Pro—

The Inventory Tax

And The Arguments For Retaining It

by Jane Sharp and Jan Ramquist

Adam Smith in 1776 described the principle of fairness in taxation as "the ability to pay," and wrote that "the subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities." Yet Governor Martin's plan to phase out the property tax on business inventories—without replacing it with another business tax or a new combination of taxes—would result in a dramatic case of tax inequity that would further shift the tax burden from business to individuals.

Why? Because it would give preferential property tax treatment to business by creating a tax exemption—a loophole—that in effect relieves business of the burden of paying ad valorem property taxes on the inventories of manufacturers, retailers, and wholesalers. But because local governments depend on property taxes as a mainstay of local financing, the burden could compound for homeowners and other taxpayers through an increase in the real estate property tax in order to replace lost revenues. Adam Smith would quake in his grave if he knew what the N.C. General Assembly was up to.

So would the state's taxpayers if they realized what this debate is all about. It's easy to lose

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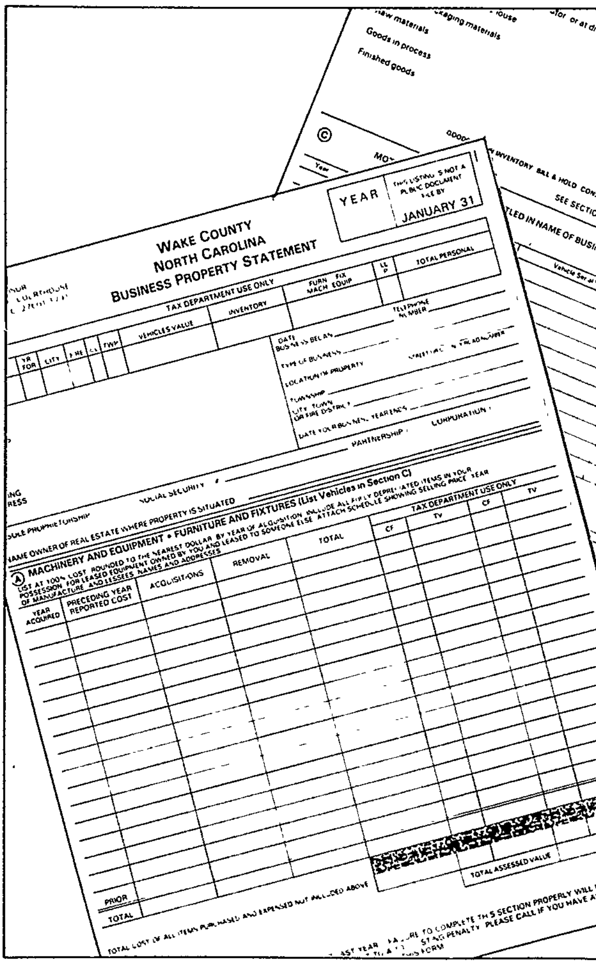
Jane Sharp is President of the North Carolina Consumers Council. Jan Ramquist is Second Vice-President and Legislative Chair of the League of Women Voters of North Carolina.

