also, there should be strong enforcement of tax laws. Finally, tax policy should be made in an open, transparent manner. If policy makers do not clearly show taxpayers why they have made policy changes and who stands to benefit or lose as a result of those changes, they undermine trust in government and the willingness to pay taxes.

The principles of fairness and adequacy are the most important because they are the most essential to maintaining a democratic system of governance. Simply stated, adhering to these two principles means that the system should treat all taxpayers fairly and that government should provide the level of services that the public demands and lawmakers enact.

Question 2. Which kinds of taxes are better for the government to use?

Cordato: Government should use the kinds of taxes that infringe the least on liberty and individual decision making and minimize damage to the economy. Further, it should avoid some forms of taxation altogether—those that are particularly inconsistent with liberty and economic growth.

Given the principle of neutrality, the state should avoid taxes that penalize some kinds of choices relative to others. These include specific excise taxes, such as those on tobacco, alcohol, hotel rooms, and rental cars. The tax code should treat all consumer choices equally.

North Carolina's approach to income taxes mirrors the federal tax code and is therefore inherently biased against work effort, entrepreneurship, and saving and investment.

On the basis of the same principle, the government should eliminate or reform the current income tax system. North Carolina's approach to income taxes mirrors the federal tax code and is therefore inherently biased against work effort, entrepreneurship, and saving and investment. Taxes on income discourage income-generating activities, much as a tax on cigarettes discourages smoking or a tariff discourages imports. The income tax compounds this bias by applying higher "marginal rates" (that is, by applying higher rates to portions of income beyond a certain amount) as incomes increase. Progressive income taxes punish those who are the most productive. In a setting of free exchange, people generate income by providing goods and services that others want. This is what it means to be productive. Progressivity, in addition

Mejia: Given the principles just discussed, the ideal state tax structure would grow with the economy, remain relatively stable during tough economic times, and be fair to all taxpayers. Therefore a state tax system should be diverse and should rely heavily on a progressive state income tax. Including property, consumption, and business income taxes diversifies and broadens the base of the tax system and provides some insurance against dramatic, harmful swings in revenues.

Over the long term, the personal income tax is the strongest of any of the major revenue sources and is most likely to ensure long-term adequacy of revenues to meet spending requirements and avoid deep structural deficits. At the same time, a highly progressive income tax makes the tax system equitable, offsetting the regressive nature of consumption and property taxes. Although most states rely to some degree on income taxes, only three states maintain an overall tax system that takes the same or less, as a share of income, from the top 20 percent of taxpayers as it does from the bottom 20 percent.[2] All three have a highly progressive personal income tax structure. North Carolina's tax system has a moderately progressive personal income tax, but from a fairness standpoint, it is far outweighed by the system's reliance on sales and property taxes.

Of North Carolina's primary taxes, the retail sales tax is the most in need of substantial reform. After adjustments for inflation and new exemptions, sales tax revenues per penny have been decreasing over time. The two chief culprits are the proliferation of remote out-of-state and online retailers and the shift in the economy from purchases of goods toward purchases of services. Failing

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to denying equality of rights, punishes productivity and discourages economic growth.

North Carolina's policy makers should reform the state's income tax so as to minimize these biases. The state should switch to a "flat-rate consumed-income tax." The economics literature has shown that this kind of tax eliminates the bias against saving and investment and reduces the bias against work effort and entrepreneurship.

To introduce such a tax, first, policy makers should convert the current five-rate system (0.00, 6.00, 7.00, 7.75, and 8.25 percent) to a single rate that treats all taxpayers equally. If policy makers desire a progressive tax code for political reasons, they can introduce it by using a large zero-tax bracket at the bottom end of the income distribution.

Second, policy makers should exempt from taxation all income that is saved or invested until it is withdrawn and used for consumption. (This often is referred to as "universal IRA treatment.") At the point of withdrawal , they should tax both the principal and the interest or other return at the normal (flat) rate. All income would ultimately be taxed, but only once, when it was used for consumption.

Sales taxes display the same economic properties as the flat-rate consumed-income tax. Because of this, the state should rely most heavily on some combination of these two forms of taxation.

Further, in the name of both economic efficiency and political honesty, the state should abolish the corporate income tax. The tax adds an additional layer of bias against investment and entrepreneurship, hurting overall economic performance. Just as important, the tax is dishonest because it is a hidden tax on corporate shareholders, employees, and customers. Corporations as legal entities cannot pay taxes; only people can. Every dollar that a corporation takes in, whether it is kept and reinvested or paid out in dividends, accrues to the benefit of one or some combination of three groups: the corporation's stockholders (its owners), employees, and customers. If every dollar that comes into a corporation benefits one of these three groups, then every dollar that a company pays in taxes comes from one of these three groups. Stockholders pay corporate taxes in the form of fewer dividends and reduced capital gains; employees pay them in the form of lower wages; and customers pay them in the form of higher prices. To claim that corporations are taxed is a charade. Those who call for higher corporate taxes are in effect advocating higher prices, reduced wages, and smaller capital gains and dividends. This last is a tax on workers' pension funds and retirement accounts, with an especially negative impact on the income of the elderly.

