

# **DEVELOPMENT-ENHANCING TAX REFORM IN NORTH CAROLINA: A PATH TO GROWTH WITH EQUITY**

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**THE RESEARCH AND WRITING OF THIS BOOKLET WAS  
FINANCED BY THE GENEROSITY OF THE  
Z. SMITH REYNOLDS FOUNDATION.**



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## EXECUTIVE SUMMARY

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The 2005 North Carolina General Assembly is having trouble coming up with a state budget for a number of reasons. There's a big shortfall, more than a billion dollars, which must be made up through some combination of painful tax hikes, user fees, and public service cuts. Moreover, the state appears to be suffering from a condition it shares with many of its peers – a structural deficit. Simply stated, these states have fiscal systems that are incapable of generating the revenues required to finance prospectively the public services they currently provide. Lastly, legislators (and the governor) fear angering the business community and slowing economic development by implementing tax hikes aimed at corporations and affluent households.

This trilemma – an immediate need to (1) balance the state budget, (2) solve any endemic revenue problems for the long haul, and (3) promote economic development – is hard to finesse. Add to the mix a concern with tax fairness (such as equally taxing households and firms with equal incomes or shielding the poor and near-poor from sacrificing too much of their subsistence income to the tax-man) and the complexities and tensions between your respective goals multiply.

We think that comprehensive and structural tax reform is a wiser course of action than letting any single concern, such as tax competitiveness, to trump all other fiscal considerations (e.g., adequacy, neutrality, elasticity, fairness, competitiveness, etc.). To explain: it is a fact that no state can rest on its laurels when it comes to economic development and all politicians are forewarned that their most important priority is typically “jobs, jobs, jobs.” Yet, while states across the country are seeking to do whatever they can to improve their economies, it's not always clear that everything done in the name of “improving the business climate” is worth the public investment or loss of tax revenue. This is especially true when it comes to state tax reform.

We agree that taxes are a big problem in North Carolina, and that major reform is needed in order to improve our business climate. The greatest obstacle to a more positive environment for business growth and profitability in North Carolina is not overly burdensome taxes on businesses and households; it is our outmoded tax system. The state is caught in a structural revenue squeeze – a chronic condition that can only be resolved through the sorts of comprehensive reform called for by the Modernizing State Finances Commission in 2002.

### HOW DOES THE NORTH CAROLINA TAX CLIMATE LOOK?

A modern tax and fiscal system embodies a variety of appropriate (and often conflicting) goals - fiscal stability, balance, fairness, and revenue potential. No structure will perfectly realize all these objectives. Instead, policymakers must draw upon their understanding of their state's problems, opportunities, and political culture to "balance" these competing goals and create a tax system that is administratively efficient and simple to understand. Such a system decreases

the cost of compliance and enhances public trust. State governments do face difficulties from interstate tax competition, raising politicians', businesses', and citizens' concerns about having a poor business climate. These are best dealt with by making sure there is a fairly balanced, broad-based revenue base that can be used to provide high quality infrastructure, skilled workforce, and attractive communities.

Although there is no one right way to measure state tax and fiscal environments. We have chosen to focus on and assess North Carolina on three identifiable and widely recognized characteristics.

1. Balance and Stability
2. Fairness
3. Competitiveness

In general, and as compared with other states, North Carolina boasts a fairly well-structured revenue system. It is not a high tax state. Its revenue base is fairly balanced. It boasts a rainy day fund. It is not plagued by operating carry-backs. Its spending limits allow some needed flexibility when dealing with tough times. "Ability-to-pay" figures more prominently in the state's income tax than in most of its peers'. The temporary addition of further top income tax rates during the first Easley administration was and is a good thing (and should be made permanent).

But readers should remember that the personal income tax, our most "progressive" revenue source, is only one tax. Analysis by the Institute on Taxation and Economic Policy finds North Carolina's overall tax incidence regressive (see Tables below). The lowest 20 percent of income earners paid 10.7 percent of their incomes in state and local taxes in 2002, while the top 1 percent paid 8.9 percent, the next 4 percent paid 9.1 percent, and the next 15 percent paid 9.7 percent. After the federal offset for deducting state income taxes, the distribution of tax burden is even more regressive. An examination of the trends in tax incidence from 1989 to 2002 shows that the bottom 20 percent of households (those whose average income is \$14,500) pay *more* taxes as a share of income while all other income groups' shares have declined! (Most states follow this same trend; only Delaware and Vermont have slightly progressive tax incidence.)

When considering these findings and the areas where the state needs to improve and modernize its revenue system, it should be pointed out that, although these reforms would generally make the NC tax code more productive, the suggested changes can be supported whether one believes that more or better public services and income supports are needed or not.

## **WHAT IS TO BE DONE?**

These points do not mean to imply that state taxes *and* fiscal policies do not affect the economic climate for business in a state. Stable and attractive conditions for business development and profitability depend to a significant extent on adequate but not excessive, efficiently

administered, and equitable tax policies just as a sound business climate depends on the quality of public services.

This is also why development-enhancing tax reform is inseparable from the “reinvent government” agenda. We must always try to get more bang for the fiscal buck by investing scarce tax resources in the highest priority and highest yielding public investments and making government service delivery more efficient, effective, customer-friendly, and accountable. Efforts to create a high-quality revenue system and good government go hand-in-hand.

Here then are twelve steps that policymakers can take to modernize North Carolina’s tax code:

1. Make the state’s personal income tax less burdensome for lower-earning families who are trying to make ends meet.
2. Maintain the top rates in the personal income tax.
3. Broaden the sales tax base to cover more of the service economy.
4. Align tax base definitions with the federal tax code and with other states’ tax codes, to the greatest extent possible. (A notable exception is the estate tax; allow North Carolina’s to remain decoupled).
5. Increase the uniformity of tax rates for similar goods and services.
6. Conform to the remaining provisions required to participate in the Streamlines Sales Tax Project so that taxes on remote sales (sales from internet, by phone, or by catalog) may be voluntarily collected.
7. Repeal corporate tax credits and deductions that don’t really improve the economic climate in the state, especially in the most distressed areas.
8. Eliminate credits that only benefit specific companies or specific industries.
9. Capture more modern forms of business in the tax base, such as limited liability companies.
10. Make sure that multi-state corporations pay their fair share via combined reporting and other mechanisms.
11. Review tax expenditures with the rest of the budget for greater accountability.
12. Sustain an adequate rainy day fund.

## INTRODUCTION

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The 2005 North Carolina General Assembly is having trouble coming up with a state budget for a number of reasons. There's a shortfall of more than a billion dollars, which must be made up through some combination of painful tax hikes, user fees, and public service cuts. Moreover, the state appears to be suffering from a condition it shares with many of its peers – a structural deficit. Simply stated, these states have fiscal systems that are incapable of generating the revenues required to finance prospectively the public services they currently provide. Lastly, legislators (and the governor) fear angering the business community and slowing economic development by implementing tax hikes aimed at corporations and affluent households.

This trilemma – an immediate need to (1) balance the state budget, (2) solve any endemic revenue problems for the long haul, and (3) promote economic development – is hard to finesse. Add to the mix a concern with tax fairness (such as equally taxing households and firms with equal incomes or shielding the poor and near-poor from sacrificing too much of their subsistence income to the tax-man) and the complexities and tensions between your respective goals multiply.

We think that comprehensive and structural tax reform is a wiser course of action than letting any single concern, such as tax competitiveness, to trump all other fiscal considerations (e.g., adequacy, neutrality, elasticity, fairness, competitiveness, etc.). To explain: it is a fact that no state can rest on its laurels when it comes to economic development and all politicians are forewarned that their most important priority is typically “jobs, jobs, jobs.” Yet, while states across the country are seeking to do whatever they can to improve their economies, it's not always clear that everything done in the name of “improving the business climate” is worth the public investment or loss of tax revenue. This is especially true when it comes to state tax reform.

**THE GREATEST OBSTACLE TO A MORE POSITIVE ENVIRONMENT FOR BUSINESS GROWTH AND PROFITABILITY IN NORTH CAROLINA IS OUR OUTMODED TAX SYSTEM.**

We agree that taxes are a big problem in North Carolina, and that major reform is needed in order to improve our business climate. The greatest obstacle to a more positive environment for business growth and profitability in North Carolina is not overly burdensome taxes on businesses and households; it is our outmoded tax system. The state is caught in a structural revenue squeeze – a chronic condition that can only be resolved through the sorts of comprehensive reform called for by the Modernizing State Finances Commission in 2002.<sup>1</sup> Instead, some in this legislature are working to lower the corporate tax rate and get rid of the highest brackets in the state's personal income tax code.

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<sup>1</sup> Governor's Commission to Modernize State Finances, (2002). Final Report. State of North Carolina, December, 2002.

This report is organized as follows.<sup>2</sup> We start by clarifying the concept of business climate and arguing for a broader conception – “an economic climate for everyone.” We take a critical look at existing tax climate report cards and outline the goals that must shape state tax policies. For many reasons, outmoded state revenue systems make it more difficult to establish good investment conditions and to meet accepted standards of revenue adequacy, efficiency, and equity. So, the paper then presents the trends that are undermining state revenue systems (including NC). It then assesses how North Carolina measures up to these standards, proposes a number of reforms, and answers critics of this entire approach.<sup>3</sup>

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<sup>2</sup> CFED wants to thank the Z. Smith Reynolds Foundation, whose generous support, made this report possible. Lillian “Beadsie” Woo at CFED provided some timely editorial and substantive comments. And a special thanks to Will Lambe, intern extraordinaire, who gave me last minute copy editing and word processing assistance. Cecilia Cuthbert and Fiona Adams provided expert desktop publishing assistance.

<sup>3</sup> The view of tax policy herein is especially grounded in such works as: David Brunori, *State Tax Policies: A Political Perspective*; Robert Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*; David Brunori (editor) *The Future of State Taxation*; National Conference of State Legislatures, National Governors Association, *Financing State Governments in the 1990s*; Robert Tannenwald, “State Business Tax Climate: How Should It Be Measured and How Important Is it?” *New England Economic Review*; National Conference of State Legislatures, *New Realities of State Finance*; Roger Vaughan, *State Taxation and Economic Development*; National Conference on State Legislatures and Lincoln Land Institute, *Principles of a High Quality Revenue System*; and Karl Seidman, *The Role of Taxation in State Economic Climate*.

## WHAT IS A GOOD BUSINESS CLIMATE?

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Business climate is the combination of factors that determines whether or not a state or locality is an attractive place to do business.<sup>4</sup> Every company has a different set of requirements and expectations, dictated by size, product, markets and so on, but there are usually three main components of business climate. The most obvious component comprises the major cost factors – particularly labor, plant, and land – when opening, expanding, or operating a facility. The second component includes those non-cost factors that affect investment and location decisions such as quality of life and amenities. The third component refers to the extent to which an area and its elected and appointed officials are perceived to be “pro-business.”

