North Carolina's Most Regressive Taxes

Charles D. Liner

In 1999 North Carolina completed the phasing out of the state retail sales tax on sales of food for home consumption. Those who led the decades-long campaign to exempt food sales from the retail sales tax contended that this so-called food tax was unfair because it was regressive. A tax is regressive if lower-income families pay more, as a percentage of their income, than higher-income families do. Lower-income families tend to spend a higher percentage of their income on food than higher-income families do. Therefore they paid more taxes on food purchases in proportion to their income, and the tax was regressive.

The perception that a regressive tax is unfair is based on one of the two basic principles of tax fairness, the ability-to-pay principle. This principle holds that taxes collected to pay for public services that benefit the entire community (or the entire state or nation) should be levied according to taxpayers' ability to pay those taxes. A regressive tax violates that principle because it imposes the heaviest burden on those least able to pay.

The other principle of tax fairness, which also is relevant to this discussion, is the benefits-received principle. It holds that taxpayers should pay for public services according to the benefits they receive from those services. Thus people consider it fair that a family that uses water lavishly to take long, hot showers or to soak the lawn should pay more than a family that uses water sparingly. Fortunately, governments can place water meters in homes to find out how much water a family is using, and bill accordingly. But they cannot measure use of public services that provide general benefits to the community as a whole, such as public schooling, public safety, and environmental protection. To pay for those kinds of services, we must design general taxes that distribute the cost equitably among the people of the community.

This article examines a type of tax that is far more regressive than the food tax, the retail sales tax, or any other sales tax—the flat tax.[1] "Flat tax," as used here, refers to a number of levies imposed by North Carolina's local governments that, with one exception, are called fees or charges but are in reality taxes because, unlike genuine fees and charges, they are levied without regard to the amount of services received by the taxpayer. That their proceeds often are earmarked for certain services, like solid waste removal, school construction, or public transportation, does not make them genuine fees or charges—it makes them earmarked taxes.

The term "flat" refers to the fact that these taxes are imposed on a "unit" as a flat amount, rather than as a rate on a base like income, spending, or property value that has some relationship to the taxpayers' ability to pay. For example, two flat taxes that played a role in North Carolina's history were a flat tax on the number of acres of land owned (replaced in the 1830s by a more equitable property tax based on value of land and other property) and the poll tax, a flat tax on adult individuals that was used until the 1960s but now is forbidden by the state constitution. Since the 1980s the flat tax has been revived, but in its current form it falls on the household, rather than the individual, or is imposed as a flat amount on such units as existing homes and apartments, newly constructed homes and apartments, businesses, motor vehicles, and telephone bills.

Flat taxes violate both of the commonly held principles of tax fairness. They violate the benefits-received principle because, although usually labeled charges or fees, they are imposed without regard to the amount of public services received. They violate the ability-to-pay principle because the poorest taxpayer pays the same amount as the richest taxpayer.

Although the amounts levied under some flat taxes might seem small, flat taxes may be quite substantial for lower-

The author is an Institute of Government faculty member who specializes in state and local taxation.

income families. Indeed, the total amount of flat taxes levied can exceed the amount those families paid in state sales taxes on food, and can be substantial when compared with property taxes they pay on their homes. Moreover, the potential for these amounts to grow, and for the use of flat taxes to expand, is very great.

