NORTH CAROLINA CENTER FOR
PUBLIC POLICY RESEARCH INC.

NEWS RELEASE

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TAX ADJUSTMENTS NEEDED TO RESTORE FAIRNESS, CENTER FINDS

North Carolina's state income tax -- designed to fall only on the well-to-do -- has become substantially less progressive over the years, says the N.C. Center for Public Policy Research in the latest edition of its quarterly magazine, North Carolina Insight. The result, even more pronounced when combined with regressive sales and gasoline taxes and user fees, is a disproportionate burden on some of the state's poorest citizens. The legislature should act this session to correct this imbalance, the Center says.

When the state income tax was adopted in 1921, it was so progressive that even the governor did not earn enough money to have to pay taxes. But tax rates, brackets, exemptions, and the standard deduction -- all of which originally helped to protect the income of the poor from taxation -- have remained almost unchanged since the inception of the income tax almost 70 years ago. As a result, inflation has forced a state income tax liability on citizens earning less than half the federal poverty level, the Center reports in an article examining the impact of the state's tax structure on the poor. The article was written by Charles D. Liner, tax specialist at the Institute of Government at the University of North Carolina at Chapel Hill, as part of the Center's 168-page report on poverty in North Carolina.

"This erosion in the value of exemptions, the maximum standard deduction, and tax brackets has transformed the income tax from a tax that once fell only on the well-to-do to a tax that now falls on a wage-earner with a family of four making only $4,350 a year -- well below the poverty level of $11,612," says Mike McLaughlin, Insight associate editor.

Center Endorses Legislative Commission Recommendations as Remedy

A bill by the legislature's Tax Fairness Study Commission would redress this history of inflation-fueled tax hikes for the poor. By adopting the federal definition of taxable income, the bill would provide the much higher personal exemptions and standard deductions allowed under federal law. The effect would be to make the state income tax more progressive, thereby taxing the poor less. The Center says the proposal would help to reverse what amounts to an over-reliance on the tax dollars of poor people. As added bonuses, the change would make it easier to fill out state income tax forms, and married couples could file joint returns.

"Our state is among the nation's harshest when it comes to taxing the income of the poor," says McLaughlin. "Why should we be taking dollars out of poor people's pockets? The legislature should carefully examine the package of tax changes proposed by its study commission with an eye toward restoring fairness."

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North Carolina's current state income tax could be adjusted for inflation each year to keep it as fair to the poor as it was on the day it was enacted in 1921. The Center finds, however, that the legislature has had a poor track record in this regard. Head of household and spousal exemptions -- originally set at $2,000 and $1,000 in the 1920s -- have been increased only once, in 1979, by 10 percent. The standard deduction -- set at $500 in 1953 -- also was increased by 10 percent in 1979. State income tax brackets and rates have not been changed since 1937.

The result of the legislature's failure to act, the Center says, is that low-income taxpayers have been hammered by inflation. For example, a taxpayer at the federal poverty line saw his state income tax increase 710 percent between 1970 and 1987, more than three times the increase in household income over the same time period. A study by the National Conference of State Legislatures found that in 1988, North Carolina had the nation's second highest income tax bite ($252) for a two-parent family of four with $10,000 in household income.

N.C. Tax Threshold Is The Fifth Lowest in U.S.

The National Conference of State Legislatures also found that the level at which North Carolina begins imposing taxes -- its tax threshold -- is the nation's fifth lowest. That means a North Carolina resident begins owing state income taxes when his household income reaches $4,350, less than half the federal poverty line for a family of four ($11,612).

The erosion of the progressivity of the state income tax is made more troubling by the fact that the state depends on many more taxes which are highly regressive, such as the state and local sales taxes, and various excise taxes and user fees. Most states, for example, do not impose a sales tax on food and utilities. Food purchases are exempted from taxation in 28 states, and charges for telephone, electricity, and natural gas service are exempted in 32 states. Eight states also exempt clothing. North Carolina does not exempt any of these basic necessities. Instead, the state is dependent on these taxes. Exempting food and utility charges from retail sales taxes in N.C. would cost the state about $425 million in annual revenues. North Carolina's dependence on regressive taxes is likely to grow as the 1989 legislature considers a 1-cent increase in the state sales tax to finance teacher pay raises and a 5¼-cent increase in the gasoline tax as part of an $8.6 billion highway construction package.