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"I see no new taxes, followed by some new taxes."

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to include remote sales and services in the sales tax base violates the tax principles of neutrality, equity, and adequacy. Along with several other states, North Carolina is working at the national level to require remote sellers such as catalog and online vendors to collect sales taxes, but that effort will take years to bear fruit. The state has made less progress in expanding the sales tax base to include services. The combined effect of these developments is that sales tax revenues have not tracked economic growth. To compensate, lawmakers have more than doubled the combined state and local sales tax rate since the 1970s.

After the retail sales tax, business taxes should be next in line for overhaul. Businesses, like individuals, benefit greatly from government spending and should pay their fair share for the benefits. Determining what represents their fair share has become increasingly difficult. Large corporations have taken advantage of the complexity of the tax code and the wide variation in business taxes from state to state to lower their tax liability. In July 2003 the nonpartisan Multi-State Tax Commission released a report showing that North Carolina lost $301 million in the 2000–01 fiscal year alone because of corporations' use of tax shelters. Currently, corporate income and franchise tax revenues combined make up only 8 percent of general fund revenues. This proportion is far less as a share of total state revenues than in the past, yet some advocates are adamant that North Carolina needs to cut business taxes. Two first steps in reversing these trends would be to move to "combined reporting" of corporate taxes (corporations reporting on all of their business activity to the North Carolina Department of Revenue, as opposed to their making their own determination of the share of their income that is attributable to doing business in the state) and to close corporate tax loopholes that already have been identified.

Question 3. Should fees be used more and taxes reduced?

Cordato: A principle of taxation that I did not discuss in my response to question 1 is the "benefit principle." This is the idea that benefits and payments should be linked. In markets this benefit-payments link is one of the factors that help ensure economic efficiency in production and consumption. When policy makers can easily identify specific beneficiaries and segment the market, it makes sense for them to finance government activities with user fees rather than general taxation. This includes not only charging admission to museums, parks, concerts, and so forth but also charging tuition to state universities so that a greater proportion of the actual cost of an education is covered.

The moral reason for using fees is to avoid forcing some people to subsidize other people's consumption, investment, and leisure activities.

The second part of this question, "and taxes reduced," is important. The moral reason for using fees is to avoid forcing some people to subsidize other people's consumption, investment (for example, education), and leisure activities (for example, using campgrounds or attending concerts or art exhibits). When policy makers use these fees to substitute for general taxation, they should return the money that is saved to the taxpayers and not use it to create new government programs or expand existing ones. The latter is a danger whenever new revenues become available. The tendency is to find new ways to spend the money. Rarely do policy makers think first about ways of returning saved revenues to the taxpayer. In accordance with the constitutional principle I discussed in my answer to question 1, a legislator has a moral responsibility to

Mejia: User fees, sometimes called "user charges," certainly serve a legitimate purpose in today's government. Governments generally, and local governments particularly, are looking aggressively to user fees to raise needed revenues. According to the latest Census data, North Carolina ranked twenty-first in the use of nontax revenue to fund state and local government in fiscal year 2000.[3] Although local governments typically rely more heavily on revenue from user fees, state governments, including North Carolina's, have been looking toward user fees for new revenues. In the 2003 legislative session, North Carolina raised user fees for visiting state parks, increased charges for various professional licenses, and boosted tuition for higher education. (The actions cover fiscal years 2003–04 and 2004–05.)

The central concern with the growing use of user fees is that on their face they violate the equity principle because they are generally assessed without regard to a user's ability to pay. Unlike broad-based taxes, user fees are set at a flat amount regardless of the income of the user. Therefore, when they are raised explicitly to replace property tax revenues, the result is a regressive shift in the burden of paying for government.

In addition to raising equity concerns, user fees generally violate the principle of being easy and economical to administer because collecting them generally costs more per dollar than levying taxes does. This is yet another reason to develop strict guidelines for determining when to charge user fees for government services.

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Governor's Commission to Modernize State Finances

Benjamin Russo

In 2002, Governor Mike Easley appointed the Commission to Modernize State Finances. He charged it to study whether North Carolina's tax revenue system is fair and sufficient and to examine the volatility and the predictability of state tax revenue in light of developments in the new economy, in particular, growth in the services sector and in the Internet. Chaired by Judge Thomas Ross, executive director of the Z. Smith Reynolds Foundation, the commission consisted of fifteen members. It issued its final report in December 2002.

