Taxes and the Poor in North Carolina: An Unfair Share?

By Charles D. Liner

Is North Carolina's tax system unfair to the poor? Although a number of the aspects of the state's tax structure are favorable to those in poverty, the system as a whole exacts a weighty toll on those least able to pay. Consider these examples:

■ *The household income for a family of four at the poverty level has increased 193 percent since 1970, while that same family's state income tax liability has increased 710 percent during the same time period.*

■ *When enacted in 1921, the state income tax was not intended to fall on the poor at all, but rates, brackets, exemptions, and the standard deduction have remained almost unchanged. All of these tools were used to shield the poor from income taxes, but inflation has eroded them to the point that the poor shoulder a substantial state income tax burden.*

■ *A worker now winds up owing state income taxes before his taxable income reaches half the federal poverty line, a tax threshold far lower than that of most states. And in 1988, a family of four earning $10,000 would have had a higher state income tax bill in North Carolina than in any other state except Kentucky.*

■ *North Carolina has increased its reliance on the retail sales tax by increasing the combined state and local tax rate to 5 percent. This regressive tax imposes a relatively high burden on low-income taxpayers, a burden that is increased by the taxation of food and utility bills. Unlike North Carolina, 28 states exempt food purchases from sales taxes, 32 states exempt utility bills, and eight exempt clothing.*

What is the magnitude of this problem of tax equity for the poor in North Carolina, and what can be done to correct it?

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The most widely accepted principle of tax equity is that taxes which are used to support general government services should be imposed according to taxpayers' ability to pay. All states violate that principle by making extensive use of certain taxes, such as sales taxes, that impose burdens on poor people which are proportionately larger in relation to income than those imposed on higher income people. Taxes are called *regressive* when citizens with the least ability to pay bear the largest proportionate burdens. In contrast to regressive taxes, a *progressive* tax imposes proportionately smaller burdens on *those who have less income*.

All states make heavy use of regressive taxes and charges. For the nation as a whole, sales taxes are by far the largest source of revenue for state and local governments.[1] These taxes include the retail sales tax, gross receipts taxes, and selective sales taxes like taxes on gasoline and alcoholic beverages. Forty-five states have a retail sales tax, and 28 of those states also authorize local retail sales taxes. Some states allow local units to impose regressive local retail sales taxes. Although there are conflicting views about whether the property tax is regressive or progressive, in either case the property tax is not tied directly to taxpayers' incomes, and therefore poor people can be subject to relatively high property tax burdens (whether they pay the tax directly or through rents and prices). Finally, user charges, such as tuition at public higher education institutions, medical bills at public hospitals, and water and sewer charges, are used in every state. These charges also are more burdensome to the poor.

Because regressive revenue sources are used extensively, the key to achieving overall tax equity in a state is to have a progressive personal income tax that offsets the disproportionate burdens placed on poor people by regressive taxes and charges. Unlike sales and property taxes, the income tax base can be adjusted according to factors such as family size or medical expenses that have a bearing on ability to pay. And the flexible structure of the tax allows the state to grant relief through personal and dependent exemptions and the standard deduction, and to impose a rate schedule that is graduated according to taxpayers' net incomes. These characteristics permit the state to design income taxes that are consistent with the ability-to-pay principle.

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North Carolina's Taxes

In North Carolina the personal income tax is the largest single tax source for the state and local governments combined. This tax produces half of the state's general fund revenue and more than 28 percent of total tax revenue collected by state and local governments. It produces more revenue than the retail sales tax or the property tax (but not more than retail and selective sales taxes combined). In fact, North Carolina relies more on the personal income tax than all but three states (Delaware, Massachusetts, and Oregon). Six states do not have a personal income tax, and in seven other states the tax accounts for less than 10 percent of total state and local tax revenue.[2]

The state's heavy reliance on the personal income tax means that it relies less on other revenue sources. Including both state and local revenue sources, the state ranks 40th in reliance on property taxes, 31st in reliance on user charges, and 25th in reliance on retail sales and gross receipts taxes.

When comparing North Carolina's tax structure in this way, at first glance it appears that North Carolina's structure favors poor people—the state's largest tax is not intended to impose a tax liability on its poorest citizens and the state relies less on sales taxes than half the states. Furthermore, the state's personal income tax is substantially progressive.[3] In 1988 a family of four with an income of $8,500 earned equally by both spouses would owe taxes of $82, slightly less than 1 percent of its income, while a similar family with an income of $66,000 would owe $3,132, or 4.7 percent of its income.[4] It is true that the poorer family would pay a higher percentage of its income in sales taxes—retail and utility sales taxes together would amount to 2.6 percent of the poorer family's income and only 1.4 percent of the wealthier family's income. But even after combining these taxes with income taxes, the family with the lower income would still pay a smaller percentage of its income than would the higher-income family—3.6 percent compared with 6.1 percent.

Regressive, Progressive, or What?

