

spotlight

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THREE TRUTHS OF TAX REFORM

Senate, House plans would spur growth, create jobs

KEY FACTS: • The House and Senate tax bills now under discussion in the General Assembly would constitute fundamental tax reform, not just a (welcome) cut in state taxes for most households.

• The impact of the House and Senate tax plans on future revenue growth will not prevent state government from funding core public services such as public schools and universities.

• There is strong empirical support for the idea that reforming and reducing state taxes as the House and Senate propose will increase job creation and economic growth.

for Truth

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as legislative leaders and Gov. Pat McCrory work to fashion a compromise bill to reform and reduce state taxes, there are three important truths that North Carolinians need to know about the tax bills produced over the past two weeks by the Senate and House. First, these bills constitute not just broad-based tax relief but also the most wide-ranging tax reforms the North Carolina legislature has voted on in decades. Second, the impact of these proposals on future revenue growth will not prevent state government from funding core public services such as public schools and universities. Third, there is strong empirical support for the idea that reforming and reducing state taxes will increase job creation and economic growth in North Carolina.

Tax Reform, Not Just Tax Cuts

While some have alleged that fundamental tax reform and significant tax relief are inconsistent, conservatives have never believed this to be the case. For decades, conservative politicians, scholars, and activists in North Carolina and beyond have debated various means of making the tax code simpler, fairer, and less biased against savings, investment, and capital formation. Recognizing that any worthwhile tax reform would reduce or eliminate special tax benefits defended by powerful interest groups, they have traditionally argued that tax reform should be structured as a net tax cut in order to motivate the majority of citizens who gain to overcome the opposition of the minority of special interests who stand to lose prized tax breaks.

Conservatives have also generally agreed on the goal of fundamental tax reform: to target consumption, not total income. All personal income is either saved, given away, or spent on goods and services. Savings is a means of shifting household consumption to the future. (Charitable giving is a means of shifting consumption from one household to another.) If government taxes the amount of money saved as well as the returns on that savings, it penalizes savings, i.e. future consumption, in favor of current consumption. In economic terms, such a system discourages the formation of private capital to finance business creation or expansion, thus reducing job creation and economic growth. Imposing a corporate income tax makes the problem even worse by subjecting the same stream of investment earnings to tax both as corporate income and again as dividends or capital gains.

While conservatives agree that tax reform should reduce the punitive treatment of savings and investment and achieve a net tax cut for most households, they have disagreed on means. Some conservatives have advocated a **Flat Tax**, which levies a single marginal tax rate on a broad base of wage income while exempting returns to investment, such as dividends and capital gains, that are earned on taxable savings. Some conservatives have advocated a **Fair Tax**, which levies a retail sales tax on a broad base of goods and services while exempting business-to-business transactions and eliminating income taxes. And some conservatives have advocated a consumed-income tax, sometimes called a **Universal Savings Allowance (USA) Tax**, which levies a single marginal tax rate on all personal income used for consumption rather than savings. All three models would abolish the corporate income tax.

Obviously, liberals have very different ideas about tax reform. For them, the main problem isn't that the current tax code hampers economic growth but that it generates too little revenue for government to spend. In other words, liberals think the current tax system lets households keep too much of their own money. Conservatives think the current tax system lets households keep too little of their own money. Many liberals also don't accept consumption taxation as the goal of tax reform (although there is a growing movement of liberal economists who favor a progressive consumption tax, albeit not in North Carolina¹) and would actually like the effective tax rate on investment to be even higher than it is now.

Because the current leaders of North Carolina's executive and legislative branches are conservatives, not liberals, it is hardly surprising that they define tax reform in conservative terms. They will certainly not let liberal activists or the news media define tax reform for them. Both the House and Senate tax bills are entirely consistent with basic

conservative principles of tax reform. Both plans reduce marginal tax rates on personal income. The House plan significantly reduces the tax rate on corporate income, and the Senate plan phases it out altogether. These measures reduce the effective tax rate on savings and investment, making North Carolina a far more attractive place to build and grow businesses.

Contrary to the claims of critics, both the House and Senate tax plans also broaden the base of North Carolina's income and sales taxes to eliminate special tax breaks and inefficiencies. The House tax bill reduces or eliminates at least 16 separate exclusions or differential rates, while the Senate tax bill reduces or eliminates at least 51 such "tax expenditures." In addition, both plans allow seven tax credits currently listed as "tax expenditures" in state reports to expire as scheduled, rather than renewing them as past legislatures have done.²

In short, whether the General Assembly enacts the House tax plan, the Senate tax plan, or something in-between, state lawmakers will be both cutting taxes and reforming the tax code.

Adequate Revenue Growth

Another liberal criticism of both the Senate and House tax plans is that they would rob state government of the revenue it needs to preserve and improve North Carolina's public schools, universities, and other core services. In reality, the fiscal impacts of the two tax plans are relatively modest. If enacted, they would leave most of the expected revenue growth over the next five years in the state treasury, available for government spending, rather than returning that money to taxpayers.