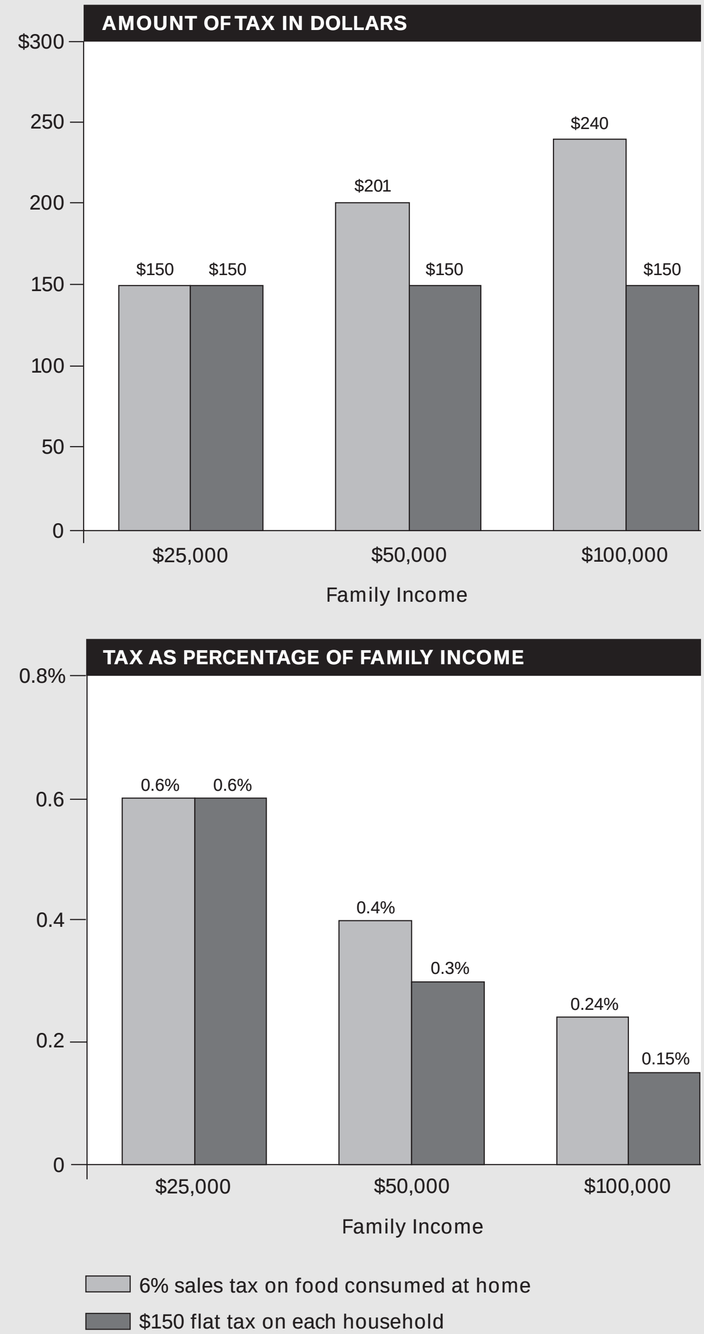
The Regressive Nature of Flat Taxes

Almost any tax that is based on spending on goods and services is regressive because, for almost all types of spending, lower-income families spend a higher percentage of their income than higher-income families do. Thus the state retail sales tax, even with food exempt, is regressive, and the continued taxation of food sales under the 2 percent local retail sales tax is just as regressive as the state tax on food sales was. Similarly, special sales taxes on gasoline, vehicles, cigarettes, alcoholic beverages, and prepared meals are regressive.

Although the relative burden of a sales tax is higher for lower-income families than for higher-income families, the actual amounts of sales taxes paid by higher-income families are substantially greater than those paid by lower-income families. For example, according to spending surveys, a family with an annual income of $25,000 spends about 10 percent of its income, or $2,500, on food for home consumption, whereas a family with an annual income of $50,000 spends about 6.7 percent, or $3,350.[2] Thus the higher-income family spends 34 percent more than the lower-income family does. Although the higher-income family pays more taxes in dollar amount, the tax is nonetheless regressive. If the 6 percent food tax still were in effect, it would represent 0.6 percent of the income of the lower-income family, compared with 0.4 percent of the income of the higher-income family.

Now consider a tax levied on every household as a flat amount, not varying at all with income. Such a tax imposed on the two families in this case would result in a relative burden twice as great for the poorer family. For example, a flat tax of $150 imposed on each family would represent 0.6 percent of the income of the poorer family, compared with 0.3 percent of the income of the higher-income family. (For a comparison of the regressiveness of a 6 percent sales tax on food with that of a flat tax of $150 per household for families with incomes of $25,000, $50,000, and $100,000, see Figure 1. As the figure demonstrates, the flat tax is much more regressive than the sales tax on food.)

Figure 1. Regressive Nature of a Sales Tax on Food Compared with That of a Flat Tax on Each Household



Source: Sales tax estimates are based on Bureau of Labor Statistics, U.S. Department of Labor, Survey of Consumer Expenditures (Washington, D.C.: 1998).