Whether North Carolina's tax structure is regressive or progressive is a question of much debate. The Special Senate Commission on North Carolina Revenue Laws reported in 1975 that the "tax system has a definite pattern of regressivity in overall terms, with a range of near proportionality in the middle income range." In other words, the state's overall tax bite started at a high level among low-income residents, dropped and then flattened out for a broad range of middle-income citizens, and then dipped again at the highest income levels. The commission based this conclusion on a study by James Wilde, an economist at the University of North Carolina at Chapel Hill. Wilde's study examined the state's tax structure using a methodology aimed at gauging its overall impact upon the poor. For example, the study assumed that corporate income taxes ultimately would be paid by the consumer through higher prices, rather than by stockholders through reduced earnings. When all of these sources of taxation were taken into account, Wilde found that the state's poorest citizens paid the largest percentage of their income in taxes. Wilde says public finance experts disagree on who ultimately pays such taxes as the corporate income tax and the property tax, and how these taxes are treated makes a big difference in determining whether the state's tax structure is progressive or regressive. He also says the proportion of revenue produced by the state income tax has increased substantially since the Senate panel's study, while certain other more regressive taxes have become less important as revenue producers. Wilde says he would need to repeat the study to determine whether the state's tax structure remains as regressive in 1989 as he found it to be in the early 1970s.

—*Mike McLaughlin*

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In addition, two recently enacted measures have provided tax relief to lower-income taxpayers. In 1985, the General Assembly authorized an income tax credit—a general credit for low- and moderate-income individuals—that is equivalent to an increase in exemptions of as much as $833 for many low-income taxpayers.[5] (Even after the credit, however, the income tax can fall on taxpayers whose incomes are half the federal poverty level). And during the same session, the General Assembly exempted food stamp purchases from the retail sales tax. For most poor families who receive food stamps, this measure largely eliminates the sales tax on food purchased for consumption at home, although many income-eligible households do not receive food stamps.

Aspects Unfavorable to the Poor

But several other factors should be considered in determining whether North Carolina's tax structure is fair to the poor. First, although the state's personal income tax is progressive, it imposes taxes at a lower income level than in most states. Furthermore, erosion in the value of personal exemptions and tax brackets due to inflation continues to increase the taxes of poor taxpayers more than it increases the taxes of higher-income taxpayers. The result is that the income tax now imposes relatively heavy taxes on families below the poverty level, and the tax has become less progressive.

The personal income tax was never intended to fall on the poor at all. When the tax was enacted in 1921, personal and dependents exemptions sheltered the income of all but the well-to-do. Increasingly, however, the tax has fallen on the poor as well because exemptions and tax brackets have not been adjusted sufficiently to offset inflation. The head of household and spousal exemptions were set at $2,000 and $1,000, respectively, in the early 1920s. Those exemptions have been increased only once—in 1979—and by only 10 percent. The dependents exemption, which was $200 in 1921, was last increased in 1979—to $800 effective in 1981. The maximum standard deduction, set at $500 in 1953, was increased by 10 percent in 1979. Tax brackets and rates have not changed since 1937.

The 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 also falls on people well below the poverty level. In 1970, a family of four with income equal to the 1970 poverty level ($3,968) would have been en-

Table 1. State Income Tax Thresholds for a One-Earner Family of Four in 1988

Highest 10 States		Lowest 10 States	
California	$18,100	Illinois	$4,000
Mississippi	15,900	Indiana	4,000
Vermont	15,100	New Jersey	4,000
Rhode Island	15,100	Kentucky	4,300
New York	14,000	North Carolina	4,350 *
Maine	13,000	Alabama	4,400
Maryland	12,900	Arkansas	5,600
South Carolina	12,800	Hawaii	5,900
North Dakota	12,800	Virginia	5,900
Nebraska	12,800 **	Montana	6,500

Figures do not include tax credits offered to low income taxpayers in some states, including North Carolina.

*A state's tax threshold is the level of income at which a citizen begins owing income taxes. In North Carolina, the true tax threshold for a one-earner family of four before the general tax credit is applied is $4,222. This comparison overstates the tax threshold because it includes the maximum standard deduction of $550. Many low-income taxpayers cannot take the maximum deduction because they do not earn enough income. These taxpayers instead deduct 10 percent of their adjusted gross income.

**Four other states also have a $12,800 threshold: Minnesota, Kansas, Idaho, and Colorado.

Source: The Unfinished Agenda for State Tax Reform, National Conference of State Legislatures, November 1988, p. 170.

titled to exemptions totaling $4,200, or 106 percent of its income. Poor families cannot always use the full value of their exemptions because exemptions cannot exceed income, and in this case the family would have owed taxes of $23.57, or 0.6 percent of its income. By 1987, a family of four at the 1987 poverty level ($11,612) would have had exemptions totaling $4,900, equal to only 42 percent of its income, and it would have owed $191 (before applying the general credit), or 1.5 percent of its income. Thus, while the officially defined poverty level increased 193 percent between 1970 and 1987, the income tax liability for families at that income level increased 710 percent. The general credit available to low income taxpayers who do not receive food stamps would have reduced the tax liability by $50 in 1987 (only $25 now, due to a 1988 amendment). But even after applying the general credit, taxes owed by a family at the poverty level would have doubled to 1.2 percent of the family's income, and its tax bill would have increased by 498 percent.

