

NORTH CAROLINA

ILLUSTRATED

A VISUAL GUIDE TO TAX REFORM



North Carolina
Chamber
Foundation

NORTH CAROLINA ILLUSTRATED

A Visual Guide To Tax Reform

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Introduction

During the 2013 legislative session, North Carolina lawmakers adopted legislation fundamentally restructuring the state's tax code. The package included tax cuts for both individuals and businesses, a simplified and more neutral tax system, and a revenue stream that is more reflective of the modern economy and better prepared to withstand economic swings. The reforms broadened, lowered, and flattened the individual income tax, reduced business taxes, moderately expanded the sales tax base, and repealed the estate tax.

In the two legislative sessions following the historic 2013 reforms, lawmakers made further improvements to the code, which will ultimately result in North Carolina having the 13th best structured tax code in the country once all changes are fully phased in, according to the *State Business Tax Climate Index*. These multi-year reforms had many moving parts, and while it's important to view them as a cohesive unit, it is still valuable to understand the importance of each individual change made.

Through a series of charts and maps, *North Carolina Illustrated: A Visual Guide to Tax Reform* puts these reforms in perspective and provides insight on several key questions. First, what did North Carolina's tax code look like before the reforms, in terms of the tax code but also in terms of the broader state economy? Second, what were the details of the tax changes, and how did they impact the state's tax code? And finally, what can North Carolina do to further improve its tax code in the future to make it an even better place to live and do business?

This chart book aims to help readers understand the state's tax system from a broad perspective. To do this, we review North Carolina in the context of six key competitor states: Florida, Georgia, Massachusetts, South Carolina, Texas, and Virginia. These states have similar economies to North Carolina in many respects and are competitors when it comes to economic development and attracting businesses and individuals to the state.

Each piece of North Carolina's new tax code tells a story, and we know how important it is to put that story into a larger context. We hope that this book will help put these pieces together to provide an in-depth picture of the new, improved North Carolina.

These charts were created and compiled by Tax Foundation Economist Liz Malm in collaboration with Tax Foundation staff.

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PART 1

North Carolina Before

Before its major tax overhaul, North Carolina was a state with a surprisingly high tax burden compared to its neighbors, coupled with a poorly structured tax code. Pre-reform, the Tar Heel State's tax system ranked 44th in the country—meaning that only six states had less-competitive tax codes than North Carolina.

In this chapter, we introduce North Carolina and the six key states we've identified as economic competitors for attracting people and business. We briefly walk through each state's economy before explaining the relative tax structure of each—including how they compare nationally and also to one another. We'll examine the relative tax burden of each state and delve into how North Carolina's tax code functioned prior to the implementation of the ongoing multi-year tax reform. Finally, we'll explore some key details about the North Carolina economy, including how it has fared over the business cycle, what kinds of jobs North Carolinians have, trends in disposable income, and geographic migration patterns.



Economic Snapshot: North Carolina and Six Competitors

North Carolina

With the ninth largest state economy in the U.S., North Carolina's production depends the most on financial activities, such as real estate, finance, and insurance. However, manufacturing has a significantly above-average presence in North Carolina and is the second largest sector in the state. Government, professional and business services, and education and healthcare also contribute heavily to the state economy. Surprisingly, agriculture is the second smallest sector (only larger than mining), comprising just 1.1 percent of total state production.

Florida

Florida has the fourth largest economy in the country, but it's more focused on services than the North Carolina economy. The state's largest sector is real estate and other financial activities, followed by professional and business services, government, education and healthcare, and retail trade.

South Carolina

South Carolina's economy is the smallest of the seven states we've chosen to compare, coming in at 27th largest in the country. The state's top industries are nearly identical to North Carolina's: the largest sector is financial activities, followed by manufacturing, government, professional and business services, and retail trade.

Georgia

Georgia's economy (at 10th largest in the U.S.) is similar in both size and composition to North Carolina's. Dominated by finance-related activities, Georgia also has a strong manufacturing sector, the fourth largest sector in the state. Georgia's economy also relies heavily on professional and business services, government, and wholesale trade.

Texas

The Texas economy is the country's second largest, and is more than three times larger than North Carolina's. Texas is heavily focused on goods production, with manufacturing and mining being the two largest sectors. After these, Texas depends heavily on financial activities, professional and business services, and government.

Note: Financial activities includes real estate.

Source: Bureau of Economic Analysis, *Gross Domestic Product (GDP) by State*, "GDP in current dollars."

Massachusetts

Massachusetts has a slightly smaller economy than North Carolina, at 12th largest in the U.S., though the sector breakdowns within the states are similar. The top five industries in Massachusetts are financial activities, professional and business services, education and healthcare, government, and manufacturing.

Virginia

Like Georgia and Massachusetts, Virginia has an economy similar to North Carolina's in size, at 11th largest in the country. The state depends on services including finance and real estate, government, professional and business services, and education and health services, though manufacturing is still the fourth largest industry in the state.

Tax Snapshot: Pre-Reform North Carolina and Six Competitors

State Business Tax Climate Index Rankings, North Carolina and Competitor States (as of July 1, 2013)

The *State Business Tax Climate Index* gauges how well structured each state's tax code is for business. States that score well on the *Index* have broad bases and low rates, but North Carolina had narrow bases and high rates on many taxes. North Carolina ranked 44th in the country prior to its reforms and had a worse rank than all six competitor states.

North Carolina



North Carolina Index Tax Component Breakdown

Corporate Tax Rank	30th
Indiv. Income Tax Rank	42nd
Sales Tax Rank	47th
U.I. Tax Rank	10th
Property Tax Rank	29th