Government, moreover, has a major impact on business climate, for public services, taxation, and regulations create the context within which companies must operate. The extent to which this political and policy environment is seen to support or burden business in comparison with other jurisdictions determines how the business climate is judged.

This governmental role in business climate has been attracting much attention in recent years. The term “business climate” has become almost synonymous with the pressure to cut taxes and remove impediments, particularly employment and environmental regulations. Growing numbers of studies have focused on the comparative tax burdens on businesses with the express intent of forcing legislators to provide tax breaks, reduce rates, or redistribute the load. Clearly, the arguments being made on behalf of business are more than economic: they are part of a growing anti-government sentiment that almost always prefers tax reductions over spending increases and believes the only appropriate government role is to get out of the way. This makes constructive debate about business climate more challenging, and even more necessary.

Yet, the conventional issue of business climate is not as cut and dried as many assume.

- What kind of economy is created by following the traditional business climate formula of cutting taxes and regulations?
- Is our niche competing with low-wage, lower-cost foreign competitors? What is important in today’s new economy? Do manufacturers require different types of

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<sup>4</sup> For background and bibliographies, see William Schweke, Brian Dabson, and Carl Rist, (1996). *Improving Your Business Climate: A Guide to Smarter Public Investments in Economic Development*. Washington, DC: Corporation for Enterprise Development. An interesting historical view can be gleaned from Greg LeRoy’s new book, *The Great American Job Scam: Corporate Tax Dodging and the Myth of Job Creation*. Its chapter on the site location firm, Fantus, takes the reader on a tour of the facts and mythology that comprises traditional concepts of business climate, as well as the origins of state and local business incentive competition. LeRoy’s work also presents a good treatment of site location decisions 101. For more on this important topic, see: J.W. Harrington and Barney Warf, *Industrial Location: Principles, Practice and Policy*. And to get an interesting perspective on the whole business climate issue, consult: *World Development Report 2005: A Better Investment Climate for Everyone*. Its discussions of the foundational importance of good governance and decent public services are especially illuminating in its treatment of “failed states.”

physical infrastructure and workforce skills than in the past and what is government's role in developing these foundations?

- How do policymakers strike a better balance between the equally appropriate goals of creating a tax system that both stimulates economic activity and generates sufficient revenues to pay for quality services?
- Where will America's comparative advantages lie in the future? What combination of private and public investments appears promising in promoting more entrepreneurial initiative and managerial savvy? How do we encourage the kinds of research and development efforts in companies and universities that could build the industrial clusters of tomorrow?
- Can necessary regulations be administered in ways that lower costs, hassles, and uncertainties? How can innovative environmental regulatory policies, administrative practices, and program design foster profitable 21<sup>st</sup> century "green" industries, not just less pollution?

**THESE BUSINESS CLIMATE QUESTIONS ARE POORLY ADDRESSED BY A MYOPIC FOCUS ON HAVING THE CHEAPEST INVESTMENT CLIMATE, NOT THE MOST PROFITABLE AND FORWARD-LOOKING.**

In what circumstances can increased educational and training opportunities for workers with the least skills pass genuine cost/benefit tests and lead to greater business competitiveness? How do the public and private returns compare on spending more monies on early childhood education versus "second chance" education and training for young adults or reemployment services for dislocated workers?

These business climate questions are poorly addressed by traditional "cut-and-deregulate" approaches or a myopic focus on having the cheapest investment climate, not the most profitable and forward-looking.

Instead, a broader concept of a positive economic development climate should guide our tax and economic development policymaking, based on the following ten big themes:

1. The notion of a good business climate puts firms, their sectors, their actual and potential clusters, their decisions, and the workings of the product cycle, ranging from research and development to commercialization, at the center of policy analysis and policymaking.
2. A good environment for business growth provides assets, opportunities, and incentives for firms – from microenterprises to multinationals – to invest productively, create jobs, and expand.

3. Location-specific factors for firm success and failure are shaped significantly by government policies and behaviors.
4. Companies do react to government policies and behavior and the overall predictability of the investment climate.
5. Factors, such as taxation, regulation, public services, infrastructure, workforce skills, educational and training institutions, finance, corruption, and civic conflict are assessed by business as a whole, not in isolation. It's the whole package, not a few glitches or weaknesses, which would typically change a decision for a branch plant to open, a firm to leave, an entrepreneur to forego the plunge, and a household to immigrate or leave for better pastures.
6. Private investment and entrepreneurship are future-oriented and the role of government in providing the conditions and public investments that ensure both stability and innovation are key.
7. Governments have limited influence on certain factors, such as geography, but bigger effects on education, property rights, good governance, tax burdens and complexity, and the physical infrastructure.
8. The focus for public action will be on minimizing costs and risks *and* creating the conditions for competition, innovation, and productivity.
9. It is fundamental to a good business climate that efforts to enhance profitability are balanced with other objectives, such as more equitable place-based growth, broadened asset and business ownership by the disadvantaged, lasting escapes from poverty, increased middle-class job and career advancement opportunities, more environmentally-compatible development, and if desired, enhanced and new public goods.
10. It must be a business climate *where everybody matters and development health is judged not just by profits and patents, but by wages, benefits and the quality of working life.*<sup>5</sup>

## AN IMPROVED NOTION: THE IDEA OF A POSITIVE DEVELOPMENT CLIMATE

Consequently, we at CFED (formerly, the Corporation for Enterprise Development) prefer using the term, development climate, because it is a broader, more inclusive term.

Along these lines, economist Kenneth Boulding sought to translate the concept of economic development into the more concrete idea of economic progress, which he, in turn, defined it as: "The discovery and application of better ways of doing things to satisfy our wants."<sup>6</sup>

Let's unpack this phrase.

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<sup>5</sup> A similar conception of the "ends" of economic development based on Aristotle's idea of "human flourishing" can be found in: Nobel Prize winner Amartya Sen, *Development as Freedom* and Martha Nussbaum, *Women and Human Development*. They call it the "capabilities" approach. Development should be viewed as a means and an end. And its goal is not just fulfilling our needs for certain commodities at a suitable price and quality, or equipping the populace with the skills to compete for market share. Indeed, it's also concerned with "life, liberty, and the pursuit of happiness."

<sup>6</sup> See Kenneth Boulding, (1958). *Principles of Economic Policy*. Englewood Cliffs, NJ: Prentice Hall.

The uses of steam and electric power, the invention of the limited liability company, the application of information technologies in the workplace, the development of the home mortgage – are all “better ways” of meeting our material needs. But Boulding notes that this conventional economist definition does not necessarily mean that the noblest types of progress are occurring. The concept is all about means and not ends. Not all our wants are needs. Some needs, such as the availability of affordable health insurance could be ranked much higher than many other concerns.

The idea of economic progress stated above says nothing about if we are getting more of what we really want and need – happiness and good health, clean air and water, middle-class job opportunities and more parks, broadened asset ownership and less poverty, greater compassion and charity, et cetera. Traditional growth measures like an expanding GDP counts economic ills and benefits – everything from environmental cleanup spending to the sales of a new miracle drug, from increased shipping to building more prisons. Thus, greater efficiency could just mean that we could be traveling faster to a future that we do not want -- global warming (e.g., more growth in energy use) and a spreading AIDS epidemic (e.g., improved transportation, more immigration, expensively patented medication).

In fact, what gets glossed over in traditional definitions of business climates and some approaches to economic development are the following questions:

- Who really benefits from a specific economic development policy or practice?
- What sorts of job opportunities are being generated?
- To what degree does economic development as currently practiced help the disadvantaged to make a lasting escape from poverty?
- Are we becoming more efficient stewards of our natural capital?

It is for these reasons that CFED’s approach to economic progress can be viewed as fostering more widely shared and sustainable increases in the standard of living. You could call it “shared prosperity.”

To sum up:

Positive development climates will differ, according to their goals: promoting entrepreneurship (e.g., new and young firms, new product development and commercialization), the “new economy,” a more equitable standard of living, rural development, “smart growth,” or a cost-sensitive mature commodity producer (e.g., apparel). The latter is a “get poor” policy agenda because it tries to beat low-wage competition in developing nations. In fact, these firms’ most likely reaction to any new tax hike, further regulation, or cheaper imports is to move abroad “lock-stock-and-barrel” or to off-shore many of its functions. They are not to be counted on in a 21st century economic development strategy.

One size (or business/development climate) *does not fit all*.

**ONE SIZE OF  
BUSINESS CLIMATE  
DOES NOT FIT ALL.**

CFED's own *Development Report Card for the States* (DRC) was originally created in 1986 to provide an alternative to the Grant Thornton Manufacturing Climate Index, which was, at its start, almost exclusively a cost minimization index. Grant Thornton presented only data and conclusions and no theoretical model. Moreover, it used state business lobbyists, not academic economists or corporate business location specialists to weight indicators – unionization, low taxes, low wages. Ironically, in our view, the Grant Thornton's "hot-beds" of cutting-edge manufacturing were places such as Mississippi or South Dakota!

We thought that the Grant Thornton index was not only methodologically flawed; it was based on a simplistic, antique, low-cost model of an economy and we wished to develop a counter index that emphasized:

1. Measuring how the economy was doing from a wage-earner, as well as a business perspective;
2. Understanding investment decisions and business growth within the "product life cycle"; and
3. Creating a climate conducive to firms in the fastest growing sectors (e.g., high tech, service sector, entrepreneurship, etc.).<sup>7</sup>

In addition, we wished to create an index that would be an ideal "first-cut" state analysis tool, and develop a regular and comprehensive report card that was assembled from lots of reliable databases.<sup>8</sup> This means the *DRC* is structured to generate more questions than it answers and that it is mainly intended as an economic analysis and policy review tool and only secondarily as a means of helping to make locational decisions for firms and ventures.

CFED also resisted simplistically distilling its results into one number or grade. That's why the *DRC* is structured as three indices:

- Performance index – How well is your state economy performing its job in generating a higher and more broadly shared standard of living?
- Business vitality index – How dynamic is your state's small and large business base?
- Capacity index – Do you have the building blocks – labor force skills, physical infrastructure, technological assets, finance, etc. – for long-term development?

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<sup>7</sup> The DRC is still going strong. You can find the latest edition at [www.cfed.org](http://www.cfed.org).

<sup>8</sup> The original GT critique is entitled, *Taken for Granted: How Grant Thornton's Business Climate index Leads States Astray* (1986). The first DRC, with the most detailed theoretical rationales and material from extensive literature reviews is called, *Making The Grade: The Development Report Card for the States* (1987).

There is a simple economic development model underlying the DRC. Capacity is the foundation for business vitality, which in turn drives performance.<sup>9</sup>

Obviously, one can grasp the importance of capacity for entrepreneurs by just looking at what constitutes this subindex:

- Finance
- Technological assets
- Human resources
- Physical infrastructure
- Quality of life and amenities

In a nutshell, it's all about comparative advantage.

