QUESTIONS FOR DR. KLASE

LWVNC Tax Policy Review, Session Two

February 20, 2024

State and Local Taxation: Pros & Cons with a Focus on Equity Issues

(Supplement to Video Recording)

1. **As noted in your presentation the rate decline on corporate income taxes creates inequities between individuals and corporations. Does the decline in rates for corporations help smaller businesses that operate as a sole proprietorship or partnership? Or does NC's current business tax system disproportionately help large corporations?**

   The decline in the corporate income tax does not help smaller businesses that operate as a sole proprietorship or partnership. In North Carolina, the corporate income tax generally does not apply to sole proprietorships and partnerships which normally operate as pass-through entities with owners and partners paying personal income taxes on their share of income. So, for the most part, NC's current business tax system does disproportionately help larger corporations more than smaller businesses as far as corporate income taxes are concerned. Nonetheless, larger corporations still have to pay the NC franchise tax which imposes higher rates for larger corporations with net worth over $1 Million ($1.50 per $1,000 of its net worth over $1 million in addition to the normal rate of $200 on all corporations), but this does not impose much of a tax burden. In addition, it should also be noted that most smaller businesses as pass-through entities do benefit from the dramatic reductions in NC personal income tax rates since 2013. So smaller businesses are helped in this way in addition to not having to pay corporate income taxes as pass-through entities in the current business tax system.

2. **When the corporate income tax goes to 0, will corporations provide any revenue for the state's infrastructure such as education of employees' children, State Highway Patrol, health and safety inspectors, etc.?**

   If the NC corporate income tax rate is reduced to 0, corporations would still have to pay the NC franchise tax, which would still impose some tax burden (however small) but only on larger corporations on their tax base over $1 million. However, the franchise tax is a much smaller proportion of the state's total revenue than corporate income tax.

3. **Do tax incentives (e.g., deductions, exemptions, credits) produce the desired results? If yes, which ones and how? If not, which ones and why not?**

   I assume that this question refers to business tax incentives in general from various tax sources rather than individual types of taxes to which these incentives might apply. First, it should be noted that public finance economists do not favor deductions, exemptions, and credits, etc., regardless of which type of tax because they diminish the tax base and cause tax rates to be higher than what they would otherwise need to be to raise equivalent revenues. In the context of business tax incentives, North Carolina is generally considered a business-friendly state with many tax incentives for business activity within the state as well as incentives for corporations/businesses to locate in the state.

As an example, the NC business tax deduction was created in 2011 by the General Assembly to provide tax relief to small businesses and support job creation in the state. It provides for a $50,000 business income tax deduction for non-passive businesses. The NC Justice Center's review indicates that this deduction does not support small businesses or encourage job creation. Benefits accrue mainly to higher income North Carolinians with high costs in lost income tax revenues and with low return in terms of relief to small businesses and job creation. https://www.ncjustice.org/publications/north-carolinas-business-tax-deduction-who-benefits/

Other examples include the wide range of exemptions from NC sales and use taxes offered for business activity within the state and for businesses to relocate or open new facilities in North Carolina: manufacturing machinery and equipment; electricity, fuel and natural gas for manufacturing facilities, raw material for manufacturing, and inventories; data centers, large fulfillment facilities, research and development and software facilities, pollution control and abatement equipment and recycling, and historic preservation. As another example, there are also tax credits for companies locating and doing business in North Carolina for creating new jobs, investing in business property, and investment in real property. North Carolina has incentives for business development in designated counties based on level of economic distress, and the tier system is incorporated into various state programs to encourage economic activity in less prosperous areas of the state.

Despite business tax incentive measures such as the examples described, there is not a consensus on whether these measures create positive effects as intended. The following quotes from a UNC School of Government article in their *Popular Government* publication are very pertinent in this regard: "The strongest argument offered by proponents for the continued and expanded use of incentives is that incentives actually influence business location decisions. Although some evidence supports this claim, skeptics cite numerous studies that show incentives having little to no positive direct effect on investment decisions." "A recent analysis of North Carolina's Lee Act tax credits suggests that "tax incentives go to firms without significantly influencing their decisions on investment and employment." " Incentives are only one of several factors that businesses consider in site selection." Corporate tax rates, state and local incentives, and tax exemptions are middle grade considerations overall compared to operational factors such as highway accessibility, labor costs, energy availability and costs, and availability of skilled labor. Beyond operational considerations, some would also include quality of life considerations.