Another indicator of income taxes on the poor is the *tax threshold*—the income level at which people begin to owe income taxes. In a recent comparison of state income taxes on one-wage-earner families, the National Conference of State Legislatures found that North Carolina's tax threshold of $4,350 for a one-earner family with an income of $10,000 was lower than that of most other states with state income taxes (See Table 1). Furthermore, the amount of state income taxes owed by a family of four with income of $10,000 was larger in North Carolina than in all states except Kentucky.[6] Although the general credit increases North Carolina's tax threshold to $5,148 for a one-earner family of four (providing it does not receive food stamps), only 11 states had thresholds that low. Sixteen states had thresholds above $8,000 and 12 had thresholds above $10,000.

Another aspect of North Carolina's tax structure that should be considered is that, although the state relies less on sales taxes than many other states, the sales taxes it uses are more burdensome to the poor than those used in most states. And since 1961 the trend has been for North Carolina to rely more on sales taxes.

Tax Term Simplification

The following is a guide to sometimes confusing tax terminology, as applied to the North Carolina personal income tax:

Adjusted Gross Income — Income from wages, salaries, and other sources of taxable income, less deductions for certain expenses incurred in earning income.

Personal Exemptions — Flat dollar amounts allowed for taxpayers and dependents. These exemptions are subtracted from gross income in determining net taxable income. Examples include $2,200 for one working spouse or head of household, $1,100 for a second spouse earning income, and $800 for each dependent.

Personal Deductions — Certain personal expenses that may be deducted from adjusted gross income. Examples include interest payments on a home mortgage, charitable contributions, property tax payments, and medical expenses. In lieu of itemizing deductions, taxpayers are allowed to take a standard deduction of 10 percent of adjusted gross income, subject to a maximum of $550. The standard deduction is often used by renters and others who do not have a lot of allowable expenses.

Net Taxable Income — The amount of taxable income remaining after subtracting personal exemptions and personal deductions from adjusted gross income.

Tax Rate — A percentage to be applied to net taxable income to determine a person's tax liability.

Tax Bracket — A range of net taxable income for which a specific tax rate applies.

Tax Threshold — The amount of gross income that can be earned before a person pays income tax. In general, the threshold is the sum of the personal exemptions and the standard deduction. In North Carolina, this amount is $4,222 for a one-earner family of four.

Tax Credit — A fixed amount that may be deducted from tax liability to determine the amount of tax actually owed. Tax credits provide relief for certain expenditures incurred by the taxpayer. In addition, credits may be used to target overall tax relief to low-income taxpayers.

Progressive Tax — A tax is progressive when the ratio of tax to income rises as income rises.

Regressive Tax — A tax is regressive when the ratio of tax to income falls as incomes rise.

Source: Definitions of tax terms were provided by David Crotts, chief tax analyst for the legislature's Fiscal Research Division, with the exception of the definitions of progressive and regressive taxes. These two definitions were taken from Joseph A. Pechman and Benjamin A. Okner, *Who Bears the Tax Burden?*, The Brookings Institution, Washington, D.C., 1974, p. 1.

The base of North Carolina's retail sales tax includes food purchases—which are exempted from taxation in 28 states—and charges for telephone, electricity, and natural gas services, which are exempted in 32 states (eight states also exempt sales of clothing).[7] Furthermore, utility charges in North Carolina are taxed at a combined rate of 6.22 percent under the retail sales and utility franchise taxes, compared with the overall state and local retail sales tax rate of 5 percent. The 1985 exemption of food stamp purchases provided substantial relief from sales taxes on food purchases for those who receive food stamps.

North Carolina has increased greatly its reliance on the retail sales tax. In addition to adding food sales to the tax base in 1961, the General Assembly in 1971 also authorized local governments to levy a 1 percent retail sales tax. That local rate was doubled with increases authorized in 1983 and 1986. North Carolina's combined state and local rate of 5 percent equals the median state rate and is levied on a base that is substantially larger than that of most states because it includes food purchases and utility charges.

Measures for Reducing Taxes on the Poor

Even if there are no further increases in sales taxes, taxes on the poor will continue to increase disproportionately because inflation will continue to erode the value of income tax exemptions and tax brackets. The following are measures that might be considered as ways to reduce the tax burden on the poor or to adjust the overall tax structure to compensate for inflation, plus a brief discussion of a proposal to replace the current state income tax with a new tax based on the federal income tax.

■ *Allow poor families to take full advantage of existing exemptions.* Many poor families cannot take full advantage of the personal and dependents exemptions to which they are entitled under current law, because the law provides that the spouse who claims the head-of-household exemption must claim all dependents exemptions ($800 for each dependent). Many poor heads of household do not have income sufficient to take full advantage of their exemptions and the standard deduction, and the spouse cannot claim the unused portion of dependents exemptions. For poor people, this provision negates the purpose of dependents exemptions, which are intended to adjust tax liabilities for family size—a poor family with eight children could be liable for the same amount of taxes as a family with the same income and two children. This problem could be corrected with relatively little revenue loss for the state by allowing a spouse to claim the unused portion of dependents exemptions.