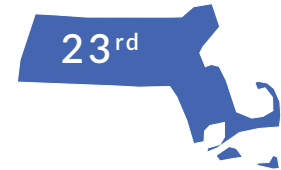
Florida



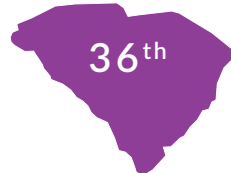
Georgia



Massachusetts



South Carolina



Texas



Virginia

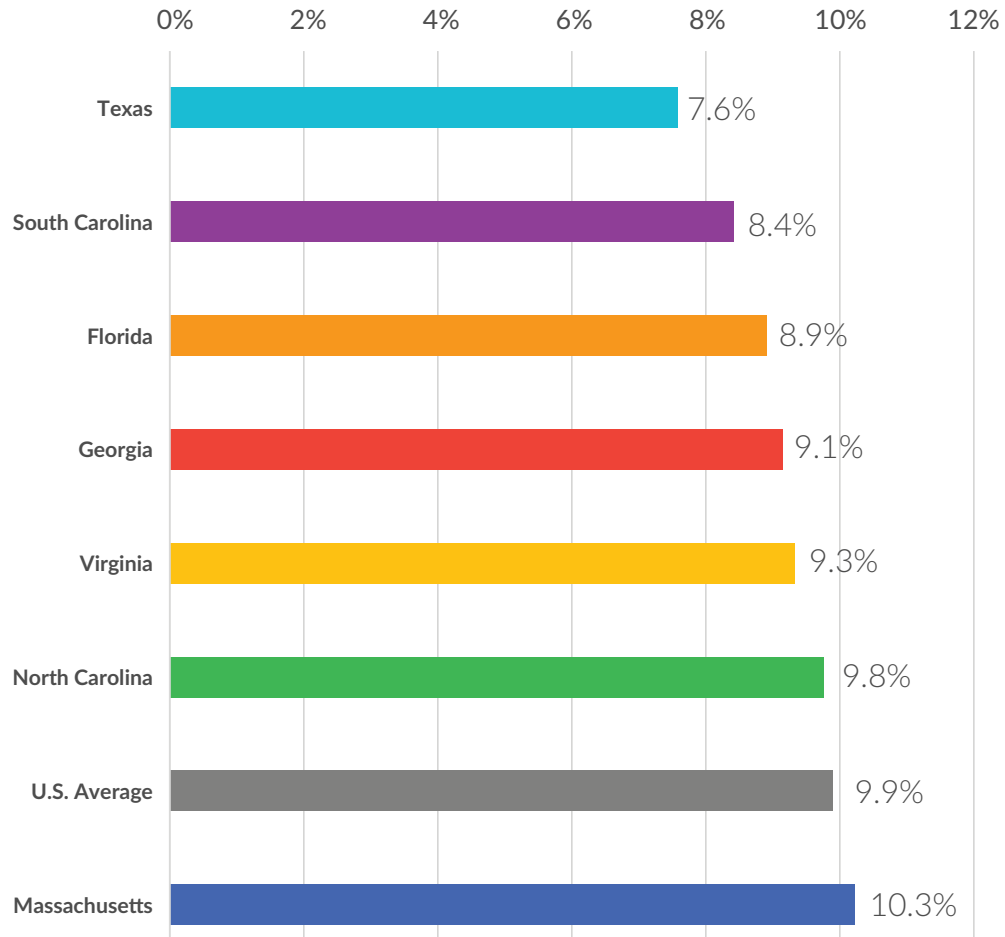


Note: This shows rankings based on 2014 *Index* scores, which are based on law as of July 1, 2013 (prior to the North Carolina reforms' effective dates).

Source: Tax Foundation, 2015 *State Business Tax Climate Index*.

The Tax Burden in North Carolina Was Higher than in Most Competitor States in 2012

Total State and Local Tax Burden as a Percent of State Residents' Income, North Carolina, Competitor States, and the U.S. Average (FY 2012)



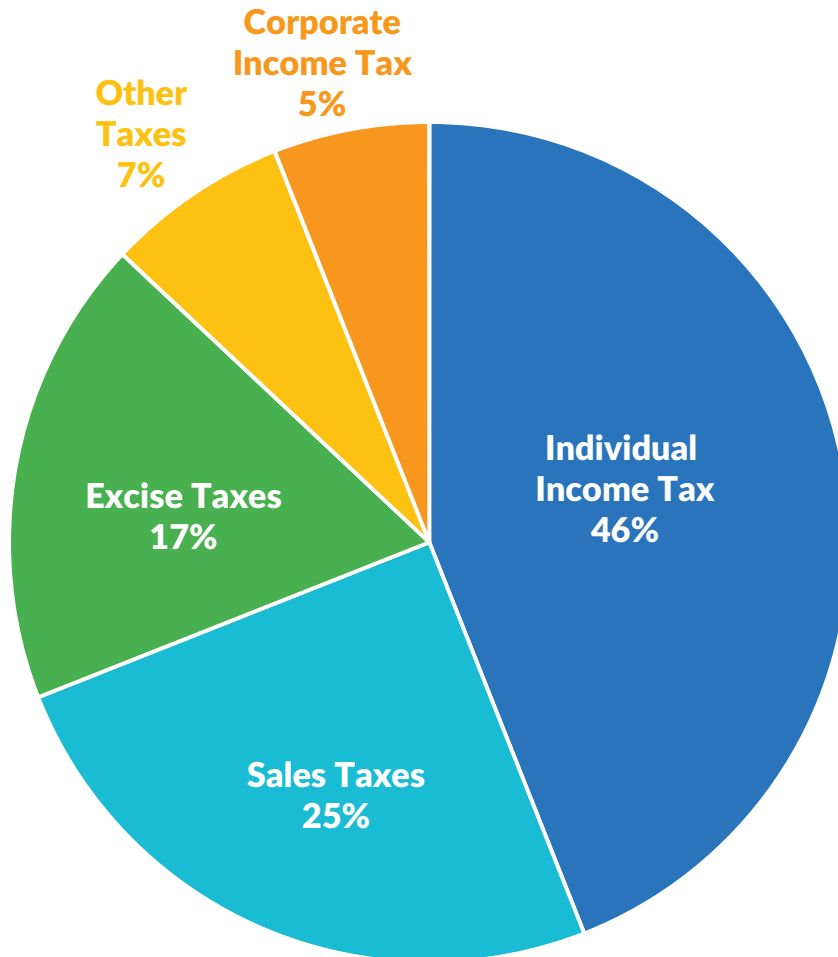
North Carolina's total state and local tax burden was ranked 20th highest in the country as of the 2012 fiscal year. At 9.8 percent of total state income, North Carolina was just below the national average of 9.9 percent, but higher than all competitor states except one (Massachusetts). The average North Carolina taxpayer paid \$3,659 in all state and local taxes in 2012. Approximately 74 percent of that total tax burden was paid to state and local governments within North Carolina, with the remainder paid to out-of-state jurisdictions.

North Carolina taxpayers pay state and local taxes not only to North Carolina but also to other state and local governments. For example, sales and excise taxes are paid by North Carolina residents when they travel to other states and spend money on lodging and food.

Note: Total state and local tax burden includes all taxes levied by state and local governments. For a full list of taxes included, see Tax Foundation Working Paper No. 10.
 Source: Tax Foundation, *Annual State-Local Tax Burden Rankings FY 2012* (2015, forthcoming).

North Carolina State Government Relied Most Heavily on the Individual Income Tax in 2012

Percent of Total Tax Collections by Tax Type, North Carolina State Government (FY 2012)



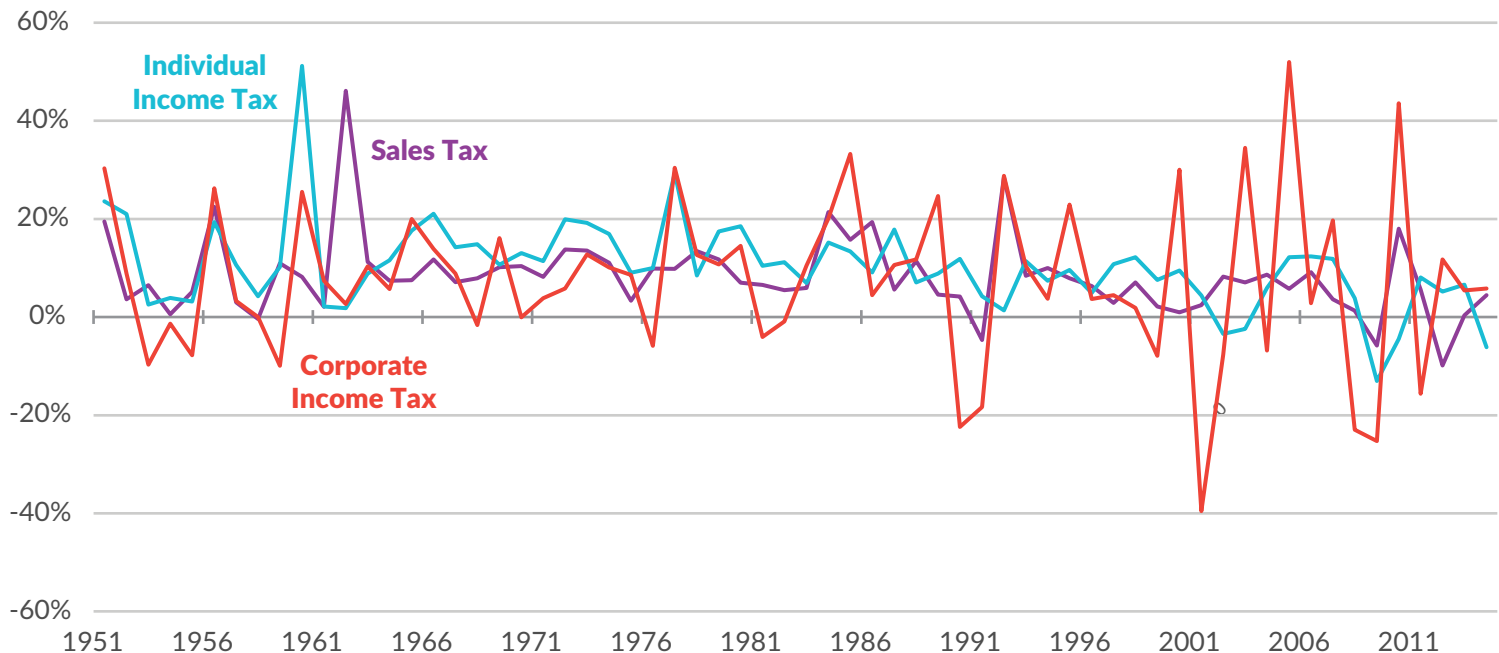
North Carolina obtained the largest share of state government tax collections in the 2012 fiscal year from individual income taxes (46 percent of total), followed by sales taxes (25 percent), and excise taxes (17 percent). As in most states, corporate income taxes make up the smallest share of state tax collections in North Carolina (5 percent) among major tax types.