As Regional Technology Strategies' technological and manufacturing policy expert and former Louisiana Deputy Secretary of Commerce Trent Williams puts the matter:<sup>10</sup>

For firms, comparative advantage is a compelling reason to choose your product or service over that of a competitor.

For communities/regions/states, comparative advantage are the assets and incentives that make it a good place to operate: Resource capacities that help companies succeed – skilled people, access to advanced technology, higher crop yields, location, ports, etc. (Such competitive assets for states are what the DRC's Capacities Index tries to identify and measure.)

## THE PERIL POSED BY SIMPLISTIC STATE TAX INDICES

Obviously, tax burdens matter. The theory that unreasonably high taxes or the wrong type of tax can slow and harm an economy is a fundamental truth. (But whether it does in a concrete case is a matter of the specific facts, not just the validity of the concept.) Moreover, a state's tax system *is* part of the development climate.

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<sup>9</sup> For those interested, it is possible to provide further underpinning for the DRC model by drawing upon "new growth theory", which emphasizes that economic growth results from the increasing returns associated with new knowledge. A good introduction to the theory and its relevance for state and local economic development can be found in: Joseph Cortright, *New Growth Theory, Technology and Learning: A Practitioner's Guide*, Review of Economic Development Literature and Practice, Number 4 (U.S. Economic Development Administration (2001). An application to the national boom economy of the 1990's can be found in Barry Bluestone and Bennett Harrison, *Growing Prosperity: The Battle for Growth with Equity in the 21st Century* (2000). Two differing, but in some respects, complimentary views of why the overall United States economy performed so well in the "roaring nineties" are: Paul London, *The Competitive Solution: The Bipartisan Secret Behind American Prosperity* (2005); and Jeff Madrick, *Why Economies Grow* (2000). Lastly, for the really avid economic development intellectual, there are two good surveys of growth theory and data: OECD, *Understanding Economic Growth: Macro-level, Industry-level, and Firm-level* (2003); and Elhanan Helpman, *The Mystery of Economic Growth* (2004).

<sup>10</sup> This is based on a PowerPoint slide show by and personal conversation with Trent Williams, December 10, 2004.

The sophisticated reader also knows that there are a variety of tax climate products focused on state level conditions. Do they shine any light on what's a positive tax environment?

Sadly, the answer is: NO.

Iowa Professor Peter Fisher illustrates this point with respect to the major products currently available – The “Small Business Survival Index” (Small Business and Entrepreneurship Council), the “State Small Business Tax Index” (Tax Foundation), the “Metro Area and State Competitiveness Report” (the Beacon Hill Institute), and the “Fiscal Policy Report Card on America’s Governors” (the Cato Institute), and the “Economic Freedom Index” (Pacific Research Institute) – in his new book, *Grading Places*. Dr. Fisher persuasively demolishes these studies by arguing that:<sup>11</sup>

1. They produce widely different rankings of the same states.
2. Any group using these reports can claim his state is succeeding or floundering by picking-and-choosing from their findings, even when the studies claim to measure the same thing.
3. They don't necessarily measure what they purport to measure.
4. They claim to measure tax burdens, but ignore other important related conditions, such as the availability of workforce skills and private venture capital.
5. They count all taxes “nominally” paid by business as part of the overall tax environment; but they fail to measure the actual tax paid (after tax credits, deductions, abatements, et cetera).
6. They are generally useless in presenting the data needed to make corporate location decisions, like labor costs and productivity, weather, amenities, transportation, energy prices, and so forth. Thus, they imply that tax competitiveness is the whole enchilada, not just an ingredient. (Trade publications and indices aimed at corporate location executives and site location consultants do a better job at this and are much broader in scope.)
7. They double- and triple-count tax burdens, but never consider any benefits of decent public services or quality higher education institutions.
8. They fail to consider or assess programs that promote new, young, and small business (such as subsidized managerial advisory services, loan insurance or guarantee programs, or seed capital) but that require tax revenues.
9. None are reliably predictive of state economic growth.

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<sup>11</sup> Peter Fisher, (2005). *Grading Places: What Do the Business Climate Rankings Really Tell Us?* Washington, DC: Economic Policy Institute.

10. All are designed for one purpose only: promoting the ideological case for smaller government, cuts in taxes for business and high income households, spending reductions, and less regulation.

So, what would be a positive tax climate for economic development?

## GOALS FOR A SENSIBLE, HIGH-QUALITY STATE REVENUE SYSTEM

A well-structured tax and fiscal system is essential for a variety of public purposes. The field of public finance has distilled the following concepts as those most important to consider in designing and assessing a tax and fiscal system.<sup>12</sup>

- **Investment.** Public investment is essential to a healthy private economy. Without adequate investment in education, infrastructure, and public services, states and locales will not be able to compete in a constantly evolving economy. The price of public investment is taxation. There's no such thing as free lunch.<sup>13</sup>
- **Predictability.** Businesses make investments based on a multi-year planning horizon. A stable tax system allows businesses to predict costs, including the cost of taxation, into the future. In order to provide stability, state and local tax systems must provide sufficient revenues to make ongoing investments and provide for a prudent reserve that can protect against unforeseen demands that might otherwise require a tax increase or reduction in service levels. Tax systems must also be "elastic," that is, they must grow over time to account for inflation and increasing demands for services.
- **Tax neutrality.** A neutral tax system is one that treats industries and investments equitably. Tax policies aimed at assisting one industry or firm over another put government in the position of picking "winners" and "losers" — decisions better left to the market. Often states violate neutrality by providing narrowly-targeted tax breaks. This penalizes competitors that do not receive equal treatment and results in a high tax burden on other businesses or individuals in order to produce adequate revenues. Economists argue that the best tax systems are those which tax a broad base, and tax all forms of economic activity comparably, but at the lowest rates possible to produce needed revenues. In that way, the impact of tax policies on investment decisions is kept

**A WELL-STRUCTURED  
TAX AND FISCAL  
SYSTEM IS ESSENTIAL  
FOR A VARIETY OF  
PUBLIC PURPOSES.**

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<sup>12</sup> See Richard A. Musgrave and Peggy B. Musgrave, (1976). *Public Finance in Theory and Practice, Second Edition*. New York: McGraw-Hill. Joel Slemrod and Jon Bakija (2000), *Taxing Ourselves: A Citizens Guide to the Great Debate Over Tax Reform (Second Edition)*. Cambridge: MIT Press. Joseph J. Cordes, Robert D. Ebel, and Jane G Gravelle (Eds.), (1999). *The Encyclopedia of Taxation and Tax Policy*. Washington, DC: Urban Institute Press. Roy Cordato and Elaine Mejia, (2004). *Face-off on Tax Policy*. Popular Government, Winter 2004. Available at [ncinfo.iog.unc.edu/pubs/electronicversions/pg/pgwin04/article1.pdf](http://ncinfo.iog.unc.edu/pubs/electronicversions/pg/pgwin04/article1.pdf).

<sup>13</sup> See Stephen Holmes and Cass Sunstein, *Why Liberty Depends on Taxes* and Liam Murphey and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* for provocative, but persuasive discussions of these issues. For a U.S. historical tour of competing tax philosophies, consult: Steven Weisman, *The Great Tax Wars*.

to a minimum. Private investments should be principally made for sound market reasons and not because of the peculiarities of a state's tax system.

- **Balance.** In order to provide stability, states should not overly rely on any particular tax. A state that relies heavily, for example, on the sales tax will be hard hit during a recession when consumer spending declines, thereby lowering revenues at a time when demand for services is high. Taxes respond differently to changes in economic conditions. A broad based tax system helps insure stability and may limit the need to increase tax rates in order to bring in adequate revenue.
- **Fairness.** Taxes must be fair. Tax systems should shield the subsistence income of the poor from taxes, extract a reasonable contribution from those most able to pay, and treat businesses and households with the same income equitably. Furthermore, policymakers and businesses should be concerned about the economic development effects of taxing less affluent households at higher than average rates. Low income families spend a higher percentage of their disposable income on taxes and high marginal rates on the poor may have a negative impact on their communities as well as limit them as a customer base for businesses.
- **Fiscal equalization.** Not all communities within a state can afford an adequate level of public services. State governments can “level the playing field” by assuming a proportion of local costs in key areas like education and anti-poverty programs. Such steps help geographically balance the resources that companies need to do business across a state.
- **Efficiency.** A tax system must be efficient in its administration and simple to understand. Structuring a system in this way decreases compliance costs and enhances public trust. Lack of uniformity between states, for instance, imposes additional compliance costs on all multistate firms. It also means that larger companies, which possess sophisticated tax planning techniques, will be able to shield some profits in a fashion that smaller firms will not be able to do. This kind of unfair competitive advantage is exacerbated by government policy.
- **Tax competitiveness.** State governments may face difficulties from interstate tax competition, raising politicians', businesses', and citizens' concerns about business climate. This is particularly true if their tax burden is out of line with that of neighboring states. States should look at their overall business and individual tax burdens and compare them to those of their peers. And they must identify any anomalies in their tax system that differentially penalizes certain types of economic activity. Typically these anomalies are best dealt with by following the above tax guidelines and by making sure that there is a fairly balanced, broad-based revenue base.

Tax burdens are important, but so are quality services, tax predictability, adequate revenues, and professional, clear, and fair tax administration. The traditional perspective on taxes and business climate over-simplifies the issues involved and encourages policymakers to make unwise and short-sighted reforms.

**TAX BURDENS ARE  
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## **WHAT'S HAPPENED TO STATE REVENUE BASES?**

Taking the wrong road on tax and fiscal policies is becoming more likely. All elected officials are under pressure to cut taxes. Active business lobbies, rising workforce anxieties about job security, the need for additional economic development, and increasing criticisms of the role of government all combine to predispose governors and legislatures to cut taxes.

Other extremely well-documented trends eroding revenues include:

- The American economy's shift from goods to services.
- The erosion of state corporate taxes through clever use of new multi-state income apportionment formulas.
- The tax incentives' "arms race" between the states.
- The growth of interstate sales.
- The aging of the population.
- The erosion of state income taxes.
- State failures to maintain a mix of taxes that can grow with the cost of government.
- States' adoption of tax expenditure limitations and supermajority requirements for raising taxes or closing tax loopholes.
- Federal policies that harm state revenues, such as the Internet Tax Freedom Act, which prohibits states from taxing certain activities.<sup>14</sup>

States are being further hobbled on the spending side as the federal budget deficit leads to numerous expenditure cuts of programs valued and used by states and localities, by increased demands for homeland security spending, exploding health care costs, and other such factors. As an example, forecasts of population growth for North Carolina expect it to overtake New Jersey as the tenth most populace state.<sup>15</sup> Such a change will significantly increase demands on K-12 and other public educational institutions, thereby, requiring more funds even if the state stands pat on decreasing classroom size or slows to a crawl in meeting its court ordered requirements to reduce primary and secondary school finance inequities.