■ *Increase the value of personal exemptions.* Exemptions are fundamentally important in achieving overall tax equity under a personal income tax. They shelter a minimum level of income, thus keeping the poorest people off the tax rolls. They also make the tax more consistently progressive. Although exemptions have the same absolute value for all taxpayers, the relative value (the percentage of income they shelter) diminishes as income rises, and an increase in exemptions provides a much greater proportionate reduction in taxes for low-income taxpayers than for high-income taxpayers.

Increasing exemptions to offset inflation is also important in maintaining the structure of the income tax. If exemptions were to remain unchanged as inflation continued, under the current rate schedule most taxable income eventually would be taxed at the highest rate, the rate schedule would become in effect largely a flat rate schedule rather than a graduated rate schedule, and the tax would continue to become less progressive.

The problem with increasing exemptions as a

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"While they're standing in the welfare lines
Crying at the doorsteps of those armies of
salvation
Wasting time in the unemployment lines
Sitting around waiting for a promotion."

—Tracy Chapman
"Talkin' 'Bout a Revolution"

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way to help poor people is that such increases benefit all those who pay state income taxes, not just the poor, and therefore cost much more in reduced revenue growth than other approaches. If exemptions were doubled, for example, the state would lose about $490 million a year in revenue, according to the legislature's Fiscal Research Division. This extra cost should be kept in perspective, however, because at the average growth rate of collections over the past decade, revenue from the personal income tax now increases about $300 million each year.

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Whether this approach should be used depends on the intended objective. If the objective is to maintain the overall equity of the income tax, adjusting exemptions, perhaps in small increments over a period of time, would be appropriate. If, on the other hand, the objective is to provide as much tax relief to the poor as possible for a given amount of loss in revenue growth, other measures like low-income tax credits would be more effective.

■ *Increase the standard deduction.* Deductions generally are more helpful to high-income taxpayers than to low-income taxpayers. For example, higher-income taxpayers are more likely to own their homes, and as homeowners they can deduct mortgage interest and property taxes. The 10 percent standard deduction (subject to a maximum of $550) is intended at least partially to offset that advantage for higher-income taxpayers. It can be taken only by taxpayers who do not claim other deductions. North Carolina's standard deduction, however, is lower than that of most other states. Only three other states have a percentage deduction that low, and others range up to 20 percent.[8] Of the 24 states in 1986 that had a maximum standard deduction, none was as low as $550. In 18 states the deduction for individuals exceeded $1,000; in 11 states it exceeded $2,000; and in two states it exceeded $3,000. North Carolina's standard deduction could be doubled to $1,100 at an annual cost (in lost revenues) of approximately $30 million.

■ *Create low-income tax credits.* Income-based credits against income tax liabilities have the advantage that they target tax relief only to low-income taxpayers, and therefore they cost much less in reduced revenue growth than increases in exemptions or the standard deduction that provide the same relief.

The primary disadvantage of this approach as a means of providing tax relief to the poor is that an income tax credit provides no relief to the poorest citizens, who are not liable for income taxes and therefore cannot use the credit. Only if a credit is refundable—if the unused portion of the credit is paid in cash—will credits benefit the poorest citizens. Another disadvantage is that this approach—unlike increases in exemptions, the standard deduction, or tax brackets—does nothing to correct the long-term effects of inflation on the overall equity of the income tax.

Despite their limitations, if income-based credits are designed carefully they can be an

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Tax Fairness Commission Recommends Restructuring of State Income Tax

The legislature's Tax Fairness Study Commission has recommended to the 1989 General Assembly a number of measures aimed at creating a more equitable tax system. Chief among these is a proposal to restructure the current state individual income tax to conform more closely to the federal system. By making the change, the state would be adopting the features of the Tax Reform Act of 1986 that eliminated the federal tax on more than 6 million poor families.

These measures include a $2,000 personal exemption for each family member and a $5,000 standard deduction for a married couple in the 1989 tax year. Thus, a family of four could earn $13,000 in income tax-free. By adopting these changes at the state level, North Carolina's 3 million state income tax returns could be trimmed by about a half million, says David Crotts, the legislature's chief tax analyst. "$13,000 is a high threshold," says Crotts. "You're knocking a lot of people off [the tax rolls]."

The Tax Fairness Study Commission's recommendation is to begin the state tax calculation with federal net taxable income. Thus, the state would be adopting federal rules on which income is taxable, which personal expenses may be deducted from gross income, and the amount of personal exemptions. For a married couple taking the standard deduction, the 5 percent rate would apply to gross income exceeding $13,000. The 8 percent rate would apply to gross income exceeding $33,000.

For a family of four with two dependents in which both spouses work, the proposal would lead to a lower tax bill if the family had a gross income of less than $45,000, according to the legislature's Fiscal Research Division. In 1988, less than 29 percent of North Carolina families had income exceeding $45,000.