The Tax Fairness Study Commission recognized the need for tax relief for the poor in advocating that the state restructure its income tax by accepting the federal definition of taxable income. This would allow taxpayers to file joint state returns and claim the higher deductions and exemptions allowed on federal returns. The effect would be a tax threshold of $13,000 for a two-earner family of four, a threshold above the federal poverty line.

"Theoretically, what we did here is super because we are starting to get away from the regressive features of the North Carolina tax system," says Sen. Marshall Rauch (D-Gaston), co-chairman of the Tax Fairness Study Commission and chairman of the Senate Finance Committee. "The North Carolina system has too much of a burden on low- and middle-income citizens."

The higher tax threshold would remove as many as a half-million people from the North Carolina tax rolls. Under the study commission's proposal, the state would substitute a largely flat rate structure for the current graduated structure, which starts at a tax rate of 3 percent of taxable income and tops out at a tax rate of 7 percent on taxable income above $10,000.

The new rates would be 5 percent for lower-income citizens and 8 percent for higher-income citizens. This higher 8 percent rate would make up for the revenue lost by increasing the tax threshold. The legislature's Fiscal Research Division estimates that taxpayers with a household income of $45,000 or less would see their state income taxes decline. Working married couples with a combined income of $57,500 would pay about 7 percent more in taxes, while those with a combined income of $118,000 would pay 12 percent more. The net result would be to make the state's income tax much more progressive at the lower end of the income range and slightly more progressive at the upper end.

"The proposal offers the legislature a chance to correct an injustice without penalizing the average citizen with a tax hike," says McLaughlin. "In fact, many citizens might welcome a simplified tax form even if they had to pay a few extra dollars in taxes. This tax simplification aspect makes reform more politically palatable, and the timing may be right for a major change."

State's History of Fine-Tuning Tax Structure Is Poor

The Center says the state's record in fine-tuning the state income tax to provide tax relief for the poor has been dismal. Except for a general income tax credit and exemption of food stamp purchases from sales taxes -- both enacted in 1985 -- most recent tax changes have been targeted toward the more affluent. For example, the state has helped the affluent with repeal of the inheritance tax for most taxpayers and partial repeal of the intangibles tax. "Given the state's recent track record, the study commission is wise to call for action," says McLaughlin. "The state has neglected preventive maintenance, and the study commission has recommended a much-needed overhaul to accomplish tax fairness for the poor."

Although the proposed state income tax restructuring would have the most dramatic impact on North Carolina's poor taxpayers, the Tax Fairness Study Commission made other recommendations that would also have an impact on the poor. The commission recommended an annual refundable food tax credit ranging from $45 to $75 for low-income people who do not receive food stamps. This would directly benefit the poor and would cost the state about $10 million in revenues annually. In addition, the commission proposed increasing the child care credit, a move that would benefit low-income citizens with children in day care.

The Institute of Government's Liner notes that there are other means of lessening the tax bite on poor citizens in case the legislature does not choose the option of embracing the federal tax code. The legislature could (1) increase personal exemptions, (2) increase the standard deduction, or (3) provide refundable income tax credits for low-income citizens.

Gov. James G. Martin also has suggested a measure of tax relief that would benefit the poor. Martin says the legislature could use part of the 1-cent sales tax increase he has proposed for higher teacher salaries to cut the state sales tax on food.

"North Carolina's poorest citizens are paying more than their share in taxes, and the legislature has been handed a number of options for granting them some relief," says McLaughlin. "State income tax restructuring is clearly the most important proposal put forward for helping the poor. The legislature should give the study commission's plan careful consideration as a means of correcting a growing problem of tax equity for the poor."

The N.C. Center for Public Policy Research is an independent, nonpartisan, nonprofit organization created to examine state government programs and important issues of public policy in North Carolina. The Center is supported in part by grants from the Z. Smith Reynolds and Mary Reynolds Babcock Foundations, both in Winston-Salem. Other funding comes from 112 corporate contributors and more than 700 individual and organizational members. In addition to publishing North Carolina Insight magazine, the Center also has conducted studies comparing the performance of for-profit and not-for-profit hospitals, problems with local landfills running out of space, and the possibility of a state environmental index.

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Copies of the issue of North Carolina Insight containing the research on tax policies affecting the poor and on poverty in North Carolina are available for $12.60 (plus $1.00 postage and handling) from the N.C. Center for Public Policy Research, P.O. Box 430, Raleigh, N.C., 27602, or call (919) 832-2839.

For more information on tax policies affecting the poor, call Mike McLaughlin at the N.C. Center for Public Policy Research at (919) 832-2839.