Types of Flat Taxes Used in North Carolina

For most of the state's history, local governments levied a poll tax, also called a head or capitation tax, as a flat amount per adult. Some local governments levied this kind of tax until the mid-1960s. Because the poll tax is very regressive compared with property, income, and other taxes, it generated political strife during the nineteenth century (income taxes were a local tax in the nineteenth century). But its demise came as a result of the civil rights struggles of the 1960s because it had been used in some places to deny voting rights to African-Americans. The North Carolina Constitution was amended in 1969 to provide that "[n]o poll or capitation tax shall be levied by the General Assembly or by any county, city or town, or other taxing unit" (Article V, Section 1).

New Forms

Following are some new forms of flat taxes that have been adopted in North Carolina in recent years.

Availability charges. In the late 1980s, some counties began to levy "availability charges" to finance building and maintenance of landfills, and later to finance green box and recycling programs. The rationale for these charges is that they are compensation for making a service available—the landfill, for example. In the case of the landfill, the charges bear no relationship to residents' actual use of that landfill or the volume of waste they put in it. This tax is levied as a flat amount per household (or apartment) and collected as a separate charge on property tax bills.

Although availability charges were first conceived to finance waste disposal, there is no limit to the type of service that could be financed using this concept. Employing the same rationale, we could conceive of other flat taxes to compensate for the "availability" of police protection, fire protection, public schools, public health services, or any other public service now financed from general revenues.

Although a solid waste availability charge of, say, $50 might seem modest, households often are subject to several such charges—for landfills, green box programs, recycling, and garbage collection—so that the total amount paid may be substantial for a poor family. For example, Chatham County collects two separate charges, an availability fee of $45 per household to cover capital and operating costs of twelve waste disposal centers, and a disposal fee of $55 per household to cover costs of transporting and disposing of waste collected at those centers. Some counties impose recycling charges on each household in addition to solid waste charges. According to fiscal year 1998 data collected by the state for fifty-eight counties, county availability charges for solid waste (including separate recycling charges in some counties) range from $10 to $156 per household per year, and average $62 per household. More than half of those fifty-eight counties charge more than $50 per household, and sixteen of them charge more than $90. These charges apply to all households in the county. Those who live in towns and cities might pay an additional flat charge for household garbage collection. The charges in the 232 towns and cities for which the state has fiscal year 1998 data range from less than $20 to more than $200 per household per year and average $86 per household.[3]

Garbage collection fees. Traditionally, garbage collection in municipalities has been financed from the general fund, meaning that the revenues have come mainly from property taxes and, since 1971, retail sales taxes. In recent years many units have begun to finance garbage collection by levying a flat tax on each household, without regard to the amount of garbage collected.

Motor vehicle taxes. Cities have long been authorized to levy motor vehicle taxes of up to $5 per vehicle. Many did not bother to collect this tax, or did not enforce payment of it, because the amount was so small. In recent years, though, seeing these taxes as a potentially significant revenue source, some units have sought and received authorization from the General Assembly to increase the amount of the tax substantially—to as much as $30 per vehicle. Although the revenue from these taxes might be used for road-related costs, in most cases they are not designated for that purpose, and there is no relationship between the amount paid and the amount of road use. Thus these levies are essentially a tax on ownership of a vehicle. Unlike the case with the property tax on motor vehicles, with these levies there is no relationship between the amount of tax paid and the value of the vehicle on which the tax is imposed: a family with a battered Chevrolet pays the same amount as one with a shiny new Mercedes-Benz.

In 1997 the General Assembly authorized a new motor vehicle tax of $5 to support public transportation facilities. That legislation also limits the total amount of motor vehicle taxes to $30 per vehicle.[4]

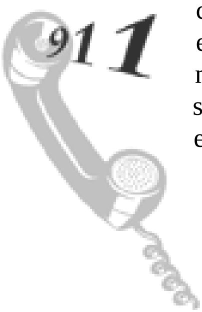
Flat taxes on motor vehicles have been used to finance other public services as well. The Regional Transit Authority in the Research Triangle region is financed in part by a flat tax of $5 on each vehicle in the counties making up that region. A similar tax supports the Global Transport Park near Kinston. One county has sought and received authorization to impose a $10 tax per vehicle to support economic development efforts.