Principles Underlying the Commission's Recommendations

The commission established six principles to guide its formulation of recommendations:

1. **Equity.** As far as practicable, the tax burden should be a "fair and equitable" share of income and wealth. Taxpayers with similar incomes should face similar tax liabilities, and the proportion of income that taxpayers owe in taxes should increase as their income increases. Beneficiaries of government services should pay fees that approximate the social costs of providing services.
2. **Competitiveness.** The tax system should not reduce a state's ability to compete with other economies and should contribute to sustainable economic development, job creation, and growth.
3. **Sufficiency.** Tax revenue should be adequate to finance essential government services, with a minimum of short-term variation in revenue collections.
4. **Simplicity.** The tax rules should be relatively easy for taxpayers to understand and comply with, and for government officials to administer.
5. **Efficiency.** The tax system should minimize interference in individual consumers' and producers' decisions.

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keep taxes as low as possible. User fees are a way of pursuing this goal.

Fees for certain activities do not fall under the benefit principle. For example, some argue that businesses should pay a user fee when filing certain forms in compliance with regulations. This is inappropriate. Typically the purpose of regulations—for example, zoning laws or regulations related to the environment—is to benefit society, not the party complying with them. If the general citizenry is the beneficiary of the activity, then the general citizenry should bear the cost of it.

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Thoughtful application of user fees does have some advantages. User fees are appropriate when government provides services that also are provided by the private sector, especially if they are not core government services (such as law enforcement), or when the person receiving the services obtains a clear substantial benefit (such as a college education). User fees also can promote conservation of scarce resources such as water and electricity. Further, user fees link government spending for particular programs directly to their funding source, thus enabling government to recoup an established percentage of the cost of providing particular services.

Most tax policy experts agree, however, that user fees are not appropriate as a way to finance core government services, particularly social services and education programs. In these areas, government provides services and benefits on the basis of social objectives such as reducing poverty or providing equal educational opportunities.

One recent and controversial development in employment of user fees by local governments in North Carolina is the "impact" or "development" fee. This is a flat fee assessed when a new home is built. Unlike other types of user fees, it is not directly linked to the amount of government services that the particular owners of the new home will require. Because it is not, and because it is set at a flat amount regardless of economic means, this "fee," in reality, is a flat tax, thus raising strong concerns regarding fairness. Although the state currently allows only a few localities to charge this type of fee, many other local governments are expressing interest. This type of fee will likely become a major tax policy controversy in North Carolina.

6. **Appropriate federalism.** Each level of government should have revenue sources tailored to its level, and fiscal tools to finance its particular responsibilities.[1]

Guided by these principles, the commission offered an overarching recommendation for tax policy and specific recommendations to reduce inequities and inefficiencies in the tax system that have developed as North Carolina's economic structure has evolved. The extraordinary and continuing economic restructuring that has taken place over the past seven decades has benefited North Carolinians enormously. It also has made the tax system obsolete. The system the state has inherited is out of sync with the modern, knowledge-based services economy.

Commission Recommendations

The commission's overall recommendation is for a broader tax base and lower tax rates. The social benefits of these changes are illustrated by the case of special exemptions to the sales tax.

Sales tax exemptions complicate compliance by retailers and administration by tax collectors. A broader tax base would **simplify the tax system** by eliminating special exemptions.

A properly structured broadening of the sales tax base would tend to **improve fairness**, as well. North Carolina's retail sales tax falls most heavily on consumers and producers of tangible goods. Most services are not taxed. The proportion of income spent on services tends to increase with income, so taxing more services would increase the likelihood that the proportion of taxes owed by taxpayers would increase with income.

Question 4.
Taxes often are seen as affecting the economic performance of businesses in North Carolina. Should tax policy address specific economic development objectives?

Cordato: Tax policy should address one specific economic development objective. Tax policy can have a profound effect on economic performance, and, as noted earlier, that effect is always going to be negative. Policy makers need to be very mindful of this fact. It means that they should construct taxes to minimize damage to the state's economy. They should leave as small a footprint on the state's private sector as possible. I discussed how they might do this in my answer to question 2. Generally speaking, though, policy makers should construct tax policy to stay out of the way. In fact, in terms of economic development, this should be a guide for all state policy.

Unfortunately, what has come to be known as economic development policy, and in particular the tax policy component of it, is guided by a false principle that runs contrary to sound economic analysis. This principle starts with the premise that, through incentives and implicit penalties, policy makers should use tax policy to encourage some kinds of investments and discourage others. I describe this approach as "corporate socialism" because it accepts the guiding premise of a socialist economy—namely that the state should have an important role in determining resource allocation. It is "corporate" socialism because it accomplishes this task by granting special favors to selected businesses and corporations, necessarily at the expense of others.

Corporate socialism has the same problems as other forms of socialism. First, it is destructive of individual liberty because it uses government power to influence

Mejia: Manipulation of tax policy specifically to encourage business development and relocation generally violates the principles of good tax policy discussed earlier. Despite this fact and overwhelming evidence that tax incentives are ineffective overall in generating new economic activity, the last twenty-five years have witnessed a steady increase in interstate competition to attract new business. Almost since the beginning of American government, lawmakers have seen a tremendous political premium in creating jobs. Often, however, in creating jobs by manipulating the tax code, lawmakers have succeeded only in violating most key tax principles, distorting the private marketplace by subsidizing certain industries and creating unfair advantages, and wasting valuable public resources.