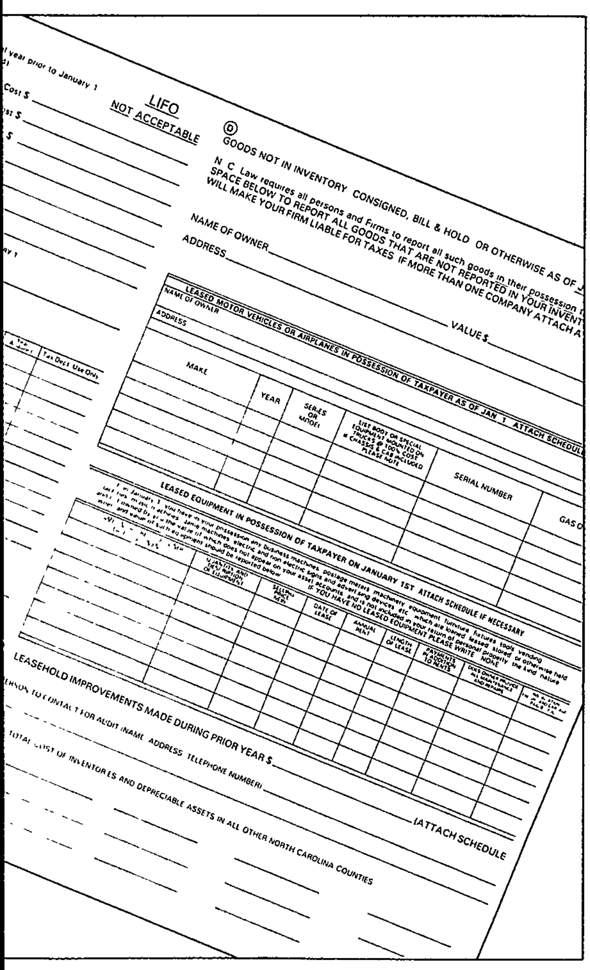


Con—

The Inventory Tax

And The Arguments For Relief

by William H. Armstrong


LIFO NOT ACCEPTABLE

GOODS NOT IN INVENTORY CONSIGNED, BILL & HOLD OR OTHERWISE AS OF

N C Law requires all persons and Firms to report all such goods in their possession

SPACE BELOW TO REPORT ALL GOODS THAT ARE NOT REPORTED IN YOUR INVENT

WILL MAKE YOUR FIRM LIABLE FOR TAXES IF MORE THAN ONE COMPANY ATTACH A

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VALUE $

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MAKE | YEAR | SERIES OR MODEL | SERIAL NUMBER

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TOTAL COST OF INVENTORIES AND DEPRECIABLE ASSETS IN ALL OTHER NORTH CAROLINA COUNTIES

North Carolina's business interests are looking to the current General Assembly with unusually high hopes that, at long last, they may begin to obtain relief from one of the most burdensome and obnoxious of all their tax obligations—the local property tax on the inventories of manufacturing, retailing, and wholesaling firms.

The focus of business' hope for a start toward inventory tax relief is the state's new Republican Governor, James G. Martin. A major plank in Governor Martin's campaign platform was that of easing or eliminating the burden imposed upon business by the twin bugaboos of inventory and intangible personal property taxes. Several of our past governors—including Gov. James B. Hunt Jr. and his predecessor, Gov. James E. Holshouser Jr. most recently—have acknowledged the undesirability of the inventory tax, but none has ever thrown the weight of his office behind a program to ease the tax's financial drain on business and industry.

North Carolina Citizens for Business and Industry, the statewide organization that represents all types of business, has for years campaigned actively in behalf of various plans that would ease or eliminate the inventory tax burden. Relief legislation has cleared one legislative house in past sessions only to be bottled up in

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William H. Armstrong is editor of We the People of North Carolina, *magazine of N.C. Citizens for Business and Industry.*

sight of exactly what the inventory tax is, and what it is not. The inventory tax is not a special, discriminatory levy aimed at soaking businesses. It is an integral part of the North Carolina tax system, levied by local governments but subject to the General Assembly's authority. Local governments collect these property taxes as a major source of revenue for schools, public safety, water and sewer treatment plants, streets, and other local services.

"Tax reform means, 'Don't tax you, don't tax me. Tax that fellow behind the tree.'"—U.S. Senator Russell Long (D-La.)

The inventory tax applies to materials and products stored in warehouses, in manufacturing plants, in wholesale houses, and in retail stores. Businesses themselves calculate, report, and pay the tax directly to the counties. And like the personal property tax for private citizens, the inventory tax revenue collections depend upon the memories, records, and honesty of those being taxed.

According to the latest estimates of the Fiscal Research Division of the N.C. General Assembly, the inventory tax generates $155 million per year for local governments.[1] That amounts to about 15 percent of the amount collected from all property taxes—3 of every 20 dollars. The Martin proposal offers a three-year phase-in of corporate tax *credits* to offset inventory taxes. In other words, counties would continue to assess and collect the tax, while corporations would deduct that tax from their state corporate income taxes. After 1988, the administration would have to decide whether to recommend continuing the tax credit system, or whether to seek outright abolition of the inventory tax.