Revenue lost by removing poor families from the tax rolls would be made up by increased taxes on high-income taxpayers. A family of four with $200,000 in income, for example, would see its tax bill increase by 12.7 percent. Commission members say shifting more of the state income tax burden to higher-income citizens is justified because the tax initially was intended to fall only on the well-to-do. Inflation and a failure to adjust tax brackets, deductions, and rates have resulted in a state income tax threshold of less than half 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. "The North Carolina system has too much of a burden on low- and middle-income citizens."

The $13,000 tax threshold for a family of four stands in sharp contrast to the current state income tax, in which a one-earner family of similar size would have a tax threshold of $5,148 (or $4,222 without the low-income credit). This is less than half the federal poverty line of $11,612 for a family of four in 1987. In one analysis of state policies affecting the poor, the Center on Budget and Policy Priorities found that in North Carolina a family of four earning $10,000 a year would owe state income taxes of $252, the second highest tax burden in the nation for a family of that income level.[1]

The proposed 5 percent rate would apply to married couples filing jointly and surviving spouses with a net taxable income of $20,000 or less; heads of households earning $16,000 or less in taxable income; single taxpayers earning $12,000 or less in taxable income; and married taxpayers filing separately and earning $10,000 or less in taxable income (See Table 2).

In addition, the restructured state income tax system generally would track the federal system so that taxpayers would not have to fill out additional forms to claim state tax credits, deductions, and exemptions. "The average person on the street, that person is going to benefit," says Rauch. The proposal is designed to be revenue-neutral, with the higher 8 per-

Table 2. A Comparison of Current Tax and Restructured Tax Proposed by the Tax Fairness Study Commission

Current Tax			Restructured Tax	
EXEMPTIONS				
$1,100	for single		$2,000	each for self, spouse and dependents
2,200	for married ($3,300 if both work)			
800	for dependents			
STANDARD DEDUCTION				
$550	maximum for each taxpayer		$5,000	for joint return/surviving spouse
			4,400	for head of household
			3,000	for single individual
			2,500	for married filing separately
TAX RATES				
All taxpayers:*			Married filing jointly and surviving spouse:	
$ 1 - 2,000	3 %		$1-20,000	5 %
2,001 - 4,000	4 %		20,001& over	8 %
4,001 - 6,000	5 %		Heads of households:	
6,001 -10,000	6 %		$1-16,000	5 %
10,000 & over	7 %		16,001& over	8 %
			Single individuals:	
* No joint returns allowed			$1-12,000	5 %
			12,001& over	8 %
			Married filing separately:	
			$1-10,000	5 %
			10,001& over	8 %

Source: Fiscal Research Division, N.C. General Assembly

cent rate supplanting revenue lost through the higher tax threshold.

The commission also proposes eliminating the intangibles personal property tax, a tax on stocks, bonds, and certain accounts receivable that is a bane to North Carolina's businesses and more affluent citizens. This action was taken independently of the decision to recommend restructuring the state income tax system, but may make more palatable the proposed income tax hike for higher-income citizens. "Sometimes you've got to sweeten the bitter dose," says Rauch.

North Carolina is one of only eight states which still have an intangibles tax in some form. The others are Florida, Georgia, Indiana, Kentucky, Michigan, Pennsylvania, and West Virginia. Eliminating the intangibles tax, however, would cost nearly $80 million in tax revenue, and the state already faces a lean budget year in 1989 because tax revenues have fallen short of projections. Because it is a property tax, intangibles tax is collected by the state but returned to local government. In some of the state's more affluent counties, such as Polk, the tax represents a substantial amount of local revenue that keeps other property taxes relatively low. In recent years, the General Assembly has made a practice of reimbursing local government for any local revenue lost through state changes in tax policy. Given this tradition, state budget leaders have said the revenue picture is too tight to consider eliminating the intangibles tax this year. But the study commission proposes that the loss be recouped through a 3.5 percent surcharge on corporate income tax bills and two additional income tax brackets for the state's wealthiest citizens.

The commission decided that corporations and the affluent should make up the lost revenue for two reasons: (1) they would be the prime beneficiaries of the elimination of the intangibles tax; and (2) their relative share of the tax burden has declined during the last 20 years. "I know if we come up with a good, sensible program, the Governor and the Speaker will listen to the proposal," says Rauch. (For more on the intangibles tax, see Sarah Denny Williamson, "Pro—The Intangibles Tax, Why It Should Be Retained," and James Culberson, "Con—The Intangibles Tax, Why It Should Be Repealed," *North Carolina Insight,* April 1985, Vol. 7, No. 4, pp. 8-15.)

Other tax adjustment proposals to benefit lower-income citizens include creating a food tax credit for low income citizens who do not receive food stamps and increasing the income tax credit for child care expenses. While food purchases are exempted from the sales tax in 28 states, North Carolina imposes a combined state and local tax of 5 percent. A 1988 study by Citizens for Tax Justice of Washington, D.C., ranked North Carolina 21st in the nation in the sales and excise tax burden it places on its poorest citizens. According to the study, the poorest fifth of North Carolina residents pay 5.6 percent of their income in sales taxes and excise taxes such as the gasoline tax.