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<sup>14</sup> This list is drawn from: Iris J. Lav, Elizabeth McNichol, and Robert Zahradnik, (2005). *Faulty Foundations: State Structural Budget Problems and How to Fix Them*. Washington, DC: Center on Budget and Policy Priorities. Other renderings can be found in Schweke, *Improving Your Business Climate* and a score of other reports and articles.

<sup>15</sup> See "The Calm Before the Storm" In *State Policy Reports*, 23(9), May 2005.

## HOW DOES THE NORTH CAROLINA TAX CLIMATE LOOK?

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A modern tax and fiscal system embodies a variety of appropriate (and often conflicting) goals - fiscal stability, balance, fairness, and revenue potential. No structure will perfectly realize all these objectives. Instead, policymakers must draw upon their understanding of their state's problems, opportunities, and political culture to "balance" these competing goals and create a tax system that is administratively efficient and simple to understand. Such a system decreases the cost of compliance and enhances public trust. State governments do face difficulties from interstate tax competition, raising politicians', businesses', and citizens' concerns about having a poor business climate. These are best dealt with by making sure there is a fairly balanced, broad-based revenue base that can be used to provide high quality infrastructure, a skilled workforce, and attractive communities.

Although there is no one right way to measure state tax and fiscal environments; we have chosen to focus on and assess North Carolina on three identifiable and widely recognized characteristics.<sup>16</sup>

1. **Balance and Stability.** Major taxes are balanced. No individual tax is unduly burdensome. All taxes, taken together, help insulate revenues from recession and economic shocks to the extent possible. Stability matters too. The tax system -- combined with a fiscal system containing prudent controls against wide swings in tax levels and quality of services -- permits states to provide businesses with the assurances needed to make long-term investments.
2. **Fairness.** Citizens and businesses must be convinced that their taxes are fair with no individual or company benefiting at the expense of others. Likewise, fiscal equalization, defined as state government finance of key service costs and revenue-sharing aid to communities, levels the playing field geographically.

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<sup>16</sup> When we developed the initial version of the DRC, it included a Tax & Fiscal Index. This paper's way of looking at tax and fiscal systems is based on this earlier work. In a number of respects, it is also derived from an index created by John Shannon and Robert Kleine of the Advisory Commission on Intergovernmental Relations. CFED's earlier index structure was divided into three parts: a balance and stability sub-index, a fairness sub-index, and a fiscal equalization sub-index. CFED staff constructed an elaborate point system that allowed you to rank order each state from 1 to 50 on each sub-index and the index as a whole, as well as group each state in an appropriate category with its peers - Plus states (+), Check states, and Minus states (-). Such a translation helps readers, the media, and policymakers see more of the forest, rather than trees, but it requires one to decide on points and weightings of tax and fiscal data measures and programs. This degree of "numerology", which is often resorted to by researchers, tends to be typically a bit "under-determined" by existing academic theory and research. It plagues the tax indices critiqued earlier in the paper. This "gap" between theory and greater rigor inevitably creates an "opportunity" for more philosophic and ideological ideas to motivate index construction. (This is not to claim that this type of index construction is always scientifically bogus. Peter Fisher's book, *Grading Places*, which was discussed earlier, has good advice about how to do it well.) Furthermore, given that some tax and fiscal measures were dropped in this study's assessment of North Carolina and others were added, it would require us to rethink all the weights anew. We chose not to do so, for reasons of time, money, and complexity. We may try to do it again or we may not. (The conservative Tax Foundation is a good example of such an index, since it gives an ultimate ranking of state tax climates for business.) But even without final ranks and grades, the elements of CFED's earlier Tax & Fiscal Index are a good starting place for getting a fix on the status of a state's revenue system. The last year that it was done and included in the regular DRC was in 1998.

3. **Competitiveness.** Legislators and public officials worry that their tax system is the key to their economic fortunes – if their tax system is not competitive with other states, then businesses will choose to invest and create jobs in those states where taxes are lower (and tax incentives for business investment are greater.)<sup>17</sup>

## FISCAL STABILITY & BALANCED REVENUE

The share of total state and local tax revenues accounted for by four separate taxes provides a measure of balance within the tax system.<sup>18</sup> The specific taxes are personal income taxes, general sales taxes, property taxes, and corporate income taxes. Each has an “ideal” range (as defined by a 1988 committee, sponsored by the National Conference of State Legislatures and the Lincoln Land Institute) that contributes to a well-balanced, diversified revenue system.<sup>19</sup>

How does the state of North Carolina fare on this front? *The state’s revenue base is fairly balanced.* It does rely more on its personal income tax than many states. This setup has a number of positive advantages, but also raises some concerns. On the one hand, it follows strong “ability to pay” guidelines. The income tax is also very elastic. It can keep up with generating the revenues needed to provide additional public services during times of rapid growth. But this also means that revenues can really take a dive during a recession. For this reason, the state of North Carolina should consider earmarking a higher proportion of the revenues generated during a boom for later use in the inevitable bust.

Revenue stability depends largely on a state’s rainy day fund, its treatment of the net operating loss carry-back provision, and its sales tax.

**Rainy day funds**, or budget stabilization funds, are created from revenues in good fiscal years for use during recessions and other economically troubled times. The fund should be about five percent of general fund appropriations.<sup>20</sup> *Today’s rainy day fund in North Carolina is in bad shape; it is close to zero.*

**Net operating loss carrybacks** are federal provisions that allow corporations to carry operating losses forward to offset future profits and to carry losses *backward* to offset past profits -- which means that they can obtain *refunds* of past tax liabilities. Carrybacks can make corporate profit tax collections even more volatile and make it difficult to forecast revenues during recessions.

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<sup>17</sup> The very thorough report, *Following the Money*, has a compatible but different categorization, which covers the same ground. It was authored by Amna Cameron of the NC Budget and Tax Center and is a guide to our revenue system.

<sup>18</sup> Some experts appropriately note that, if a state can generate steady revenues by “exporting” much of its tax base, like Nevada does with its tourism sector, can, of course, depart from these parameters. These parameters for balance should be regarded as guidelines, not absolute imperatives. After all, a good tax system is one that “balances” effectively a state’s fiscal goals.

<sup>19</sup> A summary discussion of their findings, “Principles of a High Quality Revenue System,” is reprinted in David Gold’s (editor), *The Unfinished Agenda for State Tax Reform*.

<sup>20</sup> Ronald Snell, (2004). *New Realities in State Finance*. Washington, DC: National Conference of State Legislatures. Also, personal correspondence and government data from Robert Zahradnik from the Center for Budget and Policy Priorities, December 7, 2004. All state tax data is drawn from reputable federal sources, such as the Bureau of Economic Analysis, Census Bureau, and nonpartisan and respected compendiums, such as – *State Fact Finder 2005* (published by Congressional Quarterly). We may post the underlying data charts on the CFED website in the coming months.

Consequently, many states have "decoupled" from this federal provision and only allow carry-forwards.<sup>21</sup> *NC does not allow net operating carrybacks.*

**Throwback and throwout rules** allow income from the purchaser's state to be reassigned to the producer state; they exist in 26 states.<sup>22</sup> The absence of throwback or throwout rules enables multistate corporations to create "nowhere" income (income that is taxed nowhere). *North Carolina needs a throwback provision in its tax code.*

**The sales tax base** needs to include a wider variety of consumer and business services than it did in the 20<sup>th</sup> century because services figure more prominently in today's economy. Unless services become part of the sales tax base, revenues will shrink along with the decline of manufacturing and other goods-producing sectors. It is estimated that the state of North Carolina lost about \$341 million in tax revenues from the failure to tax e-commerce in 2003.<sup>23</sup> Economist John Mikesell, the nation's leading expert on the sales tax, *ranks North Carolina overall as one of the 10 worst.*<sup>24</sup> Using a combination of indicators (e.g., the lowest feasible statutory rate, rate neutrality for all types of business, exclusion of business purchases from tax base, household purchase inclusions, taxation of nonprofit sales, type of sales tax, application of sales taxes to all household purchases of services and intangible personal property on exactly the same standard as applies to goods), Mikesell notes that *only Mississippi and South Carolina score lower than North Carolina among southeastern states regarding sales tax breadth, fairness, fiscal productivity, and overall modernity.*<sup>25</sup> Making sales tax bases more consistent with the modern economy would be a complement to efforts currently underway, such as the Streamlined Sales Project to improve tax compliance.<sup>26</sup>

Another set of policies that can generate fiscal instability are tax and expenditure limits. Despite the common sense appeal of the idea, **state tax and spending limit laws**, are not good ways to manage tax-and-spend decisions with the finesse required. A number of states have enacted strict tax and spending limits. The most notable of these is Colorado's Taxpayers' Bill of Rights law (TABOR).<sup>27</sup> TABOR (and similar proposals) involves placing a formula in the state constitution to limit annual spending increases at all levels of government. Such laws are designed to couple any growth in government spending to the overall economic growth rate.

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<sup>21</sup> Personal correspondence and data from Michael Mazerov from the Center for Budget and Policy Priorities, December 7, 2004.

<sup>22</sup> Ibid.

<sup>23</sup> John L. Mikesell, (2005). *A Quality Index for State Sales Tax Structure—Measuring the States Against an Ideal Standard*. State Tax Notes, January 10, 2005. pp. 129-136.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid and see Page 29 in Amna Cameron, (2004). *Following the Money: A Guide to North Carolina's Tax System and a Blueprint for Reform and Modernization*. Raleigh, NC: North Carolina Justice Center.

<sup>27</sup> A good discussion of TABOR can be found in: Andrew Reschovsky, (2004). *The Taxpayer Bill of Rights: A Solution to Wisconsin's Fiscal Problems or a Prescription for Future Fiscal Crises*. Marquette Law Review, 88(1); Ron Snell (January 2005). "The Nuts and Bolts of TABOR", *State Legislatures* (a publication of National Conference of State Legislatures); and Chris Frates (January 2005). "Fiscal Folly?" *State Legislatures*.

Tax and spending limit policies (such as TABOR) involve a number of negative features. First of all, they give-up on encouraging policymakers to manage state finances with greater subtlety.<sup>28</sup> For example, they restrict policymakers' degree of freedom in pursuing certain revenue raising options.<sup>29</sup> They often lead to radical spending cuts, including in higher and K-12 education. The quality of other services – roads, for example – often suffers. Tax and spending limit policies lock in a limited government philosophy that some state political cultures (e.g., Minnesota) would not accept today, while also imposing these political doctrines on future generations of citizens. North Carolina has a spending limit in effect that has not been too limiting. But TABOR has some supporters in the state and there are real dangers that a more rigid, blunt instrument could be enacted.<sup>30</sup>

Economist Roger Vaughan notes a few other cautions about expenditure and tax limits in his classic work, *State Taxation and Economic Development*.<sup>31</sup> In his opinion:

- Expenditure limitations are more effective and equitable than a tax limitation. The latter does not directly limit spending and can bestow capital gains on property owners.
- To be truly effective and fair, a spending limitation must apply to all levels of government, otherwise its main impact will be to shift functional responsibilities to the non-limited level.
- Expenditure limitations should be linked to the rate of growth of the tax base (business and personal and wealth). Limiting growth to an arbitrary annual percentage is very disruptive in periods of high inflation and growth.
- While limitations *may* encourage efficiency in government, they do so at some cost. The flexibility of the government to cope with economic problems is restricted, and equity is typically reduced.