Certainly, some level of fair competition between states is beneficial because it encourages efficiency and innovation as states try to maintain and enhance the quality of public services and keep costs in check. However, the attempts to stimulate investment and create jobs often are narrowly targeted, thus violating the principles of horizontal and vertical equity, accountability, simplicity, and unnecessary decreases in the tax base.

North Carolina has numerous examples of such well-meaning yet misguided efforts. A prime one is the cigarette export credit, which gives cigarette manufacturers a special credit against their tax bill for exporting cigarettes manufactured in North Carolina. The state does not give tax credits to any other type of industry for exporting its product. The credit diverts millions of dollars from

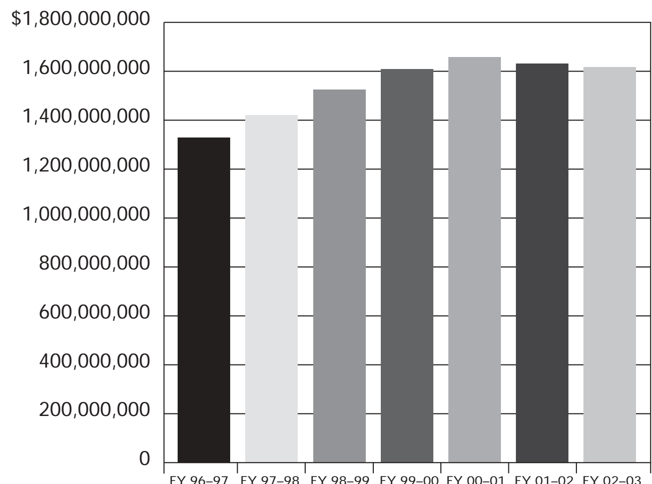
Including more services in the sales tax base also would **increase stability** in tax revenue collections during economic downturns, because spending on services is relatively less responsive to cyclical declines in income than spending on tangible goods. Long-run sufficiency of tax revenue would be improved because spending on services grows as a proportion of total spending.

Taxing more services would tend to **improve economic efficiency**. Taxes are inefficient because they interfere with consumption and production decisions. Taxing a good, such as a new refrigerator, but not a service, such as refrigerator repair, causes substitution of services for goods, reducing economic value. Taxing more services would reduce the inefficiency. It also would reduce the sales tax–induced competitive disadvantage currently suffered by manufacturers.

A broader tax base generates a given level of revenue at a lower tax rate. Tax economists have shown that inefficiency diminishes faster than tax rates. Therefore a broader tax base would **produce an efficiency "bonus."**

(For a graphic illustration of changes in sales tax revenue of local governments in recent years, see Figure 1.)

Figure 1. **Local Sales Tax Revenue, FY 1997–2003**



Source: Adapted from Rebecca Troutman, Sales Tax Perspectives (slide show) (Raleigh: North Carolina Ass'n of County Commissioners, n.d.).

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what should be freely made decisions based on entrepreneurial insights and the personal preferences of consumers. Second, it reduces economic welfare because it substitutes the decisions of policy makers and bureaucrats for those of private market participants. These government decision makers have neither the incentive nor the intimate market information necessary to allocate resources efficiently. What

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general fund revenues and does nothing to stop the natural shift in the state's economy away from tobacco growing and manufacturing. To compensate for the loss, other businesses and individuals have to pay higher taxes.

Another example, which has cost hundreds of millions of dollars in lost revenue, is the William S. Lee corporate tax incentive initiative, begun in 1996. This program pro-

The commission's primary recommendations are as follows:

1. Sales tax
   a. Eliminate differentials in sales and use tax rates and in caps on sales and use tax liabilities.
   b. Eliminate sales tax exemptions.
   c. Consider expansion of the sales tax base to include more services.
   d. Adopt changes required to comply with the Streamlined Sales and Use Tax Project.[2]
   e. Simplify administration of local sales taxes.
2. Individual income tax
   a. Tie the state income tax more closely to the federal tax code.
   b. Adopt strategies to help low-income taxpayers.
3. Corporate income/franchise taxes
   a. Eliminate or simplify tax credits.
   b. Move to combined reporting by related entities.[3]
   c. Modernize the franchise tax.
   d. Consider establishing a throw-out provision.[4]
   e. Tie the state corporate income tax more closely to the federal definition of corporate income.
   f. Consider returning to equal weights on payroll, property, and sales in apportionment.[5]
4. Other finance issues
   a. Increase fees to cover the costs of selected services provided by the state.
   b. Substantially increase the target on North Carolina's Rainy Day Fund.[6]
   c. Replace the practice of cutting tax rates and creating credits and exemptions when tax revenue expands faster than expenditures, with a policy that returns budget surpluses to citizens via tax rebates.[7]

An unedited electronic version of the commission's final report is available at www.osbm.state.nc.us/files/pdf_files/final_rpt_gov_comm.pdf.