"Despite the ambiguity about whether incentives result in the creation of jobs and investment by firms that would not otherwise occur, most studies conducted through the 1980s found that taxes and incentives have little to no effect on macrolevel economic growth. This is counterintuitive because lower business tax burdens are thought to be more conducive to growth. Later research indicates that taxes might matter more than initially thought and particularly that higher taxes can hinder economic growth. If that is true, then by easing the tax burden on firms, incentives could make a place more competitive for business investment and thereby spur economic growth." So, if the state is at a high level of business taxation in comparison to other states, then there may be a disadvantage in economic development competition. Of course, that does not mean that the state needs to have the lowest or no corporate income tax or the most extensive array of business incentives to be highly competitive in business development . "In sum, the research to date suggests that economic development incentives do not always induce firms to create substantial jobs and investment that would not occur without the incentives (or at least that it is not necessary to have the most extensive incentives creating extraordinary tax inequities between corporate and individual tax burdens). This appears to be the case despite the fact that companies say incentives are important factors in site selection. The case for using incentives to promote growth at a macrolevel and in lagging areas is more compelling." (*Popular Government* publication article: "Using economic development incentives: For Better or Worse," Jonathan Q. Morgan Using Economic Development Incentives: For Better or for Worse | UNC School of Government

4. **Do local governments have enough tax base to finance school construction or other local responsibilities?**
    a. **How does this differ across counties, particularly rural vs urban/suburban counties?**
    b. **Should poor counties get a higher distribution of taxes collected at the state level (e.g., gas taxes, taxes to pay for public education)?**
    c. **Should extra public burdens such as transportation and affordable housing faced by urban counties merit a higher distribution of state taxes?**

Counties have the primary responsibility for the cost of capital expenses (buildings and maintenance) in North Carolina's school financing system and provide the majority of capital funding for schools from a combination of property taxes and local sales tax proceeds while the state has been primarily responsible for instructional expenses including personnel. Nonetheless, funding for school infrastructure in North Carolina comes from a combination of sources: Nearly 40 percent of funding for public education stems from local taxes (44% Local, 45% State and 11% Federal). The problem with local governments relying on these two revenue sources for capital funding of school infrastructure is that these tax bases vary significantly by county, particularly in relation to urban/suburban counties versus rural counties EdBuild | Building Equity: Fairness in Property Tax Effort for Education. In addition, the following should also be noted: "Despite these funding sources, there are still concerns about insufficient funding for school infrastructure in North Carolina. In recent years, there has been an increasing demand for improvements and renovations to existing facilities, as well as a need for new construction to accommodate growing student populations. However, limited budgets and competing priorities often make it difficult to meet all the needs of schools across the state. In 2020, a report by the Public School Forum of North Carolina found that there is currently a backlog of over $8 billion in deferred maintenance needs at public schools in the state. This backlog includes repairs and updates to buildings, mechanical systems, technology infrastructure, safety improvements, and more. "

Financing Education in North Carolina – North Carolina Justice Center (ncjustice.org)

So many local governments do not have the tax base within available revenue sources to finance school construction costs of these dimensions or costs associated with many other responsibilities without additional support.

Fortunately, the state provides additional resources for school capital construction. "The state provides basic funding for new construction, renovations, repairs, and replacement of schools through the Public School Building Capital Fund (PSBCF), which is part of the state's Education Lottery. In addition, the state offers low-interest loans to local school districts for capital projects through the North Carolina Education Assistance Authority (NCEAA)… Any public school in North Carolina can apply for infrastructure funding through the PSBCF or NCEAA. However, priority is given to schools with more pressing facility needs and those in lower-wealth districts."

"North Carolina has taken several measures to improve school infrastructure funding including:

1. The North Carolina Public School Building Bond Act: This law authorizes the state to issue bonds to finance school construction and renovation projects. In 2019, voters approved a $1.9 billion bond package for school infrastructure improvements.
2. Needs-Based Public-School Capital Fund: This fund provides grants for low-wealth counties across the state to address critical school infrastructure needs.
3. Excellent Public Schools Act of 2016: This law established a new formula for distributing capital funds to schools based on need rather than size, providing more resources to schools in high-growth areas.
4. Joint Legislative Task Force on Education Finance Reform: This task force was created in 2016 to study and make recommendations on how the state funds public education, including school infrastructure.
5. State Capital Infrastructure Fund: This fund was created in 2017 and provides annual appropriations for repairs, renovations, and expansions of state-owned buildings and facilities, including schools."
6. Local Sales Tax Option: In 2017, the state legislature gave county boards of education the option to request voter approval for a quarter-cent sales tax increase to fund local school construction needs.
7. School Construction Lottery Fund: The North Carolina Education Lottery devotes a portion of its profits each year to fund K-12 school construction projects across the state.
8. Private-Public Partnerships (PPP): This approach allows private entities to finance, construct, and maintain public facilities such as schools in exchange for long-term lease agreements with local governments or school districts. (K Nordstrom, Financing Education in North Carolina, https://www.ncjustice.org › 2018/11)