The study commission's proposal would allow a refundable income tax credit of $45 to $75, depending on the number of exemptions claimed, for families with a net taxable income of less than $15,000. Crotts says the credits, which would cost the state less than $10 million a year, represent a rough approximation of the amount these families pay in taxes on food each year. Families which receive food stamps throughout the tax year would not be eligible for the credit because food stamp purchases are exempt from the sales tax. The general tax credit, which benefits all low-income households and is not targeted for food tax relief, would be eliminated in lieu of higher exemptions and deductions if the restructuring bill passed.

(Gov. James G. Martin has offered a proposal to raise salaries of teachers and other state employess that could lead to a cut in the food tax. Martin proposes that the 1989 General Assembly raise the sales tax by 1 percent. This would increase state revenues by $510 million in the first year — enough, Martin says, to implement his pay plan and cover part of the cost, in lost revenues, of removing the sales tax on food and non-prescription medicine.)

The increase in the income tax credit for child care, while not restricted to low-income taxpayers, would benefit those poor people who pay state income taxes and have dependents in day care. The current child care tax credit comes to 7 percent of the first $2,400 in expenses for one qualifying dependent. Taxpayers may claim the credit for up to $4,800 in expenses if they have two or more dependents in child care. The commission is proposing that the credit be increased from 7 percent to 10 percent of expenses. Under this proposal, the maximum credit would be $480. The estimated annual cost of the proposal is $12 million.

Although it does not have a direct impact on the poor, one proposal by the commission is of symbolic importance. Purchasers of motor vehicles, boats, airplanes, and railway locomotives currently get a tax break in the form of a 2 percent sales tax and a $300 cap. The commission proposed eliminating the cap, although it stopped short of recommending that these purchases be subjected to the full 5 percent state and local levy. Only one state, South Carolina, has joined North Carolina in placing a cap on the sales tax on motor vehicles, and only eight states give purchasers of motor vehicles a reduced sales tax rate.[2] Eliminating the cap but leaving the rate at 2 percent would increase state general fund revenue by $28 million in the first year alone.

—Mike McLaughlin

FOOTNOTES

[1]Isaac Shapiro and Robert Greenstein, "Holes in the Safety Nets, Poverty Programs and Policies in the States, North Carolina," Center on Budget and Policy Priorities, Washington, D.C., Spring 1988, p. 14.

[2]States which have a reduced sales tax rate for motor vehicle purchases are: Alabama, Mississippi, Missouri, New Mexico, North Carolina, South Dakota, Tennessee, and Virginia. Source: N.C. General Assembly's Fiscal Research Division.

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effective means of providing tax relief to low-income taxpayers. For example, a vanishing credit can be designed which diminishes as income increases, so that the most relief is offered to the poorest taxpayers, and there are no sudden jumps in tax liability when a threshold is crossed. Sudden jumps in tax liability for taxpayers are the chief drawback to no-tax floors, which provide that taxpayers below a certain income level, such as the federal poverty line, are not liable for taxes.

If adequate procedures are set up to provide refunds, credits can offset the disproportionate effects imposed by other taxes. For example, such credits can be used, as they are in several states, to compensate for the regressive effects of sales taxes, or they can be used to provide a limit on property taxes as a percentage of income (similar in effect to so-called circuit-breakers used in many states to prevent property taxes from exceeding ability to pay).

North Carolina adopted one of the nation's first tax credits for low-income citizens in 1985. When first enacted, the credit was based on the *separate* incomes of married spouses. This meant that some high-income couples could benefit from it—one spouse who earned $10,000 would qualify even if the other spouse earned $100,000, or even more. Furthermore, the amount of the credit available to families with the same income differed according to the spouses' share of earnings.

To close this loophole that allowed some high-income taxpayers to benefit from the credit, the 1988 General Assembly based eligibility of married spouses on their *combined* incomes and personal exemptions. This change also reduced by as much as half the credit available to low-income married couples. Doubling the maximum credit would restore this loss and cost the state $28 million in annual tax revenue.

■ *Reduce the burden of sales taxes on the poor.* Two approaches can be used to reduce the disproportionate burden of sales taxes on the poor. First, certain items like food, utility services, or clothing could be exempted from taxation. However, exempting food purchases and utility charges from retail sales taxes would result in $425 million in annual revenue losses, and most of that reduction would benefit moderate- and high-income taxpayers (although the poor would benefit more in relation to income). Furthermore, while such exemptions would reduce the regressivity of the retail sales tax somewhat, the sales tax overall still would be regressive.