Notes

1. Not all levels of government are equally suited to use particular revenue sources. For example, correct assessment of property values is easier for local officials than for state officials, so property taxes are easier to collect at the local level. *See* State and Local Government Relations in North Carolina: Their Evolution and Current Status (Charles D. Liner ed., Chapel Hill: Institute of Gov't, Univ. of N.C. at Chapel Hill, 1995).

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makes private markets efficient is that businesses, consumers, and entrepreneurs are using and risking their own money. If they fail or exercise bad judgment, they bear the costs and learn from their mistakes. If their judgment is correct, they reap the rewards. This system of profit and loss leads to an efficient learning and decision-making process. State policy makers face none of these incentives.

Furthermore, corporate socialism is inherently a win-lose proposition. Any business that is subsidized through tax favors or direct payments gains at the expense of others whose taxes must pick up the slack. Although business may expand in the area targeted by the tax breaks, it will contract in other areas of the economy. In spite of this effect, such programs are politically popular because the expansion that occurs is highly visible and easy for politicians to take credit for, while the contractions are not easily identifiable or directly attributable to the policy. Nearly all studies of such programs show that they do little or nothing to advance economic growth.

Examples of corporate socialist programs in North Carolina are the Golden LEAF, a program for channeling tobacco settlement money to particular businesses; the William S. Lee Act and the North Carolina Stimulus and Job Creation Act, both of which are programs that give tax breaks to attract new businesses to the state; and the recently passed Job Growth and Infrastructure Act, which gives a host of tax privileges and direct subsidies to specific pharmaceutical and cigarette manufacturers. Policy makers should abolish all such programs and, instead, lower taxes across the board. This will aid all businesses and help North Carolina become a business- and investment-friendly state.

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In creating jobs by manipulating the tax code, lawmakers have succeeded only in violating most key tax principles, distorting the private marketplace by subsidizing certain industries and creating unfair advantages, and wasting valuable public resources.

vides tax credits to certain types of businesses, such as manufacturers, that invest in particular types of preferential activities—for example, hiring more workers or supporting research and development. A study released in 2003 and commissioned by the state's Department of Commerce reveals that 96 percent of state-subsidized business activity would have taken place without the tax credits. Furthermore, this initiative is clearly unfair to small businesses, violating the principle of horizontal equity. Also, the credits are difficult to police, thereby violating the accountability principle.

At a minimum the state should limit its support of specific industries to those that will be profitable in the long run and will not grow, or will grow more slowly, without the tax preference. This type of crystal-ball tax policy will never be an exact science. Therefore some of the state's investment always will be wasted. Generally it is better to maintain competitiveness by trying to provide the best public services while keeping the over-all tax burden within a reasonable proximity of competitors. In the long run, that approach will have the broadest and longest-lasting positive impact on economic development.

2. Complications resulting from the more than 7,000 tax jurisdictions in the United States contributed to a U.S. Supreme Court decision, Quill Corp. v. North Dakota, 504 U.S. 298 (1992), precluding state and local governments from requiring out-of-state vendors to collect use taxes, without the consent of Congress. If Internet sales continue to grow rapidly, they could threaten sales and use tax bases. In the late 1990s, state and local government officials began work on the Streamlined Sales Tax Project (SSTP) to simplify sales and use taxes sufficiently to gain congressional consent. For a copy of the SSTP Agreement, *see* www.geocities.com/streamlined2000/. For a summary of state legislative action on SSTP, *see* www.ncsl.org/programs/fiscal/stateactionchart2.htm.

3. Currently, out-of-state subsidiaries of North Carolina corporations are treated as separate entities for tax purposes; that is, income earned by separate entities is not included in taxable North Carolina income. Combined reporting would make subsidiary income taxable in North Carolina and reduce the ability of North Carolina companies to avoid taxes by transferring income from intangible capital, such as trademarks and patents, to low tax jurisdictions. For discussions of combined reporting, *see* FINANCING STATE GOVERNMENT IN THE 1990S (Ronald Snell ed., Washington, D.C.: National Conference of State Legislatures and National Governors' Ass'n, 1993); Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections of a Tax Lawyer*, *in* THE FUTURE OF STATE TAXATION (David Brunori ed., Washington, D.C.: Urban Inst., 1998); and MICHAEL MAZEROV, CLOSING THREE COMMON CORPORATE TAX LOOPHOLES COULD RAISE ADDITIONAL REVENUE FOR MANY STATES (Washington, D.C.: Center on Budget and Policy Priorities, May 2003), available at www.cbpp.org/4-9-02sfp.htm.