For the first two fiscal years, legislators are working with hard revenue estimates from the Fiscal Research Division. It projects baseline General Fund revenue (after deposits in rainy day and other reserves) of \$20.6 billion in FY 2013-14 and \$21.5 billion in FY 2014-15.³ The Senate tax-reform plan would subtract about \$523 million from the FY 2014-15 baseline, amounting to about 2.4 percent. The House tax-reform plan would subtract \$353 million from that baseline, or about 1.6 percent.⁴ Keep in mind that under both tax plans, General Fund revenue will grow over the next two years, just not as quickly.

Revenue projection becomes more challenging after FY 2014-15. There are essentially two approaches. One is to make the conservative assumption that baseline General Fund revenue will grow only at the combined rate of inflation and population from FY 2014-15 to FY 2017-18. The other approach is to assume that General Fund revenue growth will return to its 20-year historical average.

These conservative and historical scenarios are depicted in the table below. Under the conservative scenario, General Fund revenue would grow by 20 percent over the next five years without tax reform. Under the Senate tax reform, it would grow by 13 percent. Under the House tax reform, it would grow by 17 percent. Under the historical scenario, growth in General Fund revenue would be stronger, at 24 percent over five years. Under the Senate tax reform, it would grow by 17 percent. Under the House tax reform, it would grow by 21 percent.

Revenue Growth Under Tax Scenarios								
	FY 2012-13	FY 2013-14	FY 2014-15	FY 2015-16	FY 2016-17	FY 2017-18	Growth	Avg Annual Growth
Conservative Baseline	\$20,397.7	\$20,628.1	\$21,532.0	\$22,457.8	\$23,378.6	\$24,383.9	20%	3.6%
Senate Bill	\$20,397.7	\$20,454.3	\$21,008.8	\$21,349.7	\$21,963.8	\$23,001.8	13%	2.4%
House Bill	\$20,397.7	\$20,623.4	\$21,178.6	\$22,074.6	\$22,917.5	\$23,813.0	17%	3.2%
Historical Baseline	\$20,397.7	\$20,628.1	\$21,532.0	\$22,709.8	\$23,952.0	\$25,262.2	24%	4.4%
Senate Bill	\$20,397.7	\$20,454.3	\$21,008.8	\$21,601.7	\$22,537.2	\$23,880.1	17%	3.2%
House Bill	\$20,397.7	\$20,623.4	\$21,178.6	\$22,326.6	\$23,490.9	\$24,691.3	21%	3.9%

As you can see, tax reform's implications for future revenue and spending growth in North Carolina vary according to one's assumption. Still, even under the conservative scenario, most revenue growth over the next five years would be available to spend on state programs under both the Senate and House plans. Furthermore, if conservatives are right about the potential effects of tax reform on state economic growth, the higher revenue projections for the historical scenario — 3.2 percent General Fund revenue growth under the Senate tax plan and 3.9 percent under the House plan — will likely prove more accurate.

State Taxes and Economic Growth

While liberal critics claim that North Carolina's economy will not derive significant benefits from the Senate and House tax plans currently under discussion, this claim is clearly at odds with the available evidence. Dozens of economic studies published in academic and professional journals have found significant relationships between state taxes and measures of state economic growth such as employment, business starts, per-capita income, or state GDP. This research is summarized and discussed in great detail in two recent John Locke Foundation books, *Our Best Foot Forward* and *First in Freedom*⁵.

In just the past two decades, studies revealing links between economic growth and state taxation have been published in many such journals, including *American Economic Review*⁶, *Southern Economic Journal*⁷, *Journal of Regional Science*⁸, *National Tax Journal*⁹, *Contemporary Economic Policy*¹⁰, *Growth and Change*¹¹, *Papers in Regional Science*¹², *Economic Letters*¹³, *Federal Reserve Bank of St. Louis Review*¹⁴, *Journal of Entrepreneurship & Public Policy*¹⁵, *Journal of the American Taxation Association*¹⁶, *International Journal of Economics and Finance*¹⁷, and *Public Finance Review*¹⁸.

It would clearly be an overstatement of the scholarly research to say that state taxes are the sole or dominant factor in determining the rate of state economic growth. Many other factors, some influenced by public policy and others arising entirely from the private marketplace, play key roles in economic development and growth. But anyone who suggests that reducing and reforming state taxes won't create at least some positive response in the private economy is ignoring a large body of empirical evidence to the contrary.

Based on previous JLF research about state tax reform, it is likely that either the House or Senate tax plans would result in thousands of new jobs created in the short run and even greater benefits for entrepreneurship, job creation, and income growth in the long run. The Senate tax plan would have stronger economic effects because of its lower tax rate on personal income and phase-out of the corporate income tax. The flipside, of course, is that it has a larger effect on state revenue availability over the next five years.

Conclusion

Whatever compromise the two chambers and the McCrory administration are about to hammer out, they can expect liberal critics to hammer them on it. But to most North Carolinians, the results will be clear: a simpler and more efficient tax code, lower tax burdens, and greater economic growth and prosperity in North Carolina. That's real tax reform.

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Endnotes

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