A change in the tax structure of that magnitude raises three significant questions: Is it fair and equitable to further shift the burden of taxation from businesses to individuals? Can the state's budget afford the loss of funds and shrinking of the revenue pool? And will the tax cut endanger local governments, now or after 1988?

More Relief for Business Is Unfair

State tax revenues come primarily from four basic areas: taxes on sales and use, personal income, corporate income, and franchise. The sales tax on food, a part of the general sales tax, is regressive—that is, it is felt most by those who are least able to pay. Nationally, North Carolina is considered a fairly low-tax state, although in the Southeast it is about average. In personal income taxes we are highest in the region, but in corporate income taxes North Carolina is about in the middle.[2]

For decades in North Carolina, the business share of the state revenue pie has gotten smaller and smaller. Charles D. Liner of the University of North Carolina's Institute of Government put it this way in a 1983 report: "State revenues from the corporation income tax and franchise and license taxes on corporations in general *fell from 24 percent of all state tax revenues in 1950 to 9.8 percent in 1981*, while state sales and individual

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the other chamber as those sessions adjourned. A token amount of relief was enacted in 1978;[1] it applied only to manufacturers of high-value-added types of inventories and afforded a limited state income tax credit for inventory taxes paid. That measure had virtually no effect on such bedrock industries as furniture, textiles, and apparel. Reeling from the flood of cheap imported foreign goods against which they must compete under severe handicaps, those industries still await inventory tax relief from Raleigh.

Businesses Need Relief

Why should business inventory taxes be abolished? Or, more practically, why should the state of North Carolina be expected to grant income tax credits to business to offset inventory tax payments to local governments? Admittedly, business will welcome the relief for reasons of self-interest. The property taxes they pay on inventories represent an increased cost of doing business and a damper on their profits.

income tax revenues increased from 67.5 percent to 81.8 percent of the total" (emphasis added).[3] Liner calculated those figures in another, more revealing way. In 1950, income tax revenues *from corporations exceeded those from individuals.* But by 1983, income tax revenues from individuals were *five times* greater than those from corporations.

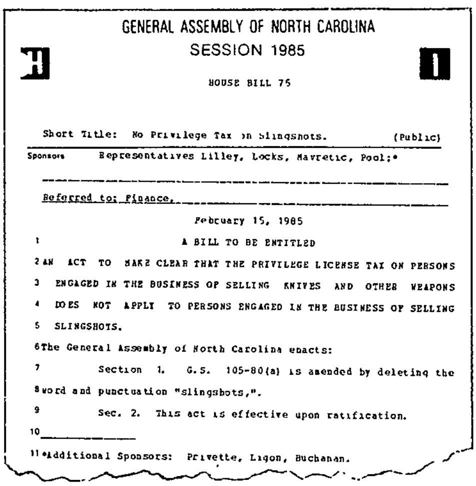
Does that sound as though North Carolina's tax policy is unfair to business?

Economic Development

Ostensibly, the purpose of inventory tax relief is to boost economic development. In theory, repealing this tax will remove an annoying and costly deterrent to industry wishing to relocate to North Carolina and to industry considering expansion of their Tar Heel operations. But the record doesn't bear out those contentions. If the inventory tax hurts industrial recruiting, for instance, then why have both *Fortune* and *Business Week* magazines rated North Carolina as one of the most attractive places for new industrial plants and businesses?[4]

In the same report in which he noted the declining share of corporate revenues, Charles D. Liner also concluded that "differences in taxes are not likely to be important in determining the state or community in which a new plant will be located."[5] Often, Liner wrote, firms did not even know if special tax incentives were available in the state in which they located. Further new research has bolstered that observation.

The Winthrop Rockefeller Foundation, headquartered in Little Rock, Ark., found in 1984 that *companies based their major relocation decisions on factors other than tax incentives.*[6] The study also found that rural Southern states expected too much from tax incentives they offer to attract new industrial development. In a study of one specific industrial recruitment case, the group found the major factors at work in a company's decision to move were, in order: available energy supplies; a good work environment with a ready pool of labor; availability of job training programs; good public transportation near the prospective plant site; and the general quality of life, including good schools, clean environment, sufficient housing, and cultural attractions. Actual tax breaks and other financial incentives were far down the list of priorities.



GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 1985

HOUSE BILL 75

Short Title: No Privilege Tax on Slingshots. (Public)

Sponsors: Representatives Lilley, Locks, Mavretic, Pool;*

Referred to: Finance.

February 15, 1985

A BILL TO BE ENTITLED

AN ACT TO MAKE CLEAR THAT THE PRIVILEGE LICENSE TAX ON PERSONS ENGAGED IN THE BUSINESS OF SELLING KNIVES AND OTHER WEAPONS DOES NOT APPLY TO PERSONS ENGAGED IN THE BUSINESS OF SELLING SLINGSHOTS.

The General Assembly of North Carolina enacts:

Section 1. G.S. 105-80(a) is amended by deleting the word and punctuation "slingshots,".

Sec. 2. This act is effective upon ratification.

*Additional Sponsors: Privette, Ligon, Buchanan.

Con—

The fact is that corporate income in North Carolina has not kept pace with individual income over the years. While some point to the fact that income tax revenues from individuals are greater than those from corporations, it is only fair to observe that there has been no increase in individual income tax rates and no decrease in corporate taxes. With inventory tax relief, corporate income would be in better position to keep pace with the growth in individual income—thus producing more capital for further economic expansion.

Economic Expansion

But there is a larger and more compelling reason—one which benefits the public interest. If the state fails to take some sort of effective remedial action on inventory taxes in the near future, North Carolina's economic expansion through the remainder of this century is likely to be inhibited. Retail and wholesale businesses find the tax bothersome and burdensome. Although supporting statistics are hard to come by, it is reasonable to assume that many retailers and wholesalers of marginal profitability have failed because the inventory tax was an extra weight they were unable to bear. Certainly there are large wholesale operations that chose states other than North Carolina for the location of large new warehousing centers in order to reduce or eliminate inventory tax obligations.

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The study, which also examined industrial recruitment efforts in other states, concluded that because tax incentives are not a prime consideration in industrial plant relocations, states should not offer expensive tax breaks. Not only do they not succeed in luring industries, but they also are so costly that they may wind up "beggaring public services." In addition, the great smokestack factories that traditionally have produced large numbers of jobs are in decline now as the economy transforms itself into a service economy. Even high-technology plants don't always offer high-paying jobs, and those that do often prefer to relocate in large urban areas instead of states with dispersed populations. Instead of offering tax breaks that may have no real beneficial impact on industrial recruiting, the study said, states should instead concentrate on nurturing smaller businesses that will become stable enterprises with a potential for growth.

> *"It was as true . . . as turnips is. It was as true . . . as taxes is. And nothing's truer than them."— Charles Dickens, in* David Copperfield

Other recent studies have drawn the same conclusion. The Joint Center for Urban Studies of MIT and Harvard University found that "empirical evidence strongly suggests that taxes are of negligible importance in the regional location and investment decisions of firms."[7] And the National Governors' Association reported, "The evidence provides little support for those who believe that poor states, or stagnating states, can stimulate their economies in any significant way by a heavy reliance on either targeted tax incentives or across the board reductions in business taxes....In contrast, if the amount of time state legislatures spend debating