4. FINANCING STATE GOVERNMENT describes throw-out rules and their costs and benefits.

5. On the use of apportionment formulas in state taxation of business income, *see* RONALD C. FISHER, STATE AND LOCAL PUBLIC FINANCE ch. 17 (Chicago: Richard Irwin Publ'g, 1996; reprint, New York: McGraw-Hill, 2000); NEIL BRUCE, PUBLIC FINANCE AND THE AMERICAN ECONOMY ch. 19 (Reading, Mass.: Addison Wesley Longman, 2001); and the entry for "apportionment" in JOSEPH CORDES ET AL., ENCYCLOPEDIA OF TAXATION AND TAX POLICY (Washington, D.C.: Urban Inst., 1999).

6. In 1991 the General Assembly established a Rainy Day Fund in North Carolina as insurance against revenue shortfalls. Currently the fund's target each year is 5 percent of the previous year's expenditures. For a detailed discussion, *see* BENJAMIN RUSSO, REPORT ON NORTH CAROLINA'S STATE REVENUE SHORTFALLS AND BUDGET STABILIZATION FUND (manuscript prepared for the Governor's Commission to Modernize State Finances, Univ. of N.C. at Charlotte, June 2002).

7. Cutting tax rates during economic expansions can create structural deficiencies in the tax system that become apparent during economic contractions, because revenue falls with the level of economic activity.

Question 5.
Should there be a requirement to have a supermajority, or other types of limits, for setting taxes?

Cordato: As I discussed in my answer to question 1, because of its coercive nature, taxation inherently violates North Carolinians' constitutionally guaranteed and creator-endowed right to use the fruits of their labor as they see fit. Given this, tax increases should be viewed very differently than tax cuts. Tax increases erode rights; tax cuts restore them. From a legislative perspective, then, legislators always should consider tax increases more carefully than they consider tax cuts, and tax increases should be more difficult to pass. Furthermore, tax increases should be a last resort. Legislators should not pass tax increases as long as the budget includes items that are not constitutionally guaranteed or federally mandated. For example, the state allocates more than $300 million a year to corporate socialism programs of the nature discussed earlier. The allocations include subsidies to the film industry, tourism, biotechnology, fisheries, and tobacco processing, among many others. None of these involve constitutionally guaranteed rights, so legislators should eliminate all of them before considering any tax increase.

> Taxation inherently violates North Carolinians' constitutionally guaranteed and creator-endowed right to use the fruits of their labor as they see fit. Given this, tax increases should be viewed very differently than tax cuts. Tax increases erode rights; tax cuts restore them.

Because of this, a constitutional amendment requiring some kind of supermajority to increase taxes, possibly two-thirds of each legislative chamber, makes sense. Such an amendment should be coupled with a constitutional check on spending increases. Governor Mike Easley took a timid step in this direction in his budget proposal in 2003 by asking for a budget limitation that would hold spending to a ten-year rolling average of increases in per capita income (so that, as incomes rise, state spending rises proportionately).

Although this proposal should be applauded, it still allows for significant increases in the size and scope of state government. A better approach is to limit the growth in spending to the population-adjusted inflation rate. This proposal, referred to as the Tax Payer Protection Act, was introduced several times in the North Carolina General Assembly during the 1990s. It would effectively freeze the budget, forcing the legislature to prioritize spending.

States such as Colorado that have had this kind of constitutional restraint in place have avoided the severe budget problems experienced by North Carolina. If North Carolina had had such a constitutional amendment beginning in the mid-1990s, state spending would have been $1.5 billion lower in 2001–02. That amount would have been more than enough to offset the budget shortfalls that the state government has experienced.

Mejia: North Carolina does not need any new restrictions on taxes or spending, for such limits can be extremely detrimental to the maintenance of public investment in popular and critical programs such as education, health care, roads, and law enforcement. Tax policy is set under constraints already in place, which require a majority of both houses of the General Assembly and, more recently, the consent of the governor. Both houses also operate under rules that limit expedited consideration of legislation affecting tax policy.

In the last few years, during the much-talked-about fiscal crisis in North Carolina, lawmakers have continuously struck a balance between spending cuts and new revenues, only sometimes looking to tax increases. The sole state taxes to be raised during the current crisis were enacted in 2001, bringing in about $500 million annually in new general fund revenues. That represents just 3 percent of current general fund revenues, compared with annual revenue shortfalls of approximately $2 billion, or around 13 percent of total general fund spending. Clearly, North Carolina lawmakers, even without new restrictions, are fiscally conservative, preferring tax increases only when absolutely necessary.

States with tax and spending limits are in no way immune to fiscal crises. California, Colorado, and Oregon, three states with expenditure limits, are experiencing sizable annual shortfalls. Often when they face growing demand for public services, these states turn to user fees and other tricks such as debt financing and spending "off budget" to avoid deep cuts in state programs and to keep pace with public demand. If locally elected officials make government taxing and spending decisions with sufficient public input and transparency, there is no need for these types of limits. Fortunately the public distrust of lawmakers that is so evident in other states is not the norm in North Carolina.