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<sup>28</sup> The tax and spending limits advocate's case for such controls would be strengthened if the data supported that states were locked into a tax raising and spending growth frenzy and that partisan politics makes it impossible for sound fiscal budgeting to drive the process. Although the latter may be a genuine possibility for the US Congress, state fiscal policymaking is not at such an impasse. However, you cannot ignore that it is easy to balance state budgets. It's just a lot harder on the national level. And a good argument can be made that state fiscal woes today are more a product of aggressive tax cutting during the roaring nineties, their underlying structural gaps, the recession, and deficit-induced federal cutbacks, than the contention that spend, spend, spend is to blame.

<sup>29</sup> Tax expert David Brunori also argues that there are other disadvantages. Because it only requires an up or down vote, there is only a very limited set of choices for the voter and no space for compromise and no structure for negotiations. What if its authors propose a \$1 billion income-tax cut, but the state can only afford a lesser figure? Or what if, given the state's tax system, reductions in consumption taxes or property taxes would be more intelligent and preferable than slashing personal income taxes? In such a situation, there is no recourse and no role for the legislature.

<sup>30</sup> The more appropriate approach to the concerns raised by the tax limitation movement is to improve the overall equity and efficiency of a state's tax system. Indeed, the right strategy is not a "mindless 'more frugal than thou' but a carefully thought-out reform of the ways that taxes are collected and expenditures are determined." (Economist Roger Vaughan)

<sup>31</sup> Roger J. Vaughan, (1979). *State Taxation and Economic Development*. Washington, DC: The Council of State Planning Agencies. Pages 132-139.

## TAX FAIRNESS

In addition to taxpayers with equal incomes being subject to the same taxes, tax fairness includes the notion that “ability to pay” characterizes at least some of the state’s tax code. Another approach to shielding essential income of the poor from the tax system entails designing highly targeted tax breaks. A state Earned Income Tax Credit (EITC), for instance, can help to make up for the regressive nature of most sales and excise taxes. Lastly, transparency tools for monitoring who benefits from tax relief initiatives are also important in achieving greater vertical (e.g., those that make more pay a higher share of their income in taxes) and horizontal equity (e.g., those that make the same pay the same rate).

**Personal income tax progressivity** occurs when upper-income households pay a larger share of their incomes in tax than do those with lower incomes. The Institute on Taxation and Economic Policy has developed a model that assesses the overall progressiveness of state personal income taxes. *North Carolina ranks 13<sup>th</sup> in terms of the overall progressiveness of its personal income tax.*<sup>32</sup> (Research suggests that the current range of progressiveness between the states does not seem to be large enough to have much effect on income growth or job creation.<sup>33</sup>)

**Income tax threshold** is the income level at which state residents begin paying taxes. The lower the threshold, the greater the tax burden on low- and moderate-income households. A higher threshold shields more of their money for use in meeting basic needs of food, shelter, health, and energy, and in increasing the potential for saving. *NC’s threshold ranks in the bottom 25 states, meaning that taxes kick-in for the poor at low incomes. In fact, a recent study found that NC’s tax thresholds are below the poverty line.*<sup>34</sup>

**Property tax circuit breakers** provide property tax relief to lower-income families. Typically, a state gives homeowners a credit equal to the amount by which their property tax exceeds a certain percentage of their income. There is usually a cap limiting the total amount of credit allowed. State-financed property tax relief may be available to all taxpayers or only a subset

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<sup>32</sup> We recognize that this is a controversial position. The conservative Tax Foundation would reverse our position and rank NC as having the 37<sup>th</sup> worst state personal income tax, because of its strong “ability to pay” features. In our defense, we would argue that studies of progressivity on the state level have shown little impact on growth. Why? Frequently, critics of progressive taxation ignore other elements of the tax code, such as excise and sales taxes and tax incentives which will shift the overall tax incidence in favor of more affluent households. Moreover, because of federal deductibility, the after-tax effect of a progressive rate structure is minimized. Many affluent households prefer, all things being equal, somewhat higher taxes, if they appear to deliver good schools and other local amenities and quality of life. However, we are not arguing that state and local progressive income taxes could never become a problem for a government which taxes at much higher marginal rates than today’s jurisdictions. What we, instead, want to get across is: (1) that a good business climate does not require regressive taxation; (2) that current levels of state and local progressivity do not appear to correlate with lower levels of growth; (3) that U.S. state and local tax incidence is not, in fact, progressive and curbing the progressive features of a personal income tax would create an even more regressive state tax code; (4) the incidence effects on poor and struggling working families of making the income tax less progressive or important are certain, while the salutary impacts on growth are speculative; and (5) that a minimal level of progressivity (and therefore, elasticity) is needed to maintain sufficient revenues to accommodate growth.

<sup>33</sup> Andrew Reschovsky, (1998). *The Progressivity of State Tax Systems*. In David Brunori (Ed.), *The Future of State Taxation*. Washington, DC: Urban Institute Press. Pages 160-187. Also see Howard Chernick, (1997). *Tax Progressivity and State Economic Performance*. *Economic Development Quarterly*, 11(3).

<sup>34</sup> Personal correspondence and state government data from Robert Zahradnik from the Center for Budget and Policy Priorities, December 7, 2004.

(e.g.—elderly or disabled homeowners). *North Carolina is one of only 11 states that offer no property tax circuit breaker of any type.*<sup>35</sup>

**NORTH CAROLINA'S STATE REVENUE SYSTEM HAS BECOME SO OUTDATED THAT NATURAL REVENUE GROWTH DOES NOT KEEP PACE WITH A GROWTH IN THE ECONOMY ABSENT REGULAR TAX INCREASES.**

**Refundable child care tax credit** is based on the federal credit. A number of state governments have enacted similar measures for low- and middle-income taxpayers. Some even have made it refundable. *Unfortunately, although the state offers such a tax expenditure, North Carolina's childcare tax credit is not refundable.*<sup>36</sup>

**State refundable Earned Income Tax Credit** is based on the federal EITC, which is a tax policy tool designed to supplement the after-tax earnings of low and moderate income families. A growing number of states have crafted their own version and even made it refundable, which means they can use it, even if they pay no taxes. The EITC and Social Security are probably America's most cost-effective anti-poverty programs. *The state does not have its own EITC in place.*<sup>37</sup>

**Combined corporate reporting** allows states to divide total profits of a multi-state enterprise among those with jurisdiction to tax it. A growing share of business is being conducted by companies that cross state and national boundaries, creating opportunities for some multi-state businesses to avoid paying their fair share of state taxes and causing in-state firms to be disproportionately taxed. This method treats the profits of all the separate legal entities, such as a parent corporation and its subsidiaries, as a single "unitary" business, preventing a multi-state corporation from using various subsidiaries to shift income between states in order to minimize its total state tax bill. *NC does not have combined reporting.*<sup>38</sup>

**Tax expenditure reports** track the cost of revenues foregone. Many states erode their tax base and horizontal equity (treating taxpayers with the same income equally) by providing a variety of tax incentives and breaks to both businesses and households. Tax expenditure reports increase accountability and should be published annually or biannually. *Although North Carolina has a tax expenditure reporting requirement in place, a report has not been published since 1991.*<sup>39</sup>

**Tax incidence analyses and reports** describe who bears what portion of the tax burden. As many states have increased taxes over the past year to counter impending fiscal shortfalls, states have developed mathematical models for determining the fiscal impact of changes to the tax

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<sup>35</sup> Personal correspondence and state government data from Robert Zahradnik from the Center for Budget and Policy Priorities, December 7, 2004.

<sup>36</sup> Ibid and see Elisabeth H. Donahue and Nancy D. Campbell, (2002). *Making Care Less Taxing: Improving State Child and Dependent Care Tax Provisions*. National Women's Law Center. Available at [www.nwlc.org/pdf/makingcarelesstaxing2002.pdf](http://www.nwlc.org/pdf/makingcarelesstaxing2002.pdf).

<sup>37</sup> Ibid.

<sup>38</sup> Personal correspondence and data from Michael Mazerov from the Center for Budget and Policy Priorities, December 7, 2004.

<sup>39</sup> See Lillian G. Woo, Jessica Thomas, and David Bucholz, (2005). *Assets and Opportunity Scorecard: Financial Security Across the States*. Washington, DC: CFED. Also, personal correspondence and data from Michael Mazerov from the Center for Budget and Policy Priorities, December 7, 2004.

code. However, states are much less sophisticated in analyzing who will pay more or less in taxes as a result of the change. Only ten states have developed the capacity to determine how proposed changes in multiple taxes would affect the amount of taxes owed by different income groups at a particular point in time. *NC has a model that assesses the incidence of only its personal income tax; other taxes cannot be simulated and analyzed.*<sup>40</sup>

State policies to promote fiscal capacity among local governments are essential to a sound business climate. Such policies assure that all communities have an equal ability to provide adequate public services to firms and individuals. We measure fiscal equalization by the extent to which state governments finance key service costs and provide revenue-sharing aid to communities.

However, we do not take the point of view that the state should cover a high proportion of local government costs. This could lead to greater waste and lessened fiscal accountability. Education, health costs, and welfare type expenditures, however, are good candidates for intergovernmental partnerships. The gap in financing between low- and high-wealth school districts is a good indicator of the equalization efforts a state makes. The bigger the fiscal chasm is, the larger the problem that a state faces in helping all children to learn and ultimately, succeed in the labor market.

Most North Carolinians are concerned about the gap in financial wherewithal between wealthy and poor districts across the state. The Leandro decision has created an imperative to redress these inequities and insure that all students in K-12 educational institutions have a “fair go at it.” However, the state does better on this score than most states. *In a recent ranking by the Education Trust, North Carolina was found to be 13<sup>th</sup> best (or 37<sup>th</sup> worst) in the United States, regarding the gap between its wealthiest and poorest districts.*<sup>41</sup> (The reader should not draw the conclusion that, just because the chasm is smaller in NC, it’s not a big problem. It only means that the price tag for fixing the problem will be smaller than some states and is no excuse for tardy action.)

## TAX COMPETITIVENESS

During the past twenty-plus years, one issue has come to dominate tax debates in state capitols: tax competitiveness.<sup>42</sup> While it does matter where metropolitan areas cross state boundaries and where central city and suburban differences within a state’s metro region are large, and, in those unusual cases when all other location factors are roughly even and a firm has complete freedom to pick among very, very close competitors – an Austin, Texas versus a Research

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<sup>40</sup> Ibid.