North Carolina relied less on individual income taxes as a revenue source in fiscal year 2012 than Georgia (where individual income taxes made up 49 percent of state tax collections), Massachusetts (50 percent of state tax collections), and Virginia (56 percent of collections), but more than South Carolina (38 percent) and Florida and Texas, which don't levy individual income taxes. Sales tax reliance is much more prominent in Florida and Texas, which obtained 59 percent and 60 percent of their total tax collections from this source, respectively.

Source: Census Bureau, *State Government Tax Collections*.

Different Tax Types Respond Differently to the Business Cycle

Annual Percent Change in Tax Collections by Tax Type, North Carolina State Government (1951-2014)

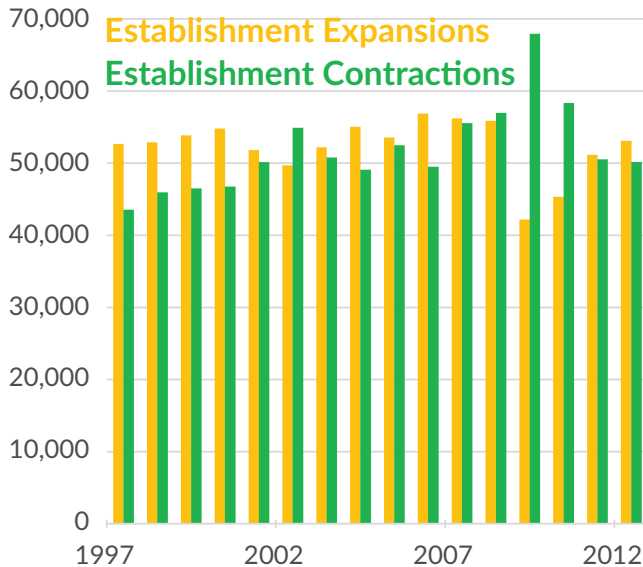


Revenue stability over the business cycle is an important facet of state tax policy. Different types of taxes react differently to changes in the economy. In North Carolina, corporate income taxes fluctuate the most, exhibiting pronounced year-to-year changes in collections over the past twenty years.

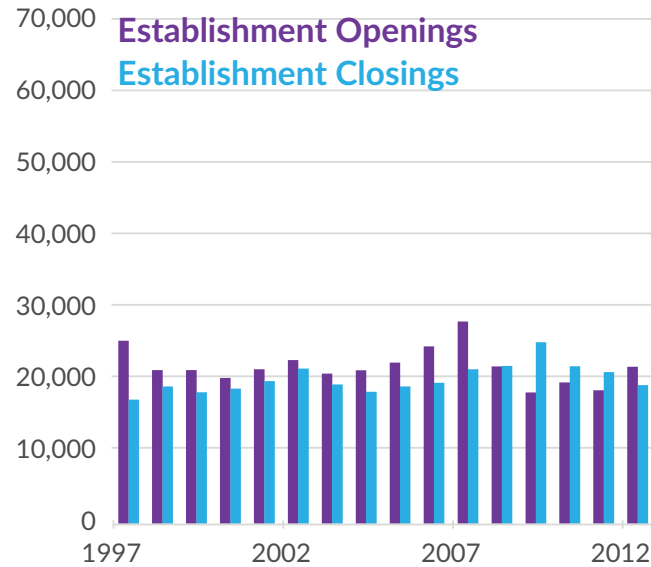
Source: Census Bureau, *State Government Tax Collections*.

By 2012, North Carolina Still Hadn't Recovered from Business Closings and Contractions during the Recession

Establishment Openings, Closings, Expansions, and Contractions, North Carolina Statewide (1997-2012)



One way to examine the impact of business cycles is to look at the behavior of in-state businesses, such as the number of businesses that are opening or closing and expanding or contracting each year. The North Carolina economy saw significant contractions in the most recent recession and had yet to recover from these as of 2012. It is estimated that the state saw almost 68,000 establishment contractions in 2009—most of which were in the retail, construction, and accommodation and food service industries.

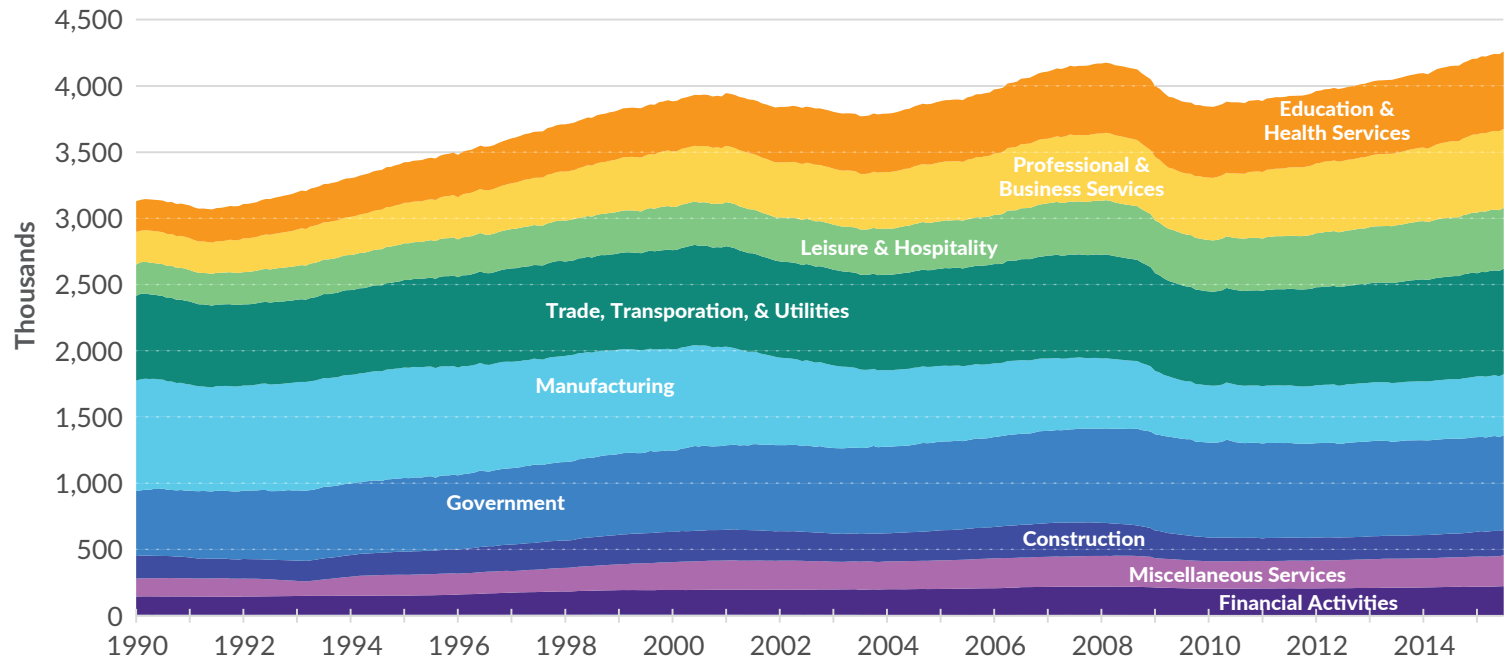


As with most states, it is more common for firms to expand and contract rather than to close or open in North Carolina. In 2009, there were just over 25,000 establishment closings. Establishment closings were most heavily concentrated in the construction sector, followed by retail trade and professional, scientific, and technical services.