Overall, the state has taken significant actions over the years (and likely will continue to do so) to support local government needs with respect to school capital construction. The state does take into consideration in many of its measures the economic status of counties and the level of needs for low-wealth counties. However, the needs in this area are significant and more could obviously be done to address these needs. Education funding is not the only area where disparate needs by local governments are taken into consideration. The distribution of state funding (including state funding for transportation and housing programs) is generally based on a formula that takes into consideration factors such as demographics and economic needs.

5. **In 2016, the sales tax base was expanded to include some repair, maintenance, and installation services. What is your assessment of the equity of expanding the sales tax base – both in fairness to businesses selling personal property vs. services and to consumers?**

   The expansion of the sales tax base to include some repair, maintenance, and installation services is an effort by the legislature to generate additional revenue from this type of tax, which the legislature generally finds preferable to income and corporate income taxes because it is based on consumption, regardless of the impact this addition to the sales tax base has on those with lesser ability to pay the tax. The rationale for categorizing the sales tax as a “fair tax” is that the tax base is consumption which in the view of some is voluntary behavior, and in addition, the tax also provide incentive for saving vs consumption which is desirable in the view of some. The rationale for the changes did not likely involve any considerations for fairness in coverage of the tax to both businesses selling personal property vs. services, and for that matter, equity in applying yet further tax burden on consumers. An argument can certainly be made that the expansion of the tax base to include some services does result in greater equity in how services are treated in comparison to other retail businesses who have previously been the only ones included in the sales tax base. It may be inevitable that more services will eventually be included in the sales tax base as other tax rates for other state taxes are being radically reduced and the need for revenue continues to expand. As far as the equity of the change in the sales tax base with respect consumers, it is clear that the sales tax has been made even more regressive in its impacts as yet more has been added to the tax base without much consideration about imposing yet more tax burden on those with less ability to pay. Perhaps it could be justified to some extent if analysis revealed that repair, maintenance, and installation services now included in the tax base were more utilized by higher income individuals than those with lesser ability to pay, but I don’t think that is the case.

6. **In the mid-90s League members lobbied for the repeal of the state sales tax on food which had risen to 4%. By 1999, the state sales tax on food was eliminated, except for the prepared food provisions. As you noted in your presentation, counties continue to tax food at 2%. If the local tax on food was eliminated or phased out to mitigate the tax burden on lower income families, what options, if any, do local governments have to replace the loss of revenue?**

   If the 2% local tax on food was eliminated or phased out for equity reasons, local governments would have limited options to replace the loss or revenue. There have been provisions for voter approval of local option sales tax increases that the state legislature has provided in the past for particular local government needs, such as additional funding for local school construction. It is possible that provisions might be approved by the state for something similar that would apply to the sales tax base while still allowing food to be excluded in eliminating the existing 2% local government sales tax on food. Additionally, there are existing provisions for local governments to request state legislative approval for a prepared meals sales tax, and some cities are already using this mechanism to generate revenue. This applies to meals prepared at restaurants, and presumably applying a tax to the sales of these prepared meals would impose the greater tax burden on those who dine in restaurants, indicating their greater ability to pay. The only other option to replace lost revenue if the 2% local government sales tax on food was eliminated would be increasing other own-source revenues, such as property taxes or user charges and fees. These would create their own equity issues.

7. **How common is it in the US for state governments to have control over the types of local taxes that can be levied and how the revenue can be spent?**

   It is very common for state governments to control local taxes and the uses for which they can be spent. In fact, this is the case in an overwhelming majority of states. In local government finance, this is the result of Dillon's Rule (a court ruling on the power of states versus their local governments who are considered creatures of the state):
   "The Dillon Rule is the principal that local government only exercises (1) powers expressly granted by the state, (2) powers necessarily and fairly implied from the grant of power, and (3) powers crucial to the existence of local government."