<sup>41</sup> Kevin Carey, (2004). *The Funding Gap 2004: Many States Still Shortchange Low-Income and Minority Students*. Washington, DC: The Education Trust.

<sup>42</sup> See Lynch’s *Rethinking Growth Strategies* for more background and information. This is, in fact, a quite complicated issue. The work of Federal Reserve Bank of Boston by Robert Tannenwald stands out here. Most of the measures we have to assess tax burden differences are, at least, in part misleading. Then there is the problem that nobody pays average taxes. All the complications in definitions of the base and tax preferences mean that comparing a state’s nominal tax rate with another peer is highly problematic. Moreover, what a firm pays also depends a lot on the specifics of its business.

Triangle, North Carolina, for example, the argument is largely overblown. North Carolina's tax competitiveness is viewed in the following ways.

The data shows that North Carolina is not a high tax state. When it comes to household tax competitiveness, the Tarheel state is roughly at the national average – both for state and local per capita taxes and for state and local taxes as a percentage of personal income.

Yet, there is what many in the business community regards as the state's "sore thumb." North Carolina's personal income tax is 13<sup>th</sup> in progressivity – meaning that it takes a larger share of the incomes of wealthy households than those with lower incomes. Progressive taxes rely on taxpayers' ability to pay, which many Americans regard as only fair. Yet, past studies suggest they have little impact on state economic growth rates.<sup>43</sup>

What about business taxes?

According to both Ernst and Young and Federal Reserve Bank of Boston studies of all types of business taxes, North Carolina has the lowest business taxes as a percent of business profits anywhere in the country.<sup>44</sup> Therefore, cutting the state's corporate income tax, as called for by some legislators, would not be a great boon to business and job creation.

Thus, North Carolina is *not a high tax, outlier* state.

## WHAT'S THE OVERALL PICTURE?

Overall and in comparison with other states, North Carolina boasts a fairly well-structured revenue system (see summary below). It is not a high tax state. Its revenue base is fairly balanced. It boasts a rainy day fund, but should sock away more reserves because of the larger role of its personal income tax and its disposition to respond sharply to downturns and upturns in the economy. On the other hand, the state does a poor job of taxing service sector sales. NC is more of a player in the business incentive field than in the past and this presents some dangers in terms of making sure that the state does not give up too much and generate a negative fiscal stream.

Thankfully, NC is not plagued by operating carry-backs, but in our view the state has not done enough to offset its eroding corporate taxes. Fortunately, the state's spending limits allow some needed flexibility when dealing with tough times and "ability-to-pay" figures more prominently in the state's income tax than in most of its peers'. The temporary addition of

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<sup>43</sup> Howard Chernick, (1997). *Tax Progressivity and State Economic Performance*. Economic Development Quarterly, 11(3).

<sup>44</sup> This indicator was developed by Federal Reserve economist Robert Tannenwald in a working paper, entitled, *Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?* Federal Reserve Bank of Boston, No. 04-4 (August 20, 2004). The measures that Tannenwald created cover all possible business taxes from property taxes to unemployment insurance taxes, from corporate net income taxes to business licenses, et cetera. Also see Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, (2005). *Total State and Local Business Taxes: Nationally 1980-2004 and by State 2000-2004*. Washington, DC: The Council on State Taxation. The latter is the latest edition of the Ernst and Young study.

further top income tax rates during the first Easley administration was and is a good thing (and should be made permanent).

But readers should remember that the personal income tax, our most “progressive” revenue source, is only one tax. Analysis by the Institute on Taxation and Economic Policy finds North Carolina’s overall tax incidence regressive.<sup>45</sup> The lowest 20 percent of income earners paid 10.7 percent of their incomes in state and local taxes in 2002, while the top 1 percent paid 8.9 percent, the next 4 percent paid 9.1 percent, and the next 15 percent paid 9.7 percent. After the federal offset for deducting state income taxes, the distribution of tax burden is even more regressive. An examination of the trends in tax incidence from 1989 to 2002 shows that the bottom 20 percent of households (those whose average income is \$14,500) pay *more* taxes as a share of income while all other income groups’ shares have declined! (Most states follow this same trend; only Delaware and Vermont have slightly progressive tax incidence.)

The current regressiveness of North Carolina’s tax code as a whole can be magnified in those cases where its business incentive tax expenditures (such as the William S. Lee Act) subsidized business attraction projects that would have happened without the incentive. In these situations, the stream of fiscal effects is negative and not positive. Because NC cannot run a budget deficit, these tax cuts will, in turn, force service cuts as well as tax hikes on other taxpayers. Indeed, somebody’s got to pay for these shortfalls. (A summary picture of NC’s fiscal positives and negatives can be found in Appendix A.)

## WHAT ABOUT FISCAL ADEQUACY?

North Carolina’s state revenue system has become so outdated that natural revenue growth does not keep pace with a growth in the economy absent regular tax increases. Baseline revenue growth (i.e. revenue growth without rate increases and other enforcement measures) lagged behind growth in total personal income by nine percentage points between 1996 and 2005.<sup>46</sup> Further evidence of the inefficient revenue system is the fact that general fund appropriations as a share of the total state personal income (and per person) has declined since 2000 even though lawmakers have raised tax rates in some instances.<sup>47</sup>

When considering these findings and the areas where the state needs to improve and modernize its revenue system, it should be pointed out that, although these reforms would generally make the NC tax code more productive, the suggested changes can be supported whether one believes that more or better public services and income supports are needed or not.

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<sup>45</sup> Robert S. McIntyre, et al. (2002). *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, 2<sup>nd</sup> Ed. Washington, DC: Institute on Taxation and Economic Policy.

<sup>46</sup> Elaine Mejia and Anna Cameron, (2005). *A 21<sup>st</sup> Century Revenue Plan: Funding State Government in a Fair and Sustainable Way*. Raleigh, NC: North Carolina Justice Center. pp. 2.

<sup>47</sup> Ibid.

## FOR THOSE WHO NEED REASSURANCE

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But can we really have it all? Isn't this too good to be true? Aren't we playing with fire and risking the alienation of prospective investors, entrepreneurs, and existing businesses? Don't our critics have some ammo they can fire at us?

Let's start our exercise in providing calm, confidence, and "back-bone building" by stating a few plain facts about: (1) revenue and public services and investments; (2) the role of taxation in development climate; and (3) the dangers posed by certain approaches to state tax and spending limitations.

The public sector plays an important role in helping to provide good locations and conditions for investment by growing and nurturing those "assets" that help companies succeed – skilled people, access to advanced technology, world class infrastructure, community colleges, quality of life, ports, and so forth. These comparative advantages cannot be created or cultivated without adequate tax revenues and prudent public investment. Thus, taxes do not just generate costs: they create benefits as well.

**THE WEIGHT OF RESEARCH EVIDENCE LENDS SUPPORT TO THE CONCLUSION THAT TAXES ARE NOT A MAJOR INFLUENCE ON STATE ECONOMIC GROWTH.**

Now, how important are taxes in the scheme of things?

The weight of research evidence lends support to the conclusion that taxes are not a major influence on state economic growth.<sup>48</sup> Some have even found a negative effect (job losses) when cutbacks in certain public services are factored in.<sup>49</sup> There are several compelling reasons:

- **State and local taxes account for a small amount of total business costs.** They are typically about only 1.2 percent nationwide. After federal deductibility of state and local business taxes, the costs of doing business would be lowered by less than 1 percent if those taxes were eliminated.<sup>50</sup>

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<sup>48</sup> Robert G. Lynch, (2004). *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*. Washington, DC: Economic Policy Institute. pp. vii, 19-45. The literature on these subjects is vast. Lynch is the most recent and comprehensive survey and critical review. Timothy Bartik's "Incentives Solutions" (Upjohn Institute for Employment Research, Working Paper, 2004); Anderson's and Wassmer's *Bidding for Business*; Federal Reserve Bank of Boston, *New England Economic Review* (March/April 1997, entire issue); and Fisher and Peter's *Industrial Incentives* include illuminating critical reviews of the literature.

<sup>49</sup> Lynch, (2004). pp. 4. For more detail, see T. Hungerford and R. Wassmer, *K-12 Education in the U.S. Economy: Its Impact on Economic Development, Earnings, and Housing Values* (April 2004).

<sup>50</sup> Ibid.

- **On the other hand, labor cost differences have a large impact.**  
 In comparison, labor costs typically account for 20 percent or more of overall business expenses. Indeed, in many jurisdictions, a relatively small wage premium would wipe out very hefty business subsidies. University of Iowa Professors Fisher and Peters found that raising per hour wages between 19 to 83 cents would wipe out the advantages provided by all state and local incentives in 16 industries located in 75 cities in 13 states.<sup>51</sup> Likewise, having skilled workers that increase productivity by 83 cents would do the same – they would erase the advantages of the deep tax-based subsidies provided in enterprise zones in these states.
- **Capital costs are largely unaffected by corporate income taxes.**  
 In a fascinating study of the user cost of capital for four industries in the 48 contiguous states over the 1963-1997 periods, economist Charles Mead discovered that despite “differences in the effective marginal tax rates, the user cost of capital across states are virtually identical for any given year examined.”<sup>52</sup> A further adaptation of Mead’s research by professor Robert Lynch indicated that the virtual elimination of NC’s corporate income tax in 1997 would have boosted employment only by 0.04 percent, lowered capital costs by 0.9 percent, increased the capital stock by 0.23 percent, and output by 0.07 percent. *This would have added about 1,500 jobs over the 10 or more years compared to the 3.7 million jobs already existing in the state in 1997. \$981 million would have been lost in corporate tax receipts for that year, reflecting a hefty price tag per job created.*<sup>53</sup>
- **Business location decisions are made on factors other than taxes.**  
 Business executives consistently point to factors other than taxes as the major items that they consider when making location decisions. These include access to markets, availability of labor and materials, local amenities, infrastructure (e.g., ports, roads, broadband), and synergies with other facilities when choosing a plant site.<sup>54</sup>
- **Cutting state income taxes does not appear to affect out-migration.**  
 A recent study of Ohio found that a personal tax rate hike from 1993-1996 did not increase outward migration, while a state income tax reduction did not spur in-

<sup>51</sup> Alan Peters and Peter Fisher, (2002). *State Enterprise Zone Programs: Have They Worked?* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.

<sup>52</sup> Lynch, (2004). pp. 35-36.

<sup>53</sup> Obviously, there are other costs and benefits to be factored in when figuring out the costs and benefits on more net basis. But the initial math provides an interesting context for understanding the cost implications for firms and some of the fiscal issues raised by tax cuts. Also see Lynch, (2004). pp. 36.

