

# Fiscal Fact

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## Critics of North Carolina Tax Reform Miss the Point

By

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Last week, I had a lively debate with Jared Bernstein of the Center on Budget and Policy Priorities<sup>1</sup> on the future of North Carolina tax reform.<sup>2</sup> I want to follow up on three main points of contention. First, that income taxation will not impede growth; second, that income taxes don't contribute to volatility of tax revenues; and third, that regressivity of sales taxes means we should abandon tax reform proposals that move away from income taxation. I'll address each in turn.

### **Does income taxation create disincentives that impede growth?**

Absolutely. Economically speaking, income taxes are the worst types of taxes because they alter individuals' decisions to work and to invest. This is especially true for those with high graduated rates. An age-old adage notes that "when you tax something, you get less of it." The last thing we want to do is discourage those things that add productive value to the economy.

A common counterargument to this idea is that encouraging consumption alone can push the economy forward. Consumption, though an integral part of our complex economy, is the byproduct of growth, not the driver. A recent *Forbes* article articulates this point eloquently:

Consumer demand does not necessarily translate into increased employment. That's because "consumers" don't employ people. Businesses do. Since new hires are a risky and costly investment with unknown future returns, employers must rely on their expectations about the future and weigh those decision very carefully.... Where do these "consumers" get their money to spend? Before we can consume, we need to produce and earn a paycheck. And paychecks have to flow to productive — that is value-creating—behavior.... Our various

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<sup>1</sup> Center on Budget and Policy Priorities, Jared Bernstein, <http://www.cbpp.org/experts/index.cfm?fa=view&id=204>.

<sup>2</sup> To watch the event in its entirety, visit <http://iei.ncsu.edu/iei-issue-areas/economy/financing-the-future-debating-state-tax-reform-2/>.

demands as consumers are enabled by our supply as workers/producers for others...Consumption is the goal, but it is production that is the means.... Increasing consumption is a result of...growth, never the cause of it.<sup>3</sup>

Higher tax liability makes it less profitable than it would be otherwise for individuals to work or businesses to expand their production. As a result, people will engage in fewer of these activities than they would have otherwise and the economy will produce less overall.

Income taxes result in larger “deadweight loss,” a fancy term economists use to demonstrate the fact that tax revenues removed from the economy aren’t the only cost of taxation. In other words, “deadweight loss” is the loss in benefit from the reduced number of productive activities as a result of the tax. An accountant that is hired to help a business navigate and comply with the complicated tax code is one less productive laborer. Those resources could be used more effectively elsewhere.

To minimize this loss, taxes on income need to be as small and as simply structured as possible, and they need to minimize a person’s disincentive to produce. The solution here is flatter, lower income tax rates applied to a broad, neutral base.

### **Does income taxation contribute to tax revenue volatility?**

Yes. Revenue stability is important because it means states won’t have to revamp their tax system or spending commitments in order to balance their budgets each time the economy changes. Income taxes exhibit very pronounced growth, but they also bounce around when the economy moves. Conventional wisdom says that property taxes are the least volatile, followed by sales taxes, individual income taxes, and finally corporate income taxes. Though sales tax revenues might grow more slowly, they are a lot more predictable. There is a lot of research supporting this assertion, a few examples of which include:

- Cornia and Nelson of the Federal Reserve Bank of St. Louis<sup>4</sup> found that corporate income tax revenues are both volatile and exhibit low growth; retail sales and gross receipts tax revenues grow moderately and are relatively stable; and individual income taxes exhibit high growth and more pronounced volatility. Further, revenue source diversification may mitigate some volatility and states should consider the relative volatility of their individual economies when crafting a tax revenue portfolio.
- The California Legislative Analyst’s Office<sup>5</sup> argued that sales tax revenues in the state are not only less volatile than personal income or corporate income taxes, but also that their volatility was stable

<sup>3</sup> John Papola, *Think Consumption Is The ‘Engine’ Of Our Economy? Think Again*, FORBES, Jan. 30, 2013, <http://www.forbes.com/sites/beltway/2013/01/30/think-consumption-is-the-engine-of-our-economy-think-again/>.

<sup>4</sup> Federal Reserve Bank of St. Louis, Gary C. Cornia & Ray D. Nelson, *State Tax Revenue Growth and Volatility*, 6 REGIONAL ECONOMIC DEVELOPMENT, 23-58 (2010), <http://research.stlouisfed.org/publications/red/2010/01/Cornia.pdf>.

<sup>5</sup> State of California Legislative Analyst’s Office, Elizabeth G. Hill, *Revenue Volatility in California* (Jan. 2005), [http://www.lao.ca.gov/2005/rev\\_vol/rev\\_volatility\\_012005.pdf](http://www.lao.ca.gov/2005/rev_vol/rev_volatility_012005.pdf).

over time. Personal income tax revenue volatility increased over time. The author attributes much of the state's revenue fluctuations to the high reliance on the personal income tax, the cyclical nature of the state's economy, the taxation of higher-income taxpayers at a higher rate, and a narrow sales and use tax base that is dependent on cyclical consumption. A report commissioned by the New Jersey Chamber of Commerce<sup>6</sup> yielded similar conclusions, as did a paper by the Federal Reserve Bank of New York<sup>7</sup> on the New York City tax system.