School impact fees. For several years Orange County has levied a one-time flat tax on each home constructed in the county and on each mobile home newly located there. Called a school impact fee because the proceeds are used for school construction, it is levied at the flat amount of $3,000 on each home constructed or each mobile home newly located within the Chapel Hill–Carrboro school district and $750 on each such unit constructed or newly located in the county outside that district. The tax is levied at the same amount whether the

home is a mobile home or a million-dollar mansion. Chatham County recently adopted a similar tax for school construction.

Development impact fees. Some units in North Carolina, and many elsewhere, levy impact fees, often as a flat amount per unit, on new homes (and in some cases businesses) to defray costs of providing public services such as streets, roads, water and sewer lines, and parks in a prescribed area where the fee is imposed. Those who favor such levies might argue that the money supports services that benefit the property being taxed. In all likelihood, though, the services benefit the entire area served by them, rather than accruing to individual properties. Therefore, development impact fees are more like a benefits-related tax. If they do not vary with the value of a property, or perhaps the size of a house, they are flat taxes.

911 charges. In 1989 the General Assembly authorized monthly charges on telephone bills to defray costs of 911 emergency call systems. Although modest—the maximum charge is $1 per month—they are an example of using a flat tax for a service that might be financed from general revenue sources and thus be less regressive in its effects.



Stormwater charges. The General Assembly has authorized local units to impose a "stormwater charge" to pay for stormwater drainage facilities. Some of these charges, which may be collected through water and sewer bills, have been imposed as a flat amount per household, though they do not have to be imposed in that way. They could be levied according to the amount of property frontage or a property's impermeable surface area so that the charge would bear some relationship to the amount of land served by the stormwater facilities. Some units have used that approach instead of using a flat tax. Others have combined the two methods. Use of the term "charge" does not fool people in one community, who call it the "rain tax."

Traditional Forms

In addition to these new flat taxes, some traditional revenue sources have features that are akin to flat taxes. For example, water and sewer fees, which are based mainly on water usage, usually include a minimum monthly flat charge, on the rationale that each property imposes a minimum fixed cost each month for meter reading or bill preparation. Although such a flat charge might be rationalized if it was reasonably related to actual costs, there is no reason that such fixed costs cannot be covered through volume-related rates (as other fixed costs of the system are).

Similarly, there often are substantial charges to hook up a new house to the water and sewer system. If these hookup charges are set to cover the actual cost of hooking up the new house, the charge is a genuine user charge. If, however, the charges are set far higher than the actual cost, they amount in part to a flat tax used to collect general revenue for the water and sewer operation or to defray capital costs.

Another traditional form of flat tax is various state and local privilege license taxes. For example, the state imposes a flat tax on professionals, such as doctors, lawyers, and architects, and the state and local governments may impose such taxes on contractors and auto dealers, among others. Consideration of these taxes, however, gets into issues that are beyond the scope of this article.

Flat Taxes and Tax Fairness

Local governments are attracted to flat taxes because they bring in additional revenues without an increase in property tax rates. However, public revenue sources have to be judged not solely by how much revenue they raise and how politically expedient they are but also by how equitably they distribute the costs of providing public services among the people of the community. Financing services through the property tax means that people pay according to the value of the property they own, and because higher-income taxpayers tend to own more property, they pay more than lower-income taxpayers. Financing services through a flat tax on households means that taxpayers who own modest homes or mobile homes pay the same amount as taxpayers who own mansions. That outcome violates the tax-fairness principle that taxes to support public services benefiting everyone should be imposed according to taxpayers' ability to pay.

The benefits-received principle of tax fairness, again, is that taxpayers should pay in accordance with the benefits they receive from public services. A genuine charge or fee—one that is related directly to benefits received from a public service—is fair, according to that principle. But a flat tax that has no relationship to benefits received by the taxpayer violates both principles. It is not a genuine charge or fee. Nor does it vary with ability to pay. Instead, it is North Carolina's most regressive kind of tax.

Notes

1. The flat taxes discussed in this article should not be confused with proposed single-rate federal income taxes, sometimes called "the flat tax." Under current proposals such a tax would not be regressive.

2. Bureau of Labor Statistics, U.S. Department of Labor, Survey of Consumer Expenditures (Washington, D.C.: 1998).

3. North Carolina Department of Environment and Natural Resources, unpublished data, fiscal year 1998.

4. S.L. 1997-417; N.C. Gen. Stat. § 20-97(c).