   "Local governments are created, or authorized, by state governments. In North Carolina, local governments can do only the things authorized by the state government. Some states allow local governments more leeway to do things so long as they are not prohibited by the state." So, in North Carolina and the majority of other states, the state decides what local governments in the state can do. LOCAL GOVERNMENT IN NORTH CAROLINA Local Government in North Carolina | UNC School of Government

8. **Do you believe nontraditional sources of revenue (e.g., lottery or casinos) are fair ways of collecting revenue and funding public needs in lieu of taxes?**

   Whether gambling nontraditional sources of revenue, such as lottery and casino generated revenues, are fair ways of collecting revenue and funding public needs is a controversial question, and its pros and cons can be debatable. The pros obviously are about the creation of additional sources of revenue for the state. These sources do in fact generate significant revenue for the state. The revenues are often tied to specific benefits to worthy public needs or just to the easy generation of revenue for the state without imposing additional taxes. Supporters often view the revenues as being generated through voluntary behavior of individuals which they view as a fair way to generate revenue as compared to taxes. The cons are often about the reality of revenues generated in comparison to proceeds that go to administrative costs and prizes and of course the often disappointing results of the real benefits achieved for the worthy public needs in comparison to expectations. In times past, raising revenues from gambling would have been considered immoral and even illegal, but that is not the case in the current era. The basis for moral and religious opposition from the past still has some continuing merit with respect to adverse social impacts and equity considerations. The potential impacts of these types of nontraditional revenues relate to issues of gambling addiction and mental health as well as other resulting social costs of gambling, which can be bad enough without government promoting gambling. From the standpoint of equity considerations for gambling revenues, lottery and casino revenues are regressive in their impacts. Regardless of the view that the behavior is voluntary, the burden of raising the revenue falls on those with lesser ability to pay. The proportion of revenues raised from those in higher income groups is lower than the proportion of revenues raised in groups with lower ability to pay. Thus, nontraditional revenues generated from gambling whether lottery or casino is not fair in relation to criteria for judging the equity of revenue sources. That being said, gambling nontraditional revenues like lottery and casino gambling will continue to be state revenue sources (and it seems expanded as in recent expansion of casino gambling in North Carolina), and the best that can be done would be to look at ameliorating their adverse impacts as suggested for example with respect to lotteries in this reference: (Smith, Ben (2002) "The State Lottery Tax: An Equity Analysis," Major Themes in Economics, 4, 1-19. Available at: https://scholarworks.uni.edu/mtie/vol4/iss1/3).

9. **Currently seven counties levy an additional 1% excise tax on land transfers on top of the 1% tax on transfers of real property. Why do only seven counties levy the land transfer tax? Is this because under state law only these seven counties are allowed to or is controlled by local ordinance? What are the revenues used for?**

   Only seven counties in North Carolina are authorized to impose an additional land transfer tax of up to 1% of the sale price. It is only seven because those are the counties that were authorized by state law to do so. It is not controlled by local ordinance. “The new(er) revenue sources are intended to help counties fund additional services and facilities necessitated by growth, but the proceeds actually may be used for any public purpose. Counties are neither required, nor authorized, to share the proceeds of either of these revenue sources with municipalities.” (New(er) County Revenue Sources – Local Land Transfer ... Coates’ Canons NC Local Government Law
   New(er) County Revenue Sources – Local Land Transfer Tax and Local Sales and Use Tax - Coates’ Canons NC Local Government Law (unc.edu)

Questions from Attendees:

1. **Will we get a copy of all the charts? They are very helpful in understanding the numbers, etc.**

   Copy of all PowerPoint slides, including charts, will be posted to the LWVNC website.

2. **What's the rationale for the corporate tax rate being less than the individual tax rate?**

   There is no particular reason that the corporate tax rate is less than the individual income tax rate. Both taxes have been reduced significantly since 2013 and continue to be reduced on a plan by the state legislature, which would like both to be as low as possible. Although the corporate income tax is already the lowest in the country, it is planned to be decreased to zero if the legislature has its way. The plan is also to reduce the individual income tax rate to 3.99% by 2027, which seems unlikely to meet the needs of the state since the individual income tax is such a large percent of total revenues (54.9%).