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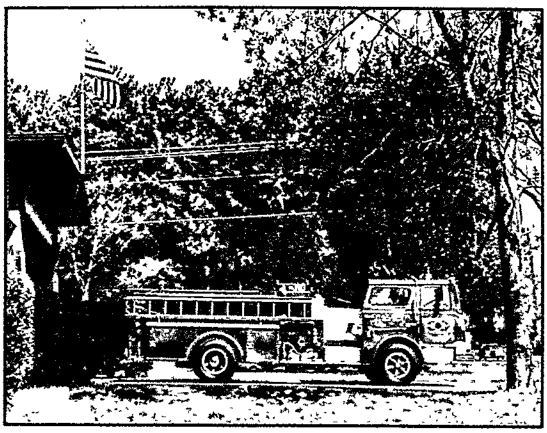
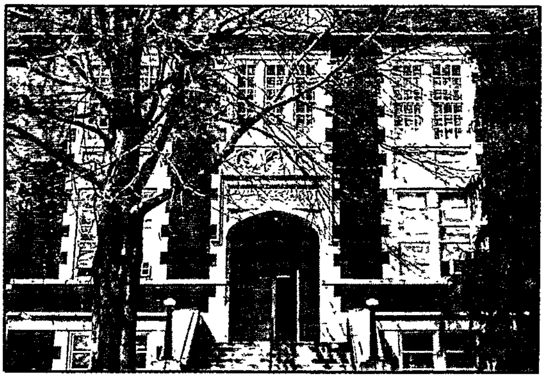
Over the past decade, the property tax on manufacturers' inventories has deterred a substantial number of corporations from constructing new production plants in North Carolina, and from expanding their existing operations in the state. Opponents of any change in the laws affecting local property taxes on business inventories often challenge those assertions. Opponents note correctly that manufacturing companies look at many factors within a state while deciding to place a new facility, and that for many of them the inventory tax is a minor consideration. North Carolina's many other attractions for industry more than compensate for the inventory tax, so the argument goes.



True in many cases, but not true in others. One cannot place an exact figure on the amount of investment dollars in new and expanded business and industry lost to North Carolina over a given number of years because of the inventory tax, because so many corporate officials decline to cite reasons for deciding against a state that was in the original running. Also, some industries that initially look at North Carolina are turned away by the presence of the inventory tax without state and local industrial recruiters ever becoming aware of the consideration.

Nevertheless, there is documentation that convincingly demonstrates the inventory property tax's chilling effect upon new and expanded economic development in the state. In 1977, the Committee on the Inventory Tax of the General Assembly's Legislative Research Commission issued a report in which 38 companies—all identified by name—were listed as having initially considered North Carolina for the location of new industrial plants before deciding to place them elsewhere.[2] Officials for most of those companies cited the inventory tax as a major



tax incentives and the effect of taxes on investment was redirected toward other areas, substantial progress might be made."[8]

North Carolina's attraction for new businesses and for local business expansion (a larger source of new revenues than incoming industries) manifests itself in the state's clean air and water, the generally favorable business climate, the technical school training system, the good transportation facilities, and the growing pool of willing workers who are not making excessive wage demands. Access to raw materials and markets are other important considerations.

Local governments understandably are concerned with the proposal to phase out the inventory tax through state corporate income tax credits. They fear those tax credits will not be redeemed by the state beyond a few initial years. Their fears may be well founded, especially if President Reagan's proposed tax simplification plans and budget proposals go through intact, leaving the states and local government with less federal aid for public works and other programs. While Governor Martin has played down the possibility of such disruptions, other state officials are more wary.

In an assessment in *State Government News,* N.C. State Auditor Edward Renfrow expressed his concern that property taxes and sales taxes would have to be raised just to pay interest on state and local bonds, let alone government services.[9] As bonds for local water and sewer development become more difficult to market, economic development suffers. No company will

disincentive—and often the sole one—that steered them away from North Carolina. Among them were Michelin Corp., which considered North Carolina before locating a $158 million, 2,500-job plant in South Carolina.

The committee report estimated that, had each of the identified companies chosen North Carolina, more than $500 million would have been added to the state's industrial investment total during the six-year period covered in the study, and more than 18,000 additional jobs would have been created. The report estimated that in one seven-year period, industrial firms that located in other states because of the inventory tax deprived state and local governments of $42.5 million in tax revenues. Another $8 million was estimated to have been lost to local governments from taxes that would have been generated by new employees, new homes, and new service industries.

It is true, of course, that North Carolina has done quite well for itself over the past quarter-century in expanding its industrial and economic base in spite of the inventory tax. As already noted, however, hundreds of millions of dollars worth of additional investment could have been applied to that industrial base if the inventory tax had not beeen an inhibiting factor.

The inventory tax has impeded growth in retail and wholesale business as well. William Rustin, executive director of the N.C. Merchants Association, pointed to the *North Carolina 2000* study, published by the state in 1983, which estimated that 80 percent of the jobs to be created at the turn of the century will come in the areas of retailing, transportation, distribution, and service organizations. "If we want to create those jobs," said Rustin, "we'd better put the opportunities there—and that means incentives like removing the inventory tax on retailers and wholesalers."