<sup>54</sup> See Ed Anderson, “Workers Key To Lure Business, Executives Rank Work Skills as Most Important,” *New Orleans Times-Picayune* (January 27, 2005). Eric P. Canada, (1995). *Economic Development: Marketing for Results!* Wheaton, IL: Blane, Canada, Ltd., Maury Forman and Audrey Taylor (Eds.), (2002). *Journey to Jobs: Techniques for Successful Recruitment and Retention*. Dubuque, IA: Kendall/Hunt Publishing. Dennis Rondnelli and William Burpit, “Do Government Incentives Attract and Retain International Business?” *Policy Sciences*, Volume 33, No. 2. William Schweke, Brian Dabson, and Carl Rist, (1996). *Improving Your Business Climate: A Guide to Smarter Public Investments in Economic Development.* Washington, DC: Corporation for Enterprise Development. Roger J. Vaughan, (1979). *State Taxation and Economic Development*. Washington, DC: The Council of State Planning Agencies. See footnote 4 for other cites.

migration between 1996 and 2000.<sup>55</sup> Examining the other 49 states, the researchers discovered no real link between interstate migration and state income tax policy.<sup>56</sup> For instance, two of the eight states with no income taxes also had negative migration rates. Area states with flat rate income taxes, such as Illinois, Michigan, and Pennsylvania had poor migration records too. Thus, migration does not appear to be linked to state income tax policy.<sup>57</sup>

- **The supposed one-to-one correlation between high taxes and a bad economy doesn't hold.**

Seven of the top ten states in per capita income, such as Connecticut, New Jersey, and Minnesota, are also in the top ten in per capita taxes.<sup>58</sup> Six of the bottom ten states in per capita income, including nearby South Carolina, are also in the bottom ten in per capita taxes.<sup>59</sup>

- **A more rounded picture of a good overall state economy also nixes the idea that a tax is a tax is a tax and all taxes are bad.**

The well-respected, objective data resource, *State Policy Reports*, created a Healthy Economy Index for the April 2005 issue.<sup>60</sup> It had seven elements: (1) percentage of people in poverty; (2) employment growth; (3) population growth; (4) per capita income growth; (5) per capita federal tax liability; (6) fiscal capacity (how robust a state's tax base is); and (7) average pay in retailing jobs. The most current data was collected and identified these states as the "top ten": Delaware, New Hampshire, Connecticut, Washington, Nevada, Virginia, New Jersey, Minnesota, Hawaii, and California. This is hardly a list dominated by low tax states. The bottom rung is a familiar low-tax grouping: South Carolina (46), Kentucky (47), Mississippi (48), Louisiana (49), and West Virginia (50). The state with the lowest overall tax burdens – Tennessee ranks at 30<sup>th</sup>.

There's one more major tax issue: Does North Carolina's top tax rate harm its competitive position?

Advocates of rolling back the state's 8.25% personal income tax rate argue that the tax is North Carolina's sore thumb, discouraging retirees from settling here, harming the venture capital industry and mobile entrepreneurs, and discouraging business attraction prospects. The July 20, 2005 *Raleigh News and Observer* editorial, "NC's Top Tax Rate Harms Bottom Line," by former banker John Medlin, Jr. ably argues this case. However, we have strong objections based on cold, hard, facts.

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<sup>55</sup> David Rothstein, (2005). *Income Taxes and Labor Migration – A Link that Doesn't Exist*. Policy Matters Ohio. Available at [http://www.policymattersohio.org/pdf/Ohio\\_migration\\_study\\_2005\\_06.pdf](http://www.policymattersohio.org/pdf/Ohio_migration_study_2005_06.pdf).

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

<sup>58</sup> Kendra A. Hovey and Harold A. Hovey, (2005). *Congressional Quarterly's State Fact Finder 2005*. Washington, DC: CQ Press.

<sup>59</sup> Ibid.

<sup>60</sup> Data from "The Correlation Between Taxes and Income," in *State Policy Reports*, Volume 23, Issue 5, 2005.

Setting aside an investor's ethical and religious values and sentimental attachments to a particular place (which undoubtedly affect business choices), basic economics dictates that decisions are made at the margin. Taxes alter incentives. Higher taxes ultimately decrease the incentive for people to improve themselves through working more hours, getting re-trained, inventing new products, and starting new firms. The inefficiency effects of progressive taxation increase as the marginal rates climb. However, less progressive taxation can be unfair, especially with respect to the economically poor and struggling. Point being, there's an inevitable tradeoff between progressive and regressive taxation, and one hopes to find a golden mean somewhere.

Theory is important, but ultimately, it all comes down to specific realities. Regarding the argument that the state's 8.25 percent personal income tax rate is a sore thumb, consider the following facts:

1. Taxpayers in this bracket come from wealthy households and can afford these rates. In 2004, there were only about 70,000 tax returns in the 8.25 percent bracket (2.5 percent of the state's total). The average taxable income of this group was \$500,000.
2. Nominal tax rates are not necessarily real tax rates. Federal and state tax deductions and credits, the taxpayer's specific tax base, and the treatment of capital gains have important implications for a taxpayer's real tax rate and must be considered before making sweeping conclusions about tax brackets. For instance, for the best-off taxpayers, close to 40 percent of their state and local income tax and property tax bills are effectively paid by the federal government. To illustrate: imagine that a higher income family pays \$5,000 in state income taxes. It gets to take this \$5,000 off of their federal taxable income.
3. Cutting the top tax rate will increase the regressivity of the state's tax system. However, doing so will not necessarily guarantee that taxpayers in the top bracket will use these savings to buy or invest more in North Carolina.
4. Higher taxes have countervailing effects. In some instances, they can encourage people to work harder to make up for money lost to taxes. In other cases, the opposite occur. But the general tendencies are clear. On the negative side, leisure is chosen over work, additional education is delayed, consumption increases and investment/saving rates fall. However, higher taxes can have positive effects, such as the role of social security taxes in encouraging retirement savings, closing distortionary tax loopholes, and curbing the subsidies on behavior that would have occurred anyway (e.g., our proliferation of federal retirement tax subsidies for the affluent).
5. Higher taxes do not necessarily lead to lower incomes for the wealthy. They also give rise to reporting less income and finding ways to legally and illicitly hide and shelter income.
6. Empirical evidence on the link between state income tax variation and growth is weak. (See earlier references) In addition, the theory has some flaws as well. Here is the logic. Start by recognizing that "personal taxes are not a direct expense of business. They affect

business costs only to the extent that tax differences across states are so noticeable to wage earners that a business in a high-tax state must pay higher wages and salaries to compensate for the higher personal taxes. On average, state and local personal income taxes represent about 2.6 percent of personal income. Payroll (wages, salaries and compensation of officers) on average represents about 16.5 percent of a corporation's cost of operations. That means that, even if personal income taxes were somehow a business cost, they would represent just four-tenths of 1 percent of costs (2.6 percent of 16.5 percent) and would be even less significant than state and local corporate and property taxes."<sup>61</sup> Past research has shown that even big direct business tax reductions have only small effects on investment and location choices. And the case is no better for the forecasted negative effects on upper income individuals. Here again the costs to firms are smaller – roughly 2.1 percent of operations for the average company. These wealthy households will itemize and take advantage of federal tax deductions. Thus, it would mean that profit-making corporations would avoid otherwise great locations simply to avoid making slight increases for executive salaries to compensate for after-tax cost of living differences. So, it seems like business investment decisions are affected little, if at all, by state personal income taxes.

The cries, threats, and prophecies of anyone asked if they would like to see their taxes reduced must be discounted. This is the equivalent of a landlord asking his tenant if his rent is too high. Thus, in considering whether the proposed tax cut is good for the state's competitiveness, we reach the Scottish law verdict of "not proven." This conclusion is weighted against the absolute certainty that the results of such a tax cut will shift taxes onto the less affluent or cut services (which are more likely to harm them as well).

These points do not mean that state taxes *and* fiscal policies do not affect the economic climate for business in a state. Stable and attractive conditions for business development and profitability depend to a significant extent on adequate but not excessive, efficiently administered, and equitable tax policies just as a sound business climate depends on the quality of public services.

This is also why development-enhancing tax reform is inseparable from the "reinvent government" agenda. We must always try to get more bang for the fiscal buck by investing scarce tax resources in the highest priority and highest yielding public investments and making government service delivery more efficient, effective, customer-friendly, and accountable. Efforts to create a high-quality revenue system and good government go hand-in-hand.<sup>62</sup>

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<sup>61</sup> Peter Fisher and Elaine Distler, *Taxes and Economic Growth: The Myths and Reality*. (May 2003) The Iowa Policy Project, p. 5-6.

<sup>62</sup> *Government is an indispensable partner in the process.* As a provider of essential services, as a conveyor of the broad range of interests within a community, and as the custodian of an area's assets, not to mention the democratic expression of the public will, government plays a vital role in economic development. There is much support around the country for reducing the size and scope of government, but business also needs government to provide the basic infrastructure within which it can operate. The challenge is to make government work better and to find ways in which the public, private, and nonprofit sectors can create complementary and reinforcing roles. But the *concept of government-as-usual is bankrupt*. New attention to reorganizing economic development program delivery for greater quality and impact is essential. Development initiatives, like all areas of government, must meet higher standards for accountability, for cost-effectiveness, and customer-friendliness. In many cases, the public sector must seek to do more

But doesn't the point of view in this paper risk giving a blank check to advocates for a tax-and-spend frenzy? Isn't there a place for super-majority requirements for any tax hike or limits to rising government spending?

Obviously, if your critic does not like taxes based on ability to pay (such as a progressive income tax) and almost never takes a position that government can do anything right, they would probably argue that creating obstacles to rising government spending is a good thing. It comes down to both ideological and empirical claims about politics and markets, about government and market failures, about public choice theory and the ideal of the public interest, and about the motives of both appointed and elected officials.

On the other hand, it does seem reasonable to appreciate this fact: "41 states have at least one structural impediment in place – most likely approved by the voters – suggest[ing] that this view carries some weight with the public."<sup>63</sup> And given the need for a majority to implement these measures, such reforms are drawing support from voters, who are not just libertarians and other conservatives. Many moderate (and possibly some liberal) Americans appear to desire containing some spending and governmental responsibilities, but not radically shrinking them. Most citizens undoubtedly see the utility of curbing public officials' tendencies to forego tax hikes and avoid spending cuts.

We have two reservations and reactions. First, we think that there is a strong case that some measures just go way too far and that TABOR has had a disastrous effect on the development climate, quality of life, and economic equity in Colorado.

So, look before you leap. Run some numbers and pay attention to the details, including the fiscal, household and business incidence effects of both tax and spending limitation initiatives.

Second, we also need sound but flexible approaches to the good times and the bad. Limitation measures and curbs on revenue raising options can be too restrictive.