3. **The terminology you used for sales tax for state purposes was different than the terminology you used for local purposes. You used "sales and use" for state purposes but "sales and gross receipts" for local purposes. Please explain the difference or are the terms interchangeable?**

   The terms are not really interchangeable, but they are related as aspects of the sales tax and how it is applied uniquely in relations to specific aspects of sales transactions at the state and local government levels. Sales and Use tax at the state level refers to both sales tax on purchases of goods and services within the state and use taxes which are taxes imposed on taxable goods and services that were not taxed at the point of sale. Each state that imposes sales tax levies a use tax for purchases made outside of the state. So, in general, use tax rates are the same as sales tax rates. Use tax most often occurs when a consumer orders goods from outside of the state (such as online) and the retailer (not having nexus, or presence, in the consumer's state) does not have to charge sales tax on the purchase. So, it is the state getting its sales tax revenue on purchases even if the outside-the-state seller did not collect them. You pay the use taxes on your state individual income tax even if it is not collected by the seller outside the state.

   In North Carolina at the Local Government level, Gross Receipts Tax is applied very much like the Sales & Use tax and often on the same specific products / services:
   Room Occupancy Tax
   Prepared Food and Beverage Tax
   Short Term Motor Vehicle Rental
   Heavy Equipment Rental

   In North Carolina at the State and Local Government levels, the tax is not assessed against the business on its receipts; the tax is assessed against the ultimate consumer based on purchases and is collected by the business from the consumer. The tax is deemed to be held by the retailer in trust, to be paid to the government on a due date (usually the 20th day of each month). The retailer is put in the position of being an agent of the government for the collection of the tax. In North Carolina, Gross Receipts Tax is much more selective- targeted at particular activities for particular purposes. A County or Municipality can only impose a Gross Receipts Tax if it has been given the legal standing to do so by the General Assembly. (NCDOR.gov) 2-6: What is a Gross Receipts Tax Anyway? – NCDOR PPT, https://files.nc.gov/ncdor/documents/presentations/reid-grossreceipts.pptx

4. **When businesses assess whether to expand or move to NC how does the quality of public education factor in their analysis vis-à-vis the low corporate tax rate?**

   As indicated in question 3 in the first set of questions above, business location decisions are primarily about operational considerations for the business and only in middle range consideration for corporate income tax rates. Within the primary factors considered are a number of factors relating to quality of education in relation to availability of skilled labor or qualified employees which relates to quality of education. From a more general perspective, quality of life considerations are important considerations with respect to business location decisions.

5. **Historically NC spends the lowest % of state revenues on the courts. What is the impact of this on our state judicial system?**

The following indicates the extensive responsibilities of the North Carolina Court System and the issues with their allotted expenditures in the state budget and the inadequacy of their revenues to meet the needs indicated.

Funding for the courts. The North Carolina Constitution requires that the operating expenses – including the salaries of judicial officials — be paid from State funds. N.C. Const. Art. IV, § 20. Nearly 90 percent of the judicial branch's $578 million appropriation was spent on salaries and benefits in 2019-20. See North Carolina Administrative Office of the Courts, Annual Report of the North Carolina Judicial Branch 2019-20.

The State also is responsible for maintaining the facilities for the appellate courts. Facilities for trial courts are, in contrast, the responsibility of the counties, which must provide courtrooms, office space, and furniture for judicial branch operations. See G.S. 7A-302. Counties (and municipalities that have agreed to provide courtrooms and related facilities) receive court facility fees collected in their respective locales from the Administrative Office of the Courts, which may be used to defray the cost of providing those facilities and other services. See G.S. 7A-304(a)(2); -305(a)(1). Defray is the operational word as those amounts do not approach what is necessary to fully cover the expenditure. And the total collected from the fee has declined steadily in recent years, from over $20 million in fiscal 2008-09 to only $11 million in 2019-20. See North Carolina Administrative Office of the Courts, Statistical and Operational Report of the Budget Management and Financial Services 2019-20. Last year, Mecklenburg County received the largest amount, $931,477, while Hyde County received the smallest, $5,734. (UNC School of Government, Facts and Figures for the North Carolina Court System, Facts and Figures for the North Carolina Court System | UNC School of Government

A research report by the Fines and Fees Justice Center indicated the following key findings: Between FY 2011-12 and FY 2017-18, fines and fees revenue increased 26 percent whereas individual income tax revenue increased 22 percent. North Carolina ranks 6th out of all U.S. states in terms of how reliant it is on fees. Less than one percent of court fines and fees is used to fund the judicial branch, but 35 percent of this revenue is sent to the state treasurer, other state agencies, and law enforcement retirement funds. Recommendations were that state policymakers must look to more equitable funding sources. (Fines and Fees Justice Center, Pandemic lays bare North Carolina's reliance on fines and fees, Pandemic lays bare North Carolina's reliance on fines and fees - Fines and Fees Justice Center