Source: Census Bureau, *State Government Tax Collections*.

North Carolina's Economy Has Changed Dramatically over Time

Total Nonfarm Monthly Seasonally Adjusted Employment Level by Sector, North Carolina Statewide (January 1990-July 2015)

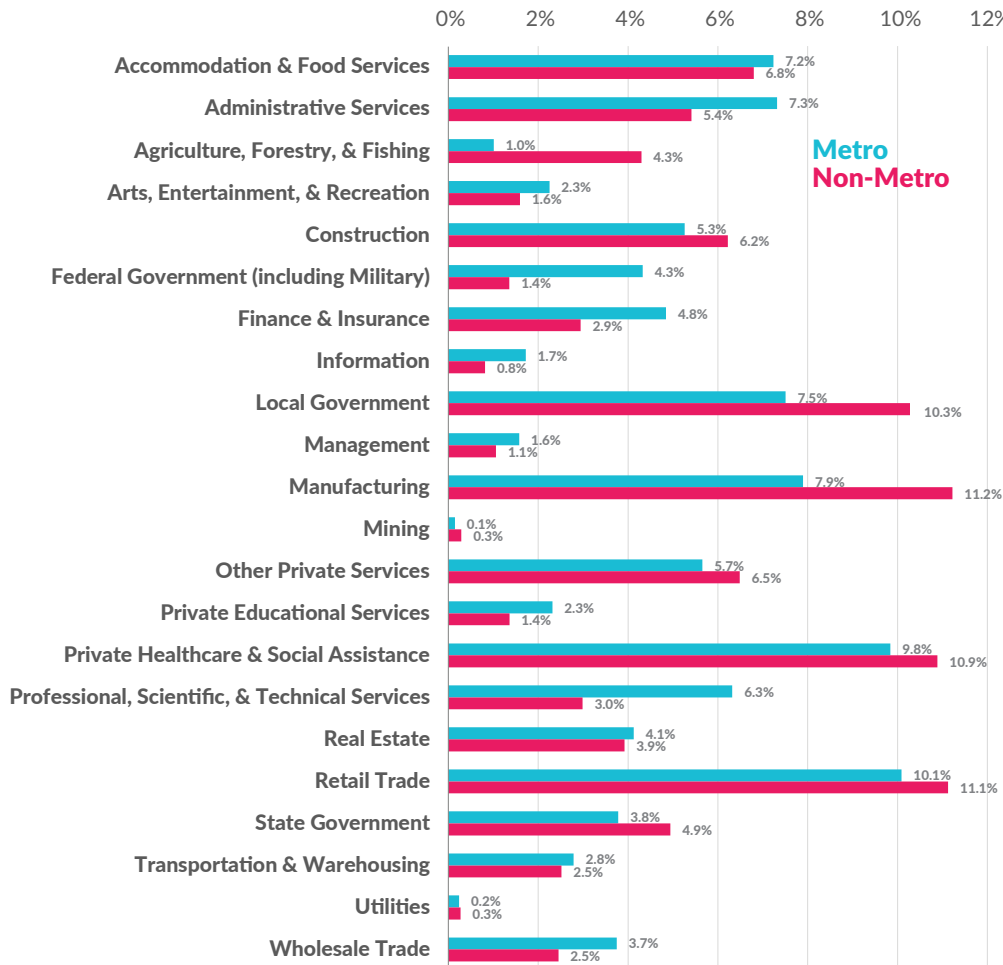


Like businesses, employment levels also fluctuate over time. While the total number of jobs in a state is a valuable statistic, it's also interesting to look at the composition of jobs by sector over time. Manufacturing has historically been an important sector in North Carolina, but manufacturing's share of total jobs in the state has declined over the years, while government's and service jobs' shares have increased. It's important to note that while some sectors, such as financial activities, employ fewer people, they still contribute significantly to total state production.

Note: Mining and logging are such a small percentage of total employment that they are not visible in this chart. Miscellaneous Services includes the information sector. Source: Bureau of Labor Statistics, *State and Area Employment, Hours, and Earnings* (Seasonally Adjusted, All Employees, Statewide).

Local Economies within North Carolina Aren't Uniform

Sector Employment as a Percent of Total Area Employment, Metro and Non-Metro North Carolina (2013)



State economies are diverse, and different areas of a state often have unique local economies, which can be seen by comparing the largest sectors (based on the share of area total employment) in metro versus non-metro North Carolina.

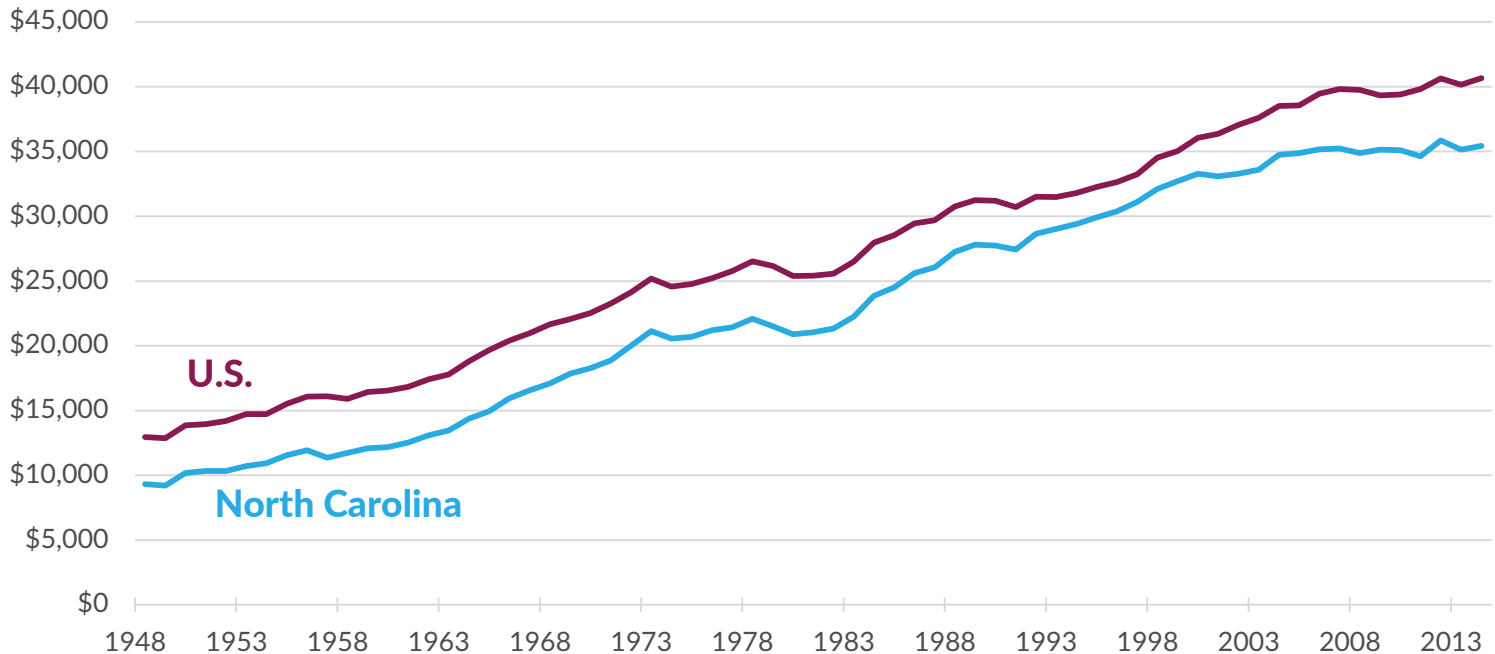
For example (and not surprisingly), agriculture makes up 4.3 percent of North Carolina's non-metro employment but only 1 percent of metro-area employment. Similarly, while manufacturing, government, and retail trade are prominent in both areas, these sectors make up a larger share of employment in non-metro areas of the state. Services such as accommodation and food, administrative, and professional services are more prominent in metro areas.