The second approach is to offset the effects of sales taxes on the poor through use of refundable income tax credits. (The Tax Fairness Study

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"Once I built a railroad, made it run.
Made it race against time;
Once I built a railroad, now it's done;
Buddy, can you spare a dime?"
from "Brother Can You Spare A Dime?"
by Harburg & Gorney

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Commission has proposed a food tax credit ranging from $45 to $75 for low income people who do not receive food stamps. The cost is estimated at less than $10 million a year. For more on this proposal, see sidebar, page 146.) Ideally, such credits, if based on a sliding scale, would convert a regressive sales tax to a progressive tax in the lower range of incomes. The main problem with this approach is that many poor families would not file the forms necessary to obtain the refund of the unused portion of their credit. State and local agencies would have to undertake special measures to get poor people who do not file income tax returns to apply for the credits. Experience in other states indicates that it takes a number of years for a majority of eligible families to seek the credit.[9]

■ *Adopt the federal definition of taxable income.* The Tax Fairness Study Commission has recommended that the 1989-1990 General Assembly replace the present income tax with one based on federal laws that define taxable income. This would mean adoption of the much higher personal exemptions and standard deductions allowed under federal law.

Under the proposal, the starting point for calculating taxable income for North Carolina returns would be the amount of taxable income as defined on the taxpayer's federal income tax return. The amount would be adjusted by certain additions or subtractions authorized by law (for example, the General Assembly might allow persons retired from the military to subtract the exclusion they receive under current law).

After adjusted federal taxable income is calculated, tax liability would be determined by applying a new income tax rate schedule. Because the federal tax uses a different approach in defining how income must be reported, married couples are allowed to file joint returns. North Carolina treats the individual as the reporting unit and therefore does not permit joint returns. The current tax rates are applied to separate taxable incomes of spouses. To achieve equity between different kinds of taxpayers, the single tax rate schedule of the current tax would have to be replaced by different rate schedules, one for each type of tax status. That is, there would be separate schedules for married couples filing jointly, married couples filing separately, heads of household, and single taxpayers. For married couples, the tax rate would be 5 percent on taxable income of $20,000 or less and 8 percent on taxable income above that amount. For taxpayers claiming a different filing status, the rates would remain the same but the break would come at different income levels.

Earlier proposals to base the state tax on the federal tax were promoted primarily as a means of simplifying tax filing—most record keeping and calculations of deductions would be the same for both federal and state purposes. But the more important and more fundamental effect would be to increase substantially the amount of exemptions and the standard deduction and therefore to make the tax much more progressive, especially for people of low and middle incomes. North Carolina's separate exemptions for heads of household, spouses, and dependents would be replaced by a single federal exemption that applies to taxpayers and dependents. Exemptions would increase to $2,000 for taxpayers and dependents. The standard deduction—now a maximum of $550 for heads of household and single taxpayers and $1,100 for working married couples—would be $3,000 for single taxpayers, $4,400 for heads of household, and $5,000 for married couples filing jointly. A one-earner family of four would have a tax threshold of $13,000, well above the federal poverty line for a family of that size and more than three times the current tax threshold of $4,222.

Increasing exemptions and the standard deduction would benefit all taxpayers, not just low-income taxpayers, so the cost in lost revenue from those increases would be substantial without some offsetting change. The proposed tax package is supposed to be revenue neutral, with the cost of higher exemptions and standard deductions offset by changing the rate schedule. According to the legislature's Fiscal Research Division, working married couples with two dependents and combined incomes below about $45,000 would pay less tax, and those taxpayers with the lowest incomes would have the largest percentage tax reductions. Working married couples with combined income of $57,500 would pay about 7 percent more, 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 increase in progressivity at lower and middle incomes is due mainly to the increased exemptions and standard deductions, but the proposed rate schedule actually is not as graduated as the present rate schedule of 3 to 7 percent. High income taxpayers would pay 8 percent rather than 7 percent on most of their taxable liability, but their taxable income would be somewhat less because of the higher exemptions.

The increased progressivity that would result from the change can be seen by comparing estimated changes in tax liability as a percent of gross income for three four-member families with gross incomes of $13,280, $57,500, and $236,000. According to the legislature's Fiscal Research Division, these families would pay 1.4, 4.6, and 5.6 percent of their gross incomes under the current system. Under the proposed system the percentages would change to 0.1, 5, and 6.4 percent. (See Table 3 for a comparison of tax liabilities under existing state personal income tax and proposal by the Tax Fairness Study Commission.)

What would be the advantages of the proposed system? The main benefit would be that the

Table 3. 1988 State Personal Income Tax Liability and Liability Under 1989 Tax Fairness Study Commission Proposal

Gross Income	$10,000	$20,000	$40,000	$80,000	$200,000
			Tax Liability		
Single:					
Current	$ 315	$ 988	$ 2,118	$ 4,610	$ 12,506
Proposed	250	840	2,346	5,256	14,328
% Change	-20.6 %	-15.0 %	10.8 %	14.0 %	14.6 %
Head-of-Household, Two Dependents:					
Current	$ 223	$ 876	$ 1,978	$ 4,498	$ 12,254
Proposed	—	480	1,888	4,820	13,744
% Change	-100.0 %	-45.2 %	-4.6 %	7.2 %	12.2 %
Married, Two Workers, No Dependents:					
Current	$ 207	$ 699	$ 1,821	$ 4,369	$ 12,069
Proposed	90	550	1,880	4,904	13,784
% Change	-56.5 %	-21.3 %	3.2 %	12.2 %	14.2 %
Married, One Worker, Two Dependents:					
Current	$ 98	$ 876	$ 1,950	$ 4,442	$ 12,114
Proposed	—	133	1,560	4,480	13,320
% Change	-100.0 %	-84.8 %	-20.0 %	.9 %	10.0 %
Married, Two Workers, Two Dependents:					
Current	$ 223	$ 604	$ 1,653	$ 4,145	$ 11,817
Proposed	—	350	1,560	4,480	13,320
% Change	-100.0 %	-42.1 %	-5.6 %	8.1 %	12.7 %