"Welcome aboard. You are now exempt from federal, state, and local taxes."

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Question 6: Is North Carolina a "high-tax state"?

Cordato: In comparison with the states with which North Carolina most directly competes for business and job opportunities, yes. North Carolina has tax rates and a tax burden that are well above average. Among southeastern states, North Carolina has by far the highest top marginal income-tax rate (the rate applied to the top income earners), 8.25 percent; the highest corporate tax rate, 6.9 percent; and the second-highest sales tax rate, 4.5 percent. Tennessee is the only southeastern state with higher sales taxes, but it has no income tax. North Carolina's sales tax rate is higher than that of Florida, which also has no income tax.

In terms of economic impact, corporate and personal income taxes are the most damaging. The high rates of these taxes have the strongest impact on investment, entrepreneurship, and business expansion. Most small business owners are not incorporated and therefore have their business income taxed at the extraordinarily high 8.25 percent personal tax rate. In addition, any significant capital gains, such as those resulting from the sale of a business or a family farm, are taxed at this rate.

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Also, North Carolina's tax burden as a percentage of its citizens' personal income now

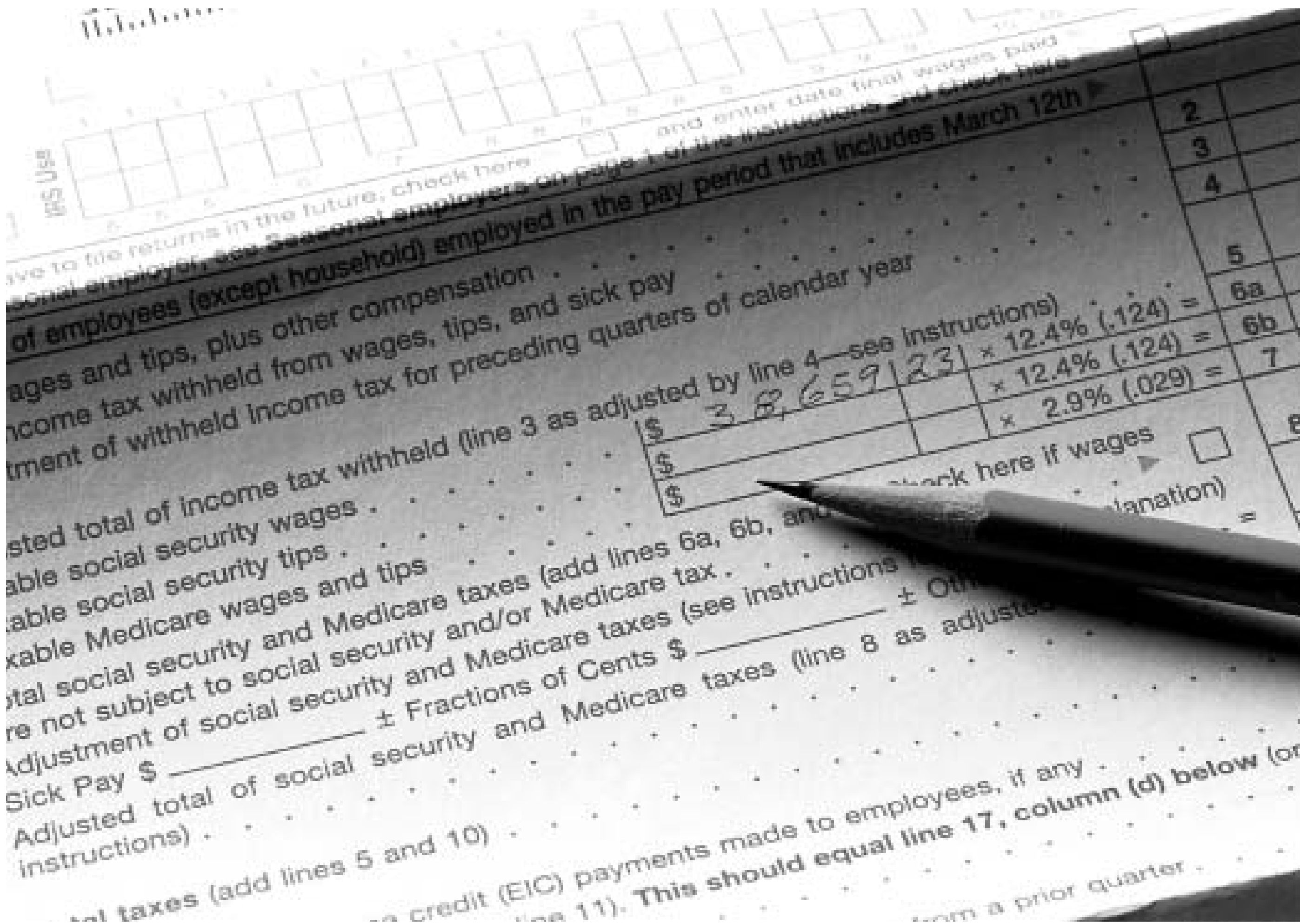
Mejia: People typically answer this question by comparing North Carolina's total state and local taxes with those of other states, either on a per capita basis or in relation to the size of the state's economy as measured by gross state product or total personal income. However, given the tax policy principle of appropriate level of resources, answering this question simply by comparing North Carolina with other states hardly seems fair. There is no widespread dissatisfaction with the level of government services provided in this state. Indeed, the demand for government services continues to grow. The level of government services approximates the will of the majority of the citizens, regardless of how the level compares with that of states whose citizens may have different needs and desires for government programs. By this standard, North Carolina is not a high-tax state.