In December, Rustin said, he was advised by Rite Aid Corp. that it would locate a multi-million dollar warehouse facility in South Carolina rather than in North Carolina. Rite Aid Vice President James E. Krahulec told Rustin, "The fact that North Carolina still retains the inventory tax put it at an immediate economic disadvantage" in competition with South Carolina, which is phasing out its inventory tax.[3]

Now there are signs that North Carolina has lost ground, and could lose more, in its relative attractiveness to industry. The January-February 1984 issue of the publication *Industrial* build where it can't be assured of a dependable water and sewer system. Yet, according to the state's latest estimate, there are at least *$1.7 billion* in unmet water and sewer needs and *$2.4 billion* in unmet capital needs for public schools.

Will Local Governments Suffer?

During the political campaign last year, Governor Martin suggested that the state budget could accommodate tax repeal without program cuts. But the Governor got more specific on March 4 in his proposed supplemental budget. Martin suggested slashing planned increases in the rate of growth for various state budget programs, including education. Under Martin's overall tax and spending proposal, public education will suffer in order to pay for a tax break for business. Local governments which do not wish to suffer those education budget cuts will just have to raise other taxes—especially the property tax—to maintain education programs.

Another worry for local governments is whether the General Assembly will make up for lost inventory taxes in perpetuity. Not even the rawest freshman legislator would take that bet, because Martin will not be governor forever and because one session of the General Assembly cannot bind the next to a certain course of action.

There simply is no way to guarantee that sooner or later, local government won't be forced to pick up the tab for the loss of inventory tax revenues. The Governor's own proposal specifically cites the possibility of eliminating the inventory tax outright after 1988.[10] The counties, of course, could turn to the state to ask it to assume fiscal responsibility for functions which have traditionally been performed by local governments. But if the state is cutting its own income, how could it pay for those services? By further cutting other programs? Not likely. By raising other taxes? Which ones?

Tax Relief Not That Great

Businesses counting on deliverance from the inventory tax must face up to the fact that they will get less bottom-line relief than they seek. Currently, inventory taxes are deductible from federal and state corporate income tax returns. At the federal level, large businesses may write off 40 percent and, on state tax

Development ranked North Carolina last among the 50 states in terms of forms of financial assistance offered to industry by various public agencies.[4] In the same survey, North Carolina was tied at the bottom of the ranking in terms of tax incentives offered to industry.

Economic competition among the states is certain to intensify as new high-technology industry seeks congenial areas in which to locate manufacturing facilities. As we approach the year 2000 and witness the continuing changeover from a smokestack economy to a service economy, each of the 50 states will be busy devising new incentives to land those new industries and the jobs and tax revenues they will create. If North Carolina fails to keep up in terms of investment incentives, within a few years we could be left at a serious competitive disadvantage.

Local Government Revenues Won't Suffer

Were it not for the matter of revenues derived by local governments from inventory property taxes on business, the levy might have been abolished long ago. But local governments do depend on those revenues. If they were suddenly cut off, there would have to be substantial compensatory hikes in other property tax rates, or possibly the imposition of new types of local taxes. So long as the influential city and county government lobbies continue to operate in the General Assembly, the inventory tax will remain on the lawbooks, and the revenues will continue to flow into city and county treasuries. For that reason, all practical legislative approaches to the inventory tax problem, including those sponsored by N.C. Citizens for Business and Industry, have guaranteed the protection of local government revenues. So has Governor Martin's proposal.

Nothing in any of these approaches would actually abolish inventory taxes. Most of the bills considered by the General Assembly during the past decade have been based on the concept of granting state income tax credits to businesses for the inventory taxes paid to local governments. In all cases the credits would have been phased in over a period of years. Governor Martin's plan would phase in the tax relief over a returns, 6 percent. Thus, the federal and state corporate tax burdens are reduced. But if relief is granted, either through elimination of inventory taxes or by creating state income tax credits for inventory taxes paid, businesses won't be able to take those federal deductions, and their tax liability on federal returns will increase. That means a shift in tax revenues from state and local coffers to the federal treasury. In other words, the federal government gets more, while hard-pressed state and local governments get a smaller slice of the revenue pie. That makes it even harder to meet local needs.