For example, consider a state that is running a surplus. Policymakers could establish a number that would trigger legislative and executive action around the three "R's" – rainy day funds, rebates, and reinvestment. If necessary, a special session could be held to discuss alternative uses of these surplus funds. If meeting the Leandro requirements for shrinking school financing inequities are still not being met, it might be a good thing to reinvest some or all of these monies in this program. Perhaps the state's fiscal reserves are down and it needs to earmark more dollars for the rainy day fund. Or, it might be a good time to give some money back to the

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with less. Those that deny these trends, that do not innovate and that do little to educate constituencies and political leadership about the rationale and benefits of their programs, inevitably will face budget cuts and possible elimination. "Reinventing government" is not a fad: it is standard operating procedure.

<sup>63</sup> See "Another Take on Structural Deficits" in State Policy Reports, 23(10), p.11, May 2005.

citizenry and the business community, but not make significant changes in the tax rates or structure.

In a nutshell, develop fiscally responsible state budget practices, because smart tax policy should be inseparable from sound state fiscal management efforts.

- First, maintain adequate flexibility by not setting rigid tax and expenditure limits, by being very selective when earmarking revenues, and by imposing user fees where appropriate.
- Second, create an adequate Rainy Day Fund, which sets aside a portion of available revenues in good times to avoid tax increases or drastic reductions in state spending in bad times.
- Third, establish a constitutional or statutory process to produce a sound revenue forecast that is binding upon the legislature and governor.
- Fourth, review tax expenditures with the rest of the budget.
- Fifth, develop a real capital budgeting plan for financing infrastructure.
- Sixth, beware of quick fixes that create long-term problems, such as: using one-time revenues for recurring expenses; failing to calculate the full annual cost of a program that begins in the middle of a fiscal year; raiding the public employee pension fund; and giving tax cuts that permanently erode tax bases, rather than rebates in unusually good tax collection years.

The imperatives behind all these rules are simple. Keep enough fiscal room for error. Be conservative. Make the budget as transparent as possible. Maintain fiscal flexibility. And above all, don't rely on additional federal monies to keep needed programs afloat because they ain't coming.

*By creating a more modernized and fiscally adequate tax system, North Carolina will not have to once again use less prudent, "jerry-rigged, get-by" techniques of balancing its budget during the next recession.*

## WHAT IS TO BE DONE

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Here are twelve steps that policymakers can take to modernize North Carolina's tax code:

1. Make the state's personal income tax less burdensome for lower-earning families who are trying to make ends meet.
2. Maintain the top rates in the personal income tax.
3. Broaden the sales tax base to cover more of the service economy.
4. Align tax base definitions with the federal tax code and with other states' tax codes, to the greatest extent possible. (A notable exception is the estate tax; allow North Carolina's to remain decoupled.)
5. Increase the uniformity of tax rates for similar goods and services.
6. Conform to the remaining provisions required to participate in the Streamlines Sales Tax Project so that taxes on remote sales (sales from internet, by phone, or by catalog) may be voluntarily collected.
7. Repeal corporate tax credits and deductions that don't really improve the economic climate in the state, especially in the most distressed areas.
8. Eliminate credits that only benefit specific companies or specific industries.
9. Capture more modern forms of business in the tax base, such as limited liability companies.
10. Make sure that multi-state corporations pay their fair share via combined reporting and other mechanisms.
11. Review tax expenditures with the rest of the budget for greater accountability.
12. Sustain an adequate rainy day fund.

**CHARLOTTE OBSERVER  
EDITORIAL STAFF  
STATED THAT "IF THIS  
WERE THE 1930S,  
NORTH CAROLINA  
WOULD HAVE A GOOD  
REVENUE STRUCTURE."**

Such a fiscal modernization reform agenda has been proposed in the past by august groups, such as the North Carolina's Economic Futures Commission (1991) and the Governor's

Commission to Modernize State Revenues (2002), as well as recent editorials in newspapers, like the *Raleigh News and Observer*.<sup>64</sup>

For example, the May 29, 2005 *Charlotte Observer* editorial staff stated that “if this were the 1930s, North Carolina would have a good revenue structure – one based on taxing consumable goods produced in a manufacturing economy and purchased locally in retail stores. But in the first decade of the 21<sup>st</sup> century, the state’s economy has changed drastically.”<sup>65</sup> Its recommendations included: broadening the sales tax base to include services and standardize tax rates, reducing corporate tax credits and curtailing job creation incentives, adopting an effective system of taxing mail and internet sales, adopting a state EITC, modernizing corporate taxes and thereby making rate reductions more affordable, and giving local governments a menu of tax options.

There’s even a very specific revenue plan proposed for North Carolina by the NC Budget and Tax Center that costs out many of the ideas above.<sup>66</sup> Its 2005 report suggest 26 concrete ways to augment revenues and make the state’s fiscal system more modern, productive, and fair. This reform package would add \$1,479 billion to state coffers annually, thereby overcoming NC’s structural deficit and increasing fiscal predictability.

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<sup>64</sup> See the Lead Editorial, *Raleigh News & Observer*, June 10, 2005.

<sup>65</sup> See the Lead Editorial, *Reform N.C. Taxes: Here’s a Start Toward a Revenue System for the 21<sup>st</sup> Century*. *Charlotte Observer*, May 29, 2005.

<sup>66</sup> Elaine Mejia and Amna Cameron, (2005). P. 2.

## CONCLUSION

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Although many argue that North Carolina's state and local taxes discourage investment, slow economic growth, and destroy jobs, they have the wrong target. The real obstacle to achieving a better development climate is our outmoded tax systems. We need to understand that our revenue system:

- Is out-of-step with technological change, today's multi-national, information-based, service economy, and demographic trends;
- Imposes tax burdens on an increasingly narrow slice of economic activity;
- Establishes an unfair advantage for large businesses and out-of-state companies;
- Results in a chronic structural funding gap; and
- Requires the less affluent to shoulder more of the tax load.

Simply responding to pressure to escape again from these conundrums by tinkering with NC's tax codes will do little to create a positive tax climate. A better way requires that:

1. Tax competitiveness becomes only one of a number of goals for a quality fiscal system.
2. A modernizing tax reform is based on creating a better fit between NC's fiscal system and its changing economic base.
3. Tax reform is comprehensive in its scope, rather than seeking to "just get by."
4. Ineffective and wasteful tax expenditures are curbed.
5. NC policy leadership would seek to cooperate with their neighboring states on issues of tax uniformity, taxing multi-state corporations, and restraining the incentives' "arms race."

Most importantly, we can have it all: a moderately burdensome tax code, increased fairness, lower rates and a broader base, more adequate and predictable revenues, and more transparency and accountability. And these changes can be accompanied by sustained economic development.<sup>67</sup>

Development-enhancing tax reforms can lead to equitable growth in North Carolina.

Don't be fooled.

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<sup>67</sup> In a "Vision for Public Finance for Oregon" (Introductory Report for Oregon Business Council, April 15, 1998), the author describes it as a virtuous circle: "Our vision suggests a positive cycle in which a strong economy holds down public costs", like that caused by rising unemployment and poverty rates, "and provides additional public revenues, supporting quality public services at relatively low tax rates, which, in turn, benefit the economy. We also understand this cycle in reverse: a declining economy can trigger increased poverty and social problems, lower public sector revenues, and lead to cuts in the quantity and quality of public services, which reduce the attractiveness of the state as a place to do business."

## APPENDIX A: SUMMARY OF NORTH CAROLINA FISCAL POSITIVES AND NEGATIVES

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POSITIVES	NEGATIVES
<b>TAX BALANCE AND STABILITY</b>	
Balanced state and local revenue base	
Rainy day fund exists	Rainy day fund depleted
No corporate tax carry-backs	
	No throw back rule
	Sales tax should cover more sectors
Limited state spending cap	
<b>TAX FAIRNESS</b>	
Progressive state personal income tax	State income tax threshold too low
	No property tax circuit breaker/relief
State child care tax credit	Child care tax credit is not refundable
	No refundable state earned income tax credit
Decoupled estate tax	State estate tax must be renewed
	No combined reporting
Tax expenditure budget required	Tax expenditure report very infrequent
Tax incidence model for income tax	Need incidence model for other taxes
<b>FISCAL EQUALIZATION</b>	
Leandro court order calls for school finance equity	Redressing Leandro inequities going slow
<b>TAX COMPETITIVENESS</b>	
Moderate state and local tax burden per capita	
Low business taxes as percent of profits	

## APPENDIX B: WILLIAM SCHWEKE BIOGRAPHY AND ABOUT CFED

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**William Schweke** is the vice president of learning and innovation for CFED in the Durham, North Carolina office. Mr. Schweke is a specialist in development finance, plant closings, small and community business initiatives, local development planning, environmentally compatible development, and urban neighborhood development initiatives. In his technical assistance work, he has advised a variety of state and local governments, community-based organizations, foundations, trade unions, chambers of commerce, private utilities, and governmental authorities in the U.S., Europe and Great Britain. In the area of training, Mr. Schweke has developed courses on rural development, community economic development, and local development planning.

Mr. Schweke's latest publications include: *Smart Money: Education and Economic Development; Promising Practices to Aid North Carolina's Displaced Workers; Has the William S. Lee Act Worked for North Carolina?; Dislocated Workers in North Carolina: Aiding Their Transition to Good Jobs; Curbing Business Subsidy Competition: Does the European Union Have an Answer; Hidden in Plain Sight: A Look at the \$335 Billion Federal Asset Budget; Could Economic Development Become Illegal in the New Global Policy Environment?; and Trade Agreements and Sustainable Development: 13 Reasons Why They Should Be More Compatible*. He is currently researching and advising in these areas: addressing the potential impact of global trade, investment and procurement agreements on the future of domestic economic development, developing new state approaches for addressing plant closings and mass layoffs, and devising new business incentive reform alternatives. Mr. Schweke is a graduate of the University of Texas at Austin.

### ABOUT CFED

At CFED (formerly Corporation for Enterprise Development) we believe that expanding economic opportunity to include all people will bring greater social equity, alleviate poverty and lead to a more sustainable economy. As a leader in economic development for more than two decades, CFED collaborates with diverse partners at the national, regional, state and local levels.

We bring together community practice, public policy and private markets in new and effective ways. We combine the innovation of a think tank with the "on-the-ground" insight of practitioners to:

#### Identify Good Ideas

CFED identifies ideas that make the economy work for everyone. We focus on communities that have traditionally been excluded from or limited by the mainstream economy. We conduct rigorous research, seeking ideas that have potential for practical application.

#### Find What Works

CFED works with partners in the field to help test and refine promising ideas. We pilot

programs and provide funding to design and modify effective strategies to be successful in different cultures, regions and economic conditions.

### **Help Good Ideas Reach Scale**

CFED develops and advocates for federal and state policies that move the nation toward a more equitable and inclusive economy. We publish reports, convene working groups and provide information to help partners participate in the policymaking process.

### **Foster New Markets to Achieve Greater Economic Impact**

CFED drives the application of proven ideas until other stakeholders are invested enough for these strategies to stand on their own. We document viability and market ideas to potentially interested partners. We help create intermediary institutions to broker skills, information and funding.