Note: Counties designated by the Bureau of Economic Analysis as metropolitan are Alamance, Alexander, Brunswick, Buncombe, Burke, Cabarrus, Caldwell, Catawba, Chatham, Craven, Cumberland, Currituck, Davidson, Davie, Durham, Edgecombe, Forsyth, Franklin, Gaston, Gates, Guilford, Haywood, Henderson, Hoke, Iredell, Johnston, Jones, Lincoln, Madison, Mecklenburg, Nash, New Hanover, Onslow, Orange, Pamlico, Pender, Person, Pitt, Randolph, Rockingham, Rowan, Stokes, Union, Wake, Wayne, and Yadkin.

Source: Bureau of Economic Analysis, *Gross Domestic Product (GDP) by State*, "GDP in current dollars."

North Carolinian's After-Tax Income per Person Has Always Been Lower than the U.S. Level

Disposable Personal Income per Capita, North Carolina and the U.S. (1948-2014, in 2014 Dollars)



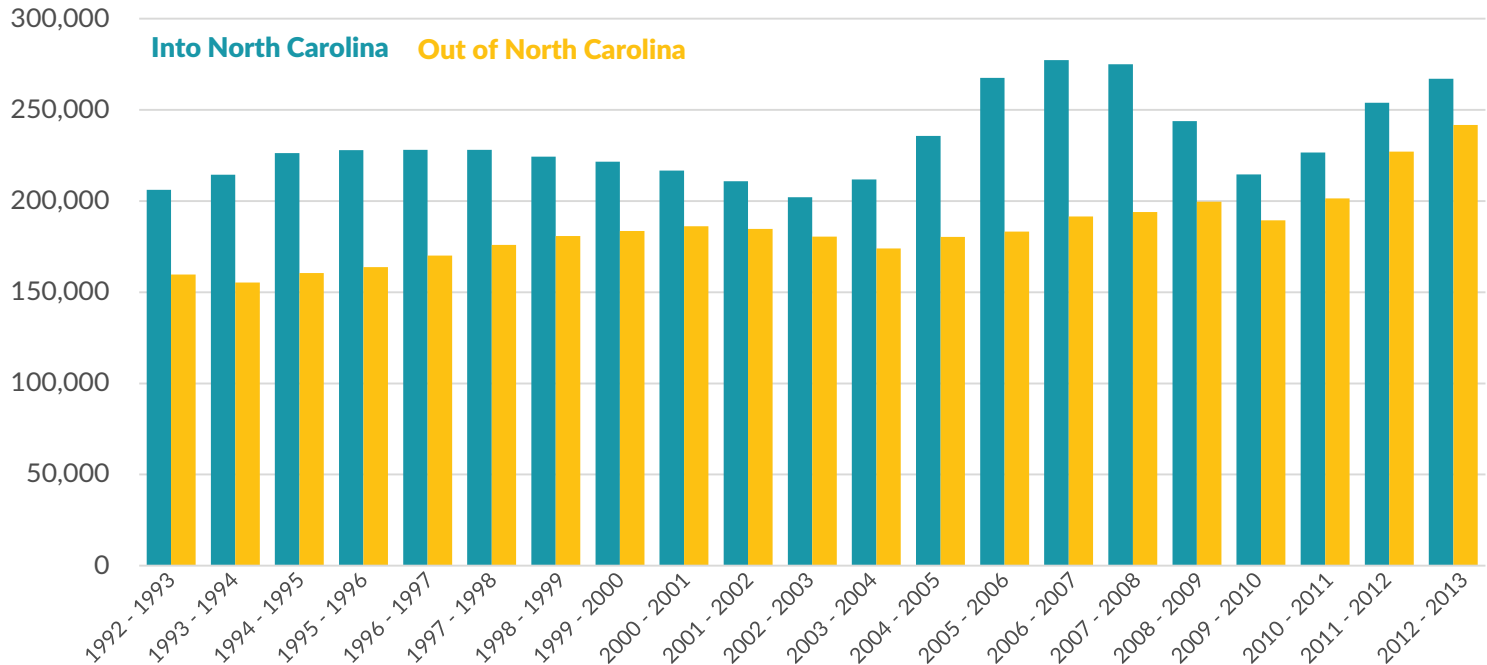
Disposable income is a measure of income available after taxes are paid. North Carolina disposable income per capita has historically been below the U.S. average, though that gap began to close in the 1990s. Since the early 2000s, however, the gap has begun to widen again. North Carolina's disposable income per capita in 2014 was \$35,437, while the U.S. level was \$40,670 that year.

Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2014 base year.

Source: Bureau of Economic Analysis, *Annual State Personal Income and Employment*, "Disposable Personal Income Summary."

North Carolina Has Seen Consistent In-Migration over the Last Two Decades

Migration to and from North Carolina Based on the Number of Federal Tax Exemptions Claimed (1993-2013)

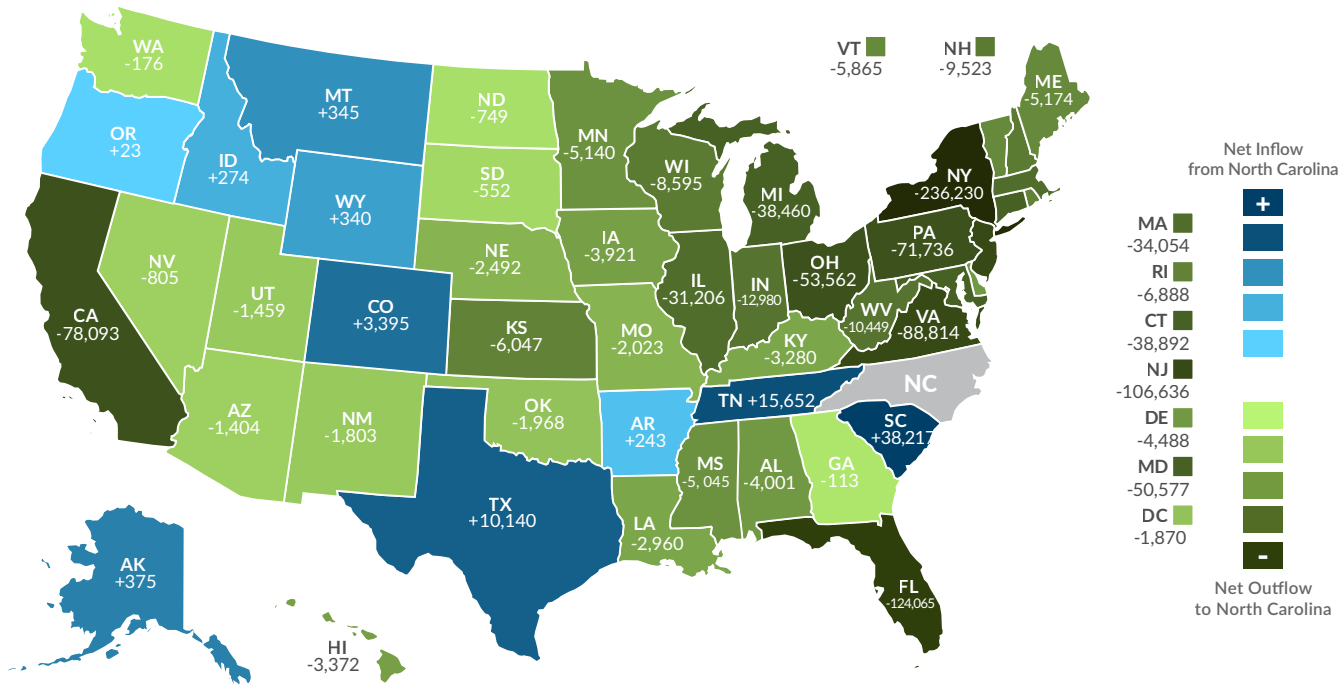


Since the early 1990s, North Carolina has seen a net influx of individuals each year, with in-migration exceeding out-migration. That net amount has varied over the years, with net in-migration peaking in the 2006 to 2008 period, then dipping lower during the Great Recession.