North Carolina ranked thirty-seventh nationally in combined state and local taxes as a percentage of personal income and thirty-first in total taxes per capita in 2000.

Even responding to this question by comparing North Carolinians' tax burden with that of other states, however, the answer to the question is no. In fact, North Carolina's total state and local taxes continue to rank in the bottom half of states. The latest unbiased government statistics to give total combined state and local taxes are from fiscal year 1999–2000. These data make clear that, overall, North Carolina is not a high-tax state when compared with its neighbors or the rest of the nation. The new data show that North Carolina ranked thirty-seventh nationally in combined state and local taxes as a percentage of personal income and thirty-first in total taxes per capita in 2000.[4]

True, some categories of taxes are higher in North Carolina than the national average. For example, the personal income tax is approximately the tenth highest overall. However, this tax is offset by the state's comparatively low reliance on property taxes. Moreover, as noted previously, North Carolina's reliance on income taxes is consistent with sound tax policy principles.

Any discussion about high- versus low-tax states must account for the fairness of current tax policy and any proposed changes. Although, as a general proposition, North Carolina is not a high-tax state, taxes on low-income taxpayers, who pay the greatest share of their income in state and local taxes, are clearly too high. Currently there is no requirement that lawmakers discuss the relative burden of proposed tax policy changes before they are made. The focus that some groups give to marginal rates ignores this great injustice in the current tax code—that the bottom 20 percent of North Carolina's taxpayers, with an average income of only $9,100, pay 43 percent more in state and local taxes as a share of income than the top 1 percent of taxpayers, with an average income of $814,000, after



Cordato continued

stands at 9.5 percent. This is well above the average for the region, which is about 8.9 percent. North Carolina's burden is second only to that of Georgia, which has the highest tax burden in the Southeast at 9.9 percent. This is not new. North Carolina's tax burden has been well above the regional average for the last decade. However, the gap has widened considerably with the tax increases of the last few years. North Carolina is the only state in the country to have implemented tax increases in each of the last three years.

Clearly, though, how high taxes are is a function of how large state government is, and this relationship is at the root of the state's tax and budget problems. Inflation-adjusted general fund spending has increased by more than $200 per person since the 1995–97 budget cycle. Although many blame the state's budget deficits on tax cuts in the mid-1990s, these cuts were not enough to compensate for the tax increases of the early 1990s. During the 1990s, net taxes increased, but even the increases could not compensate for the spending binge that the state engaged in between 1995 and 2000.[1]

Note

1. All the statistics in this paragraph were calculated by the John Locke Foundation using data from North Carolina state budget documents, the U.S. Census Bureau, and the Consumer Price Index.

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accounting for federal deductions.[5] Despite this fact, talk of tax cuts continues to focus on "high" personal and corporate tax rates. The evidence is overwhelming that the highest overall rates actually are paid by those with the least ability to afford such a burden.

Notes

1. David Brunori, State Tax Policy: A Political Perspective 15–27 (Washington, D.C.: Urban Inst., 2001).
2. Institute on Taxation & Economic Policy, Who Pays? A Distributional Analysis of the Tax Systems in All 50 States (2d ed., Washington, D.C.: the Institute, Jan. 2003), available at www.ctj.org/itep/whopays.htm.
3. The data are from U.S. Census Bureau, Government Finance Series, available at www.census.gov/govs/www/estimate.html, and U.S. Department of Commerce, Bureau of Economic Analysis, available at www.bea.gov. In fiscal year 1999–2000, North Carolina ranked twenty-first in Charges (for example, higher education tuition and public hospital fees) and Miscellaneous revenue (for example, interest earnings) as a percentage of total personal income, twenty-fourth in Charges and Miscellaneous revenue per capita.
4. *New Data Show North Carolina not a "High Tax" State*, BTC Reports (published by the N.C. Budget and Tax Center), Jan. 2003, available at www.ncjustice.org/btc/2003reports/03_jan_1Rpt.pdf.
5. Institute on Taxation & Economic Policy, Who Pays?