Keep the Tax

How are those local needs going to be met? That's hard to say—but it's harder still if the General Assembly cuts out a prime source of revenue for local governments, even through the ploy of tax credits. To maintain tax equity, to nourish long-term economic development, and to support local governments' tax base, *keep the inventory tax.* □

FOOTNOTES

[1]Estimate prepared by Fiscal Research Division, Legislative Services Commission, North Carolina General Assembly, February 1985. That figure would be slightly higher were it not for partial inventory tax relief granted by the 1977 legislature in a special provisions section of the appropriations bill for certain categories of raw materials. Since that relief was granted, businesses have pressed for complete elimination of the inventory tax.

[2]Property Tax Study Committee report to the 1983 General Assembly, second session 1984, Sen. A. D. Guy, chairman.

[3]*Business Taxation & Economic Development in North Carolina,* published by Institute of Government, University of North Carolina at Chapel Hill, March 1983, by Charles D. Liner.

[4]*Why Corporate America Moves Where,* May 1982, prepared for Belknap Data Solutions, Ltds., as a *Fortune* market research survey; and *Plant Site Selection: A Survey of Management Subscribers in Industry,* September 1984, by McGraw-Hill Research at the request of *Business Week* magazine.

[5]Liner, *op. cit.*

[6]*Locating Industry in Arkansas: York Hanover—A Case Study in Public Incentives,* 1984, The Winthrop Rockefeller Foundation, 308 E. 8th Street, Little Rock, Ark., 72202.

[7]*State Tax Policy: Evaluating the Issues,* 1983, Joint Center for Urban Studies, Massachusetts Institute of Technology and Harvard University, by Andrew Reschovsky, p.166.

[8]*Taxes and Growth: Business Incentives and Economic Development,* 1981, The Council of State Planning Agencies of the National Governors' Association, by Michael Kieschnick.

[9]*State Government News,* February 1983, p. 3.

[10]*Governor's Supplemental Budget and Tax Relief Package 1985-1987,* March 4, 1985, p. 20.

three-year period. (A decision would be made in 1988 whether to continue the credit on corporate incomes taxes for inventory taxes paid, or whether to simply abolish authorization for local governments to collect inventory taxes, according to Governor Martin's supplemental budget presented to the legislature on March 4.)[5]

Approve Inventory Tax Relief

Those who are active in North Carolina's industrial recruitment efforts believe the incentives created by the total or even partial relief from inventory taxes would inspire enough added industrial investment over a period of a few years to compensate for most if not all of the losses to North Carolina's General Fund from the tax credit method. Ultimately, perhaps in less than a decade, backers of inventory tax relief are convinced that economic expansion inspired by such relief will more than offset any General Fund losses.

Now, as debate on the tax picks up steam in the legislature, partisan considerations could endanger Governor Martin's proposals. It will be extremely unfortunate for the economic development in North Carolina if relief legislation founders on the rocks of partisanship. It's time for legislators and all those who deal with public policy issues to recognize that continuation of the inventory tax burden on business and industry can rob North Carolina of a substantial slice of the future economic progress that is potentially available to us.□

FOOTNOTES

[1]Chapter 1200, section 3, 1977 Session Laws, second session, 1978, as codified in NCGS 105-163.03.

[2]Legislative Research Commission Report to the 1977 General Assembly of North Carolina, second session, 1978, Report on Inventory Taxation, Appendix C, pp. 7-8.

[3]Letter from James E. Krahulec, Vice President, Rite Aid Corp., Harrisburg, Pa., to William Rustin, Executive Director, N.C. Merchants Association, December 4, 1984.

[4]*Industrial Development,* January-February 1984, published bimonthly by Conway Data, 1954 Airport Road NE, Atlanta, Ga. 30341.

[5]*Governor's Supplemental Budget and Tax Relief Package 1985-87,* released March 4, 1985, p. 20.