Source: Internal Revenue Service, *Statistics of Income Tax Stats*, "State-to-State Migration Data."

North Carolina Has Seen a Net Gain of 996,463 People between 1993 and 2013

Net Migration to and from North Carolina (1993-2013)



Over the 20-year time period since 1993, North Carolina has seen a net gain of almost one million people. On net, North Carolina has gained people from every state except ten (losing the most people to South Carolina, Tennessee, and Texas). On net, the most people have come from New York, Florida, New Jersey, Virginia, California, and Pennsylvania.

For example 236,230 people migrated out of New York into North Carolina between 1993 and 2013, and 38,217 people migrated into South Carolina from North Carolina over the same period.

Note: Net migration to and from North Carolina is determined by the net number of federal individual income tax exemptions out of North Carolina between the 1992-1993 period and the 2012-2013 period.

Source: Internal Revenue Service, *Statistics of Income Tax Stats*, "State-to-State Migration Data."

PART 2

The New North Carolina

North Carolina made sweeping changes to its tax code during the 2013 legislative session and built on those reforms in 2014 and 2015—enough to move the state from having the 44th best tax code in the country to the 13th best tax code in the country once reforms are fully phased in, according to the *State Business Tax Climate Index*.

The charts, tables, and maps in the following section outline the overall tax reforms made, and then zoom in on many of the major changes, providing both historical and geographic context. We explain the big changes made to the individual income tax, business taxes, sales taxes, and finally the estate tax.



Raleigh, North Carolina, photo: Mark Turner

Tax Reform Lowered Rates, Broadened Bases, and Made the Tax Code More Neutral and Simple

Overview of Major Tax Changes (2013, 2014, and 2015)



Individual Income & Estate Taxes

- Replaced graduated rates with one flat rate
- Lowered the individual income tax rate over several years
- Broadened the tax base by closing or limiting many income tax credits and deductions
- Expanded the Child Tax Credit and Standard Deduction (also known as the zero tax bracket)
- Repealed the state estate tax



Business Taxes

- Lowered the corporate income tax rate over three years with a further deduction subject to a revenue trigger
- Broadened the tax base by allowing many credits to expire
- Eliminated local business privilege taxes
- Phased in single sales factor apportionment which determines the percentage of a multi-state operation's total profits that are taxable in North Carolina, based on the percentage of sales made in the state

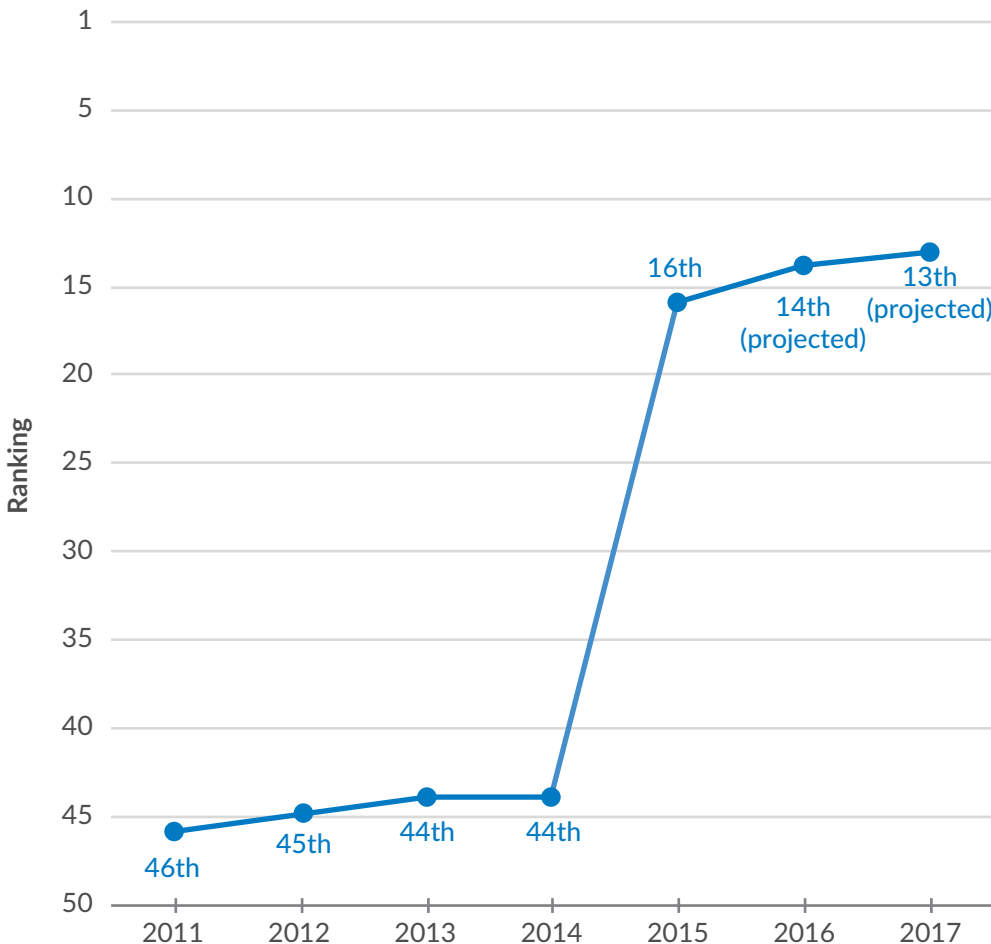


Sales Taxes

- Modestly broadened the sales tax base to include certain service contracts and repair or maintenance services associated with the purchase of tangible personal property
- Eliminated the state sales tax holidays
- Eliminated special sales tax rates for electricity, piped natural gas, amusements, and entertainment

North Carolina's Tax Climate Used to Be One of the Worst but Is Now One of the Best

State Business Tax Climate Index Rankings, North Carolina (2011-2017)



Our *State Business Tax Climate Index* compares the structure of state tax codes on over 100 variables to determine which states have the best and worst climates for business. The result is a relative ranking of all 50 states, in which a ranking of 1 indicates the best climate for business and a ranking of 50 indicates the worst.

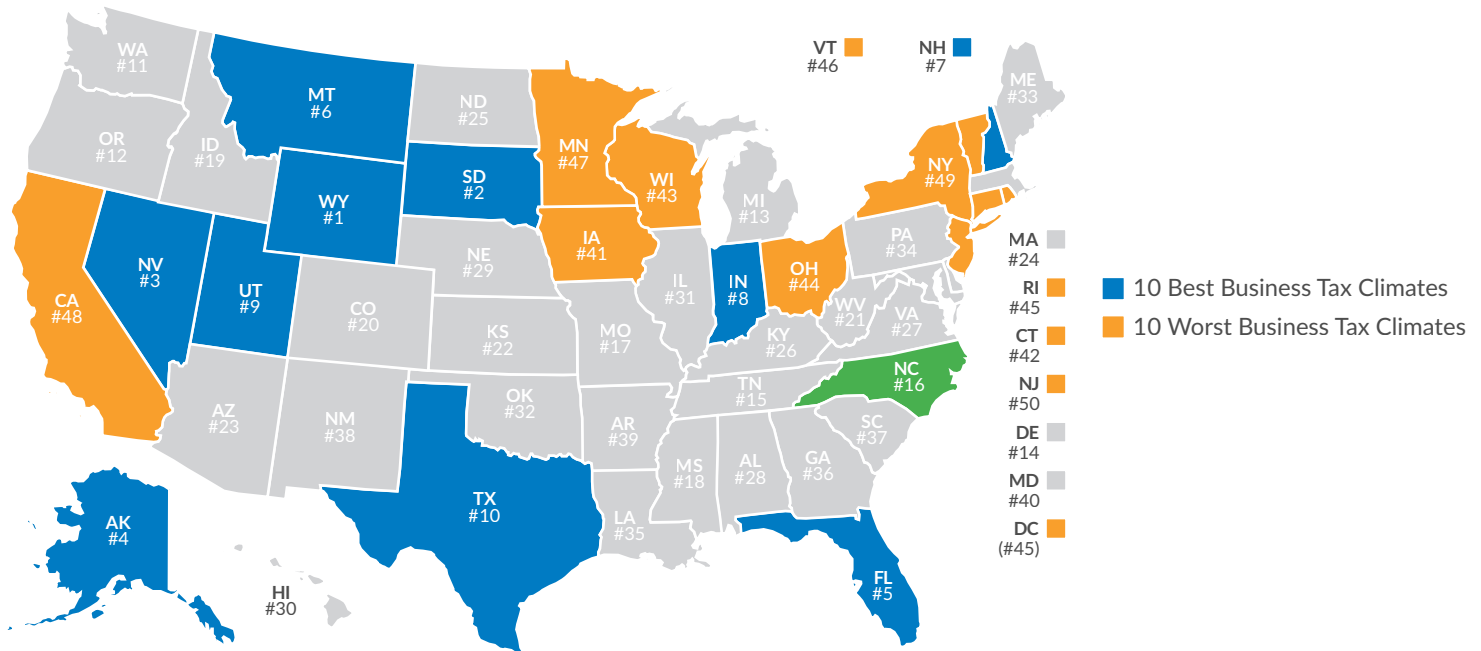
Prior to North Carolina's historic tax reforms, the Tar Heel State was in the bottom ten, ranking 46th in 2011 and moving up slightly to 44th in 2013 (we've chosen 2014 *Index* scores as our "before" snapshot, since they reflect laws as of July 1, 2013, which was before any tax reform legislation took effect). Post-reform, North Carolina's ranking skyrocketed to 16th best in 2015. It's expected to reach 13th best once reforms are fully phased in and the revenue trigger is met.

Note: Projected rankings use 2015 rankings as a baseline. That is, North Carolina's scheduled future changes are considered alongside the tax codes of other states as of July 1, 2014 (the start of the 2015 standard state fiscal year).

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

In 2015, North Carolina's Tax System Was Better than 34 Other States' Tax Systems

State Business Tax Climate Index Rankings (2015)

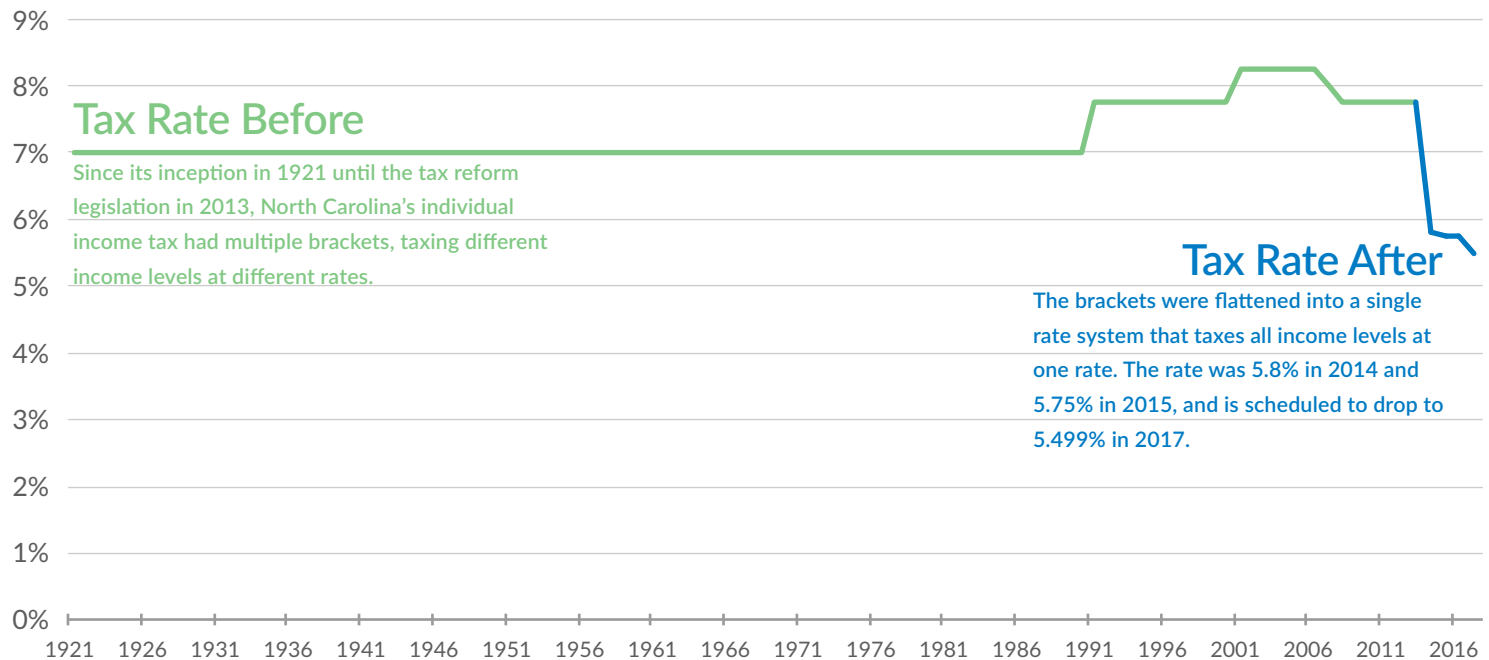


The absence of a major tax is a common factor among many of the top ten states in the *Index*. Wyoming and South Dakota have no corporate or individual income tax; Alaska has no individual income or state-level sales tax; Florida and Nevada have no individual income tax; and New Hampshire and Montana have no sales tax. Indiana and Utah, on the other hand, have all of the major tax types, but levy them with low rates on broad bases, earning them spots in the top ten as well. The states in the bottom ten all suffer from the same afflictions: complex, non-neutral taxes with comparatively high rates.

Note: A rank of 1 indicates the state's tax system is more favorable for business; a rank of 50 indicates the state's tax system is less favorable for business. The (*) next to North Carolina's rank indicates that the 16th best score is the state's 2015 score, an improvement from 44th best in 2014. The state is projected to improve even further to 13th if all planned reforms continue as scheduled.
Source: Tax Foundation, 2015 *State Business Tax Climate Index*.

Individual Income Tax Rate: Before and After Reform

Top Marginal Individual Income Tax Rate, North Carolina (1921-2015)

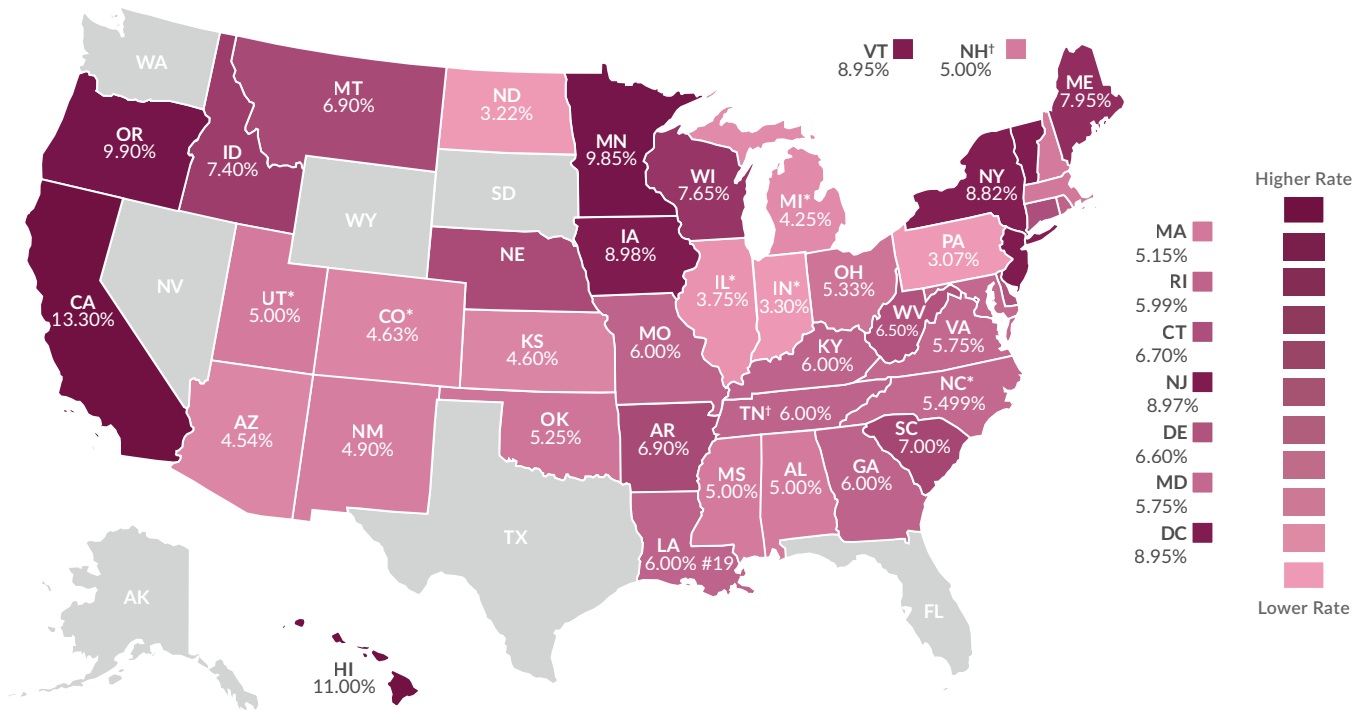


From its inception in 1921 through the 2000s, the North Carolina individual income tax had multiple brackets, with rates ranging from 3 to 8.25 percent. In 2014, the individual income tax changed dramatically to a flat rate of 5.8 percent on all income levels, followed by a further decline to 5.75 percent in 2015. The rate is scheduled to go down even further in 2017 to 5.499 percent, which would make it the lowest rate among our key competitor states levying an individual income tax.

Source: State tax statutes and forms; Roby B. Sawyers, *The History of State and Local Taxes in North Carolina - Changes in Sources and Burdens*, North Carolina State University (Nov. 28, 2006).

North Carolina's Individual Income Tax Will Be the Region's Lowest among States Levying an Income Tax

Top State Marginal Individual Income Tax Rates (as of April 15, 2015 unless otherwise noted)



Once North Carolina's new tax rate of 5.499 percent is fully phased in as of 2017, the state will have the 27th lowest top marginal rate in the country and the lowest among its neighbors.

Note: The map shows the maximum statutory tax rate in each state. The map does not include local income taxes. All tax rates except North Carolina's are as of April 15, 2015. North Carolina's rate is the rate scheduled to take effect in 2017. States with (*) have a flat income tax. States displaying (†) only tax interest and dividend income.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare*; Tax Foundation, *North Carolina Budget Compromise Delivers Further Tax Reform*, Tax Policy Blog (Sept. 17, 2015).

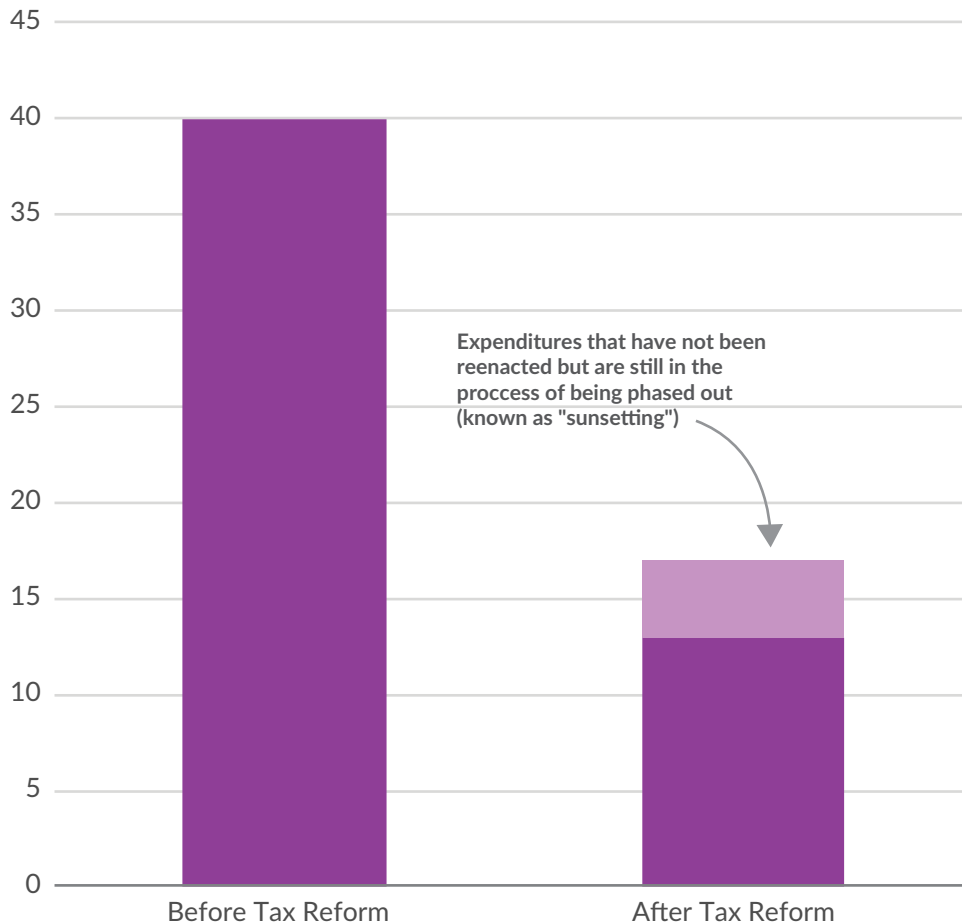
Individual Income Tax Base: Before and After Reform

Overview of Major Individual Income Tax Base Changes (2013, 2014, and 2015)

Tax Base Before			Tax Base After		
Standard Deduction	Personal Exemption	Child Tax Credit	Standard Deduction	Personal Exemption	Child Tax Credit
\$6,000	\$2,000	\$100	\$15,500	None	\$125
for Married Filers	per Person	for All Taxpayers	for Married Filers		for Married Filers
More if taxpayer is 65 years or older or blind	\$2,500 if income is less than \$100,000				if adjusted gross income is less than \$40,000
<p>Credits & Deductions Available</p> <