Source: Fiscal Research Division, N. C. General Assembly changes would correct the past effects inflation has had in reducing the value of exemptions, the standard deduction, and tax brackets, and therefore would make the income tax more progressive. If the change could be made with the proposed rate schedule, it could be implemented without unduly increasing the amounts of taxes owed by moderate- and high-income taxpayers, and the highest marginal tax rate would increase by only 1 percent. If the changes were in fact revenue neutral, relief could be provided to lower-income taxpayers without having to increase other taxes or reduce the state's revenue. In addition, filing tax returns would be simplified.

But there are potential drawbacks to the proposed change, aside from the objections likely to come from higher-income citizens who will have higher tax liability. Income tax revenues probably would not grow as fast as in the past, because there would be fewer rate brackets and the rate structure would be less graduated than under the current system, meaning less bracket creep due to inflation. And by adopting the federal definition of taxable income, North Carolina would be using provisions enacted by Congress rather than the General Assembly. Changes in federal provisions, such as the major tax reforms of 1986, would affect state revenue. Some of these federal changes might be offset by authorized adjustments, though perhaps at the expense of simplified filing.

The proposed change seems appealing because it would increase the progressivity of the tax and simplify tax return filing. But the effects of the change on different kinds of taxpayers and on revenue are unknown. Using the federal tax as a base involves more than simply an increase in exemptions and standard deductions and easier filing of returns. The federal tax is based on a different kind of reporting unit and allows joint returns. The approach used in the present state tax does not permit joint returns. Which approach is best is debatable, but a shift to the federal approach can result in substantially different effects among taxpayers. Inequities between different types of taxpayers at comparable income levels can result if the tax rate schedules are not set carefully.

A Growing Burden

North Carolina's growing reliance on sales taxes has increased the disproportionate burden of those taxes on the poor. Erosion in value of exemptions, the standard deduction, and tax brackets has increased income taxes on the poor and reduced the progressivity of the income tax. Recently adopted measures like the exemption of food stamp purchases from the retail sales tax and the general credit for low-income taxpayers have provided some relief for the poor. However, income taxes on the poor will continue to increase unless changes are made to offset the effects of inflation. As a result, the effectiveness of the income tax in achieving overall equity according to the ability-to-pay principle will continue to be eroded.

FOOTNOTES

[1]*State Government Finances in 1986,* U.S. Department of Commerce, Bureau of the Census, Table 58, p. 89.

[2]The six states with no personal income tax are Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. The seven states in which the tax accounts for less than 10 percent of total state and local tax revenue are Alaska, Connecticut, Louisiana, New Hampshire, New Mexico, North Dakota, and Tennessee. Sources: *State Government Finances in 1986,* Table 6, pp. 10-13, and *Government Finances in 1985-1986,* Table 29, pp. 46-97, both publications by U.S. Department of Commerce, Bureau of the Census.

[3]Although North Carolina's highest personal income tax rate of 7 percent applies to taxable income in excess of $10,000, the state does not permit joint returns. Thus, a two-earner family of four with income divided equally between the spouses would pay the full 7 percent rate only for household income in excess of $26,000 (includes head of household and spousal exemptions totaling $3,300, plus exemptions of $800 each for two dependents, and standard deductions of $550 each for the two taxpayers). According to N.C. Department of Revenue data, only 39 percent of taxpayers who filed returns for tax year 1986 had taxable income in excess of $10,000 so that at least part of their income was taxed at the full 7 percent rate.

[4]Tax estimates are based on hypothetical families whose income and spending patterns are derived from data from the U.S. Bureau of Labor Statistics, Survey of Consumer Expenditures.

[5]G. S. 105-151.16. As amended by Chapter 1039 of the 1988 Session Laws, the credit is based on combined income and personal exemptions of married couples. If income less personal exemptions is less than $5,000, then the credit is $25; the credit is $20 if income is $5,001 to $10,000, and $15 if income is $10,001 to $15,000. Recipients of food stamps and certain others such as those in prison or in a hospital for more than six months of the tax year are not eligible.

[6]Steven D. Gold, *State Tax Relief for the Poor,* National Conference of State Legislatures, Denver, Colo., April 1987, Table 3-1, pp. 34-35.

[7]Comparisons of tax provisions are from the Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism,* 1987 edition, Washington, D.C., Table 50, pp. 56-57.

[8]Gold, *op. cit.,* Table 3-5, p. 46. The three states are Delaware, Arkansas, and West Virginia.

[9]Steven D. Gold, *The Unfinished Agenda for State Tax Reform,* National Conference of State Legislatures, Denver, Colo., November 1988, p. 170.