- R. Alison Felix of the Federal Reserve Bank of Kansas City<sup>8</sup> found that sales taxes grew at a slightly slower rate than personal income and were slightly more volatile than income over the last four decades, but when compared to other tax types, were one of the least volatile. Personal income taxes grew twice as fast as income, but were the second most volatile tax revenue source after corporate income taxes (which failed to grow as quickly as income and were the most unstable).
- An older, but equally important paper by Dye and McGuire<sup>9</sup> demonstrates that the structure of taxes is just as important as the type of tax when assessing revenue growth and stability. A sales tax with a narrow base is much more volatile than one with a broad base, though both grow more slowly than the income tax. The more a state depends on high-income earners for income tax revenues, the more growth and volatility in revenues the state will experience. Flatter income tax rates can lend stability to a tax system.

The main lesson is that there is a tradeoff between revenue growth and revenue stability when it comes to individual income and sales taxes. Income taxes track the economy, but do so in a much more pronounced manner, meaning they fluctuate more from year to year. Sales taxes do not grow as quickly, but are more stable over time. The structure of the tax in question is as important (if not more) than the type of tax. A good tax, if poorly structured, can do just as much revenue damage as a bad tax.

Critics of sales taxes argue that lackluster revenue growth will make it difficult for states to fund public services over time. Slowing of growth is a result of the existing badly-designed, narrowly-based sales tax. A broad-based tax that includes services will generate significant additional revenue.

### **Does moving away from income taxation and towards sales taxation lead to regressivity in the tax code?**

<sup>6</sup> Capitol Matrix Consulting, *Revenue Volatility in New Jersey: Causes, Consequences, and Options*, Report prepared for the New Jersey Chamber of Commerce (May 2012), [http://www.njchamber.com/pdf/NJ\\_Volatility\\_Final\\_5-7-2012.pdf](http://www.njchamber.com/pdf/NJ_Volatility_Final_5-7-2012.pdf).

<sup>7</sup> Federal Reserve Bank of New York, Jesse Edgerton, Andrew F. Haughwout, & Rae Rosen, *Revenue Implications of New York City's Tax System*, 10 CURRENT ISSUES IN ECONOMICS AND FINANCE, SECOND DISTRICT HIGHLIGHTS (Apr. 2004), [http://www.newyorkfed.org/research/current\\_issues/ci10-4.pdf](http://www.newyorkfed.org/research/current_issues/ci10-4.pdf).

<sup>8</sup> Federal Reserve Bank of Kansas City, R. Alison Felix, *The Growth and Volatility of State Tax Revenue Sources in the Tenth District*, THE ECONOMIC REVIEW 63-88 (Third Quarter 2008), <https://www.kansascityfed.org/Publicat/Econrev/PDF/3q08Felix.pdf>.

<sup>9</sup> Richard F. Dye & Therese J. McGuire, *Growth and Variability of State Individual Income and General Sales Taxes*, 44 NATIONAL TAX JOURNAL 55-66 (1991), [http://ntj.tax.org/wwtax/ntjrec.nsf/E95E884E6235C9AE8525686C00686D47/\\$FILE/v44n1055.pdf](http://ntj.tax.org/wwtax/ntjrec.nsf/E95E884E6235C9AE8525686C00686D47/$FILE/v44n1055.pdf).

The short answer is yes, but there is an important caveat to consider here. Progressivity is not the only concern when designing a tax code, as my first two points have demonstrated. Generally, sales taxes are thought to be more regressive than income taxes because low-income individuals devote a larger portion of their income to consumption. A common argument for income taxation, particularly progressive income taxation, is that it's more equitable.

If we want to ensure the economy is producing at its maximum potential, then sales taxes are the way to go. Since altruistic concerns are equally important, we should address them in a way that does not hinder the economy's forward movement. It is important to remember that the public finance system has two components: taxation and spending. Programs to assist low-income residents are often better addressed on the spending side because they are more closely monitored and don't complicate the tax code. For example, a prebate, or cash payment, to lower-income taxpayers to mitigate sales tax payments could be used. But if lawmakers wish to directly address regressivity in the tax code itself, a well-designed tax incentive program such as the Earned Income Tax Credit can be used. This lowers tax liability while still encouraging production. These types of tax carve-outs should be used sparingly, however, and adequate care needs to be taken to ensure work disincentives are not created.

One drawback of an otherwise good proposal is not a reason to abandon it altogether. Regressivity of the sales tax is something that can be fixed, and the benefits of income taxation over sales taxation should encourage us to reconcile these concerns in a way that doesn't undermine the overall objective of a well-designed tax system: revenue generation that is as least costly as possible.

### **Don't Put All Your Eggs in One Basket**

Critics of tax reform are misunderstanding my argument entirely. I'm not selling any "snake oil"<sup>10</sup> asserting that any and all tax cuts will lead to instant growth. What I am arguing, however, is that the ultimate goal of tax reform should be creating an atmosphere where business can thrive and economic growth is possible while still generating revenue for the government to pursue its priorities. Growth won't be instant, but a continued, consistent commitment to a system that won't discourage the very things that will move North Carolina's economy forward will most definitely benefit the state in the long run.

Though I recognize and understand concerns about regressivity and fairness in the tax code, putting all of the focus of tax reform on this aspect leaves out two very important factors: efficiency and revenue stability. Equity is important, but a system that encourages production and minimizes revenue volatility is equally vital.

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<sup>10</sup> Jared Bernstein, *Don't Leave Home!*, ON THE ECONOMY, May 7, 2013, <http://jaredbernsteinblog.com/dont-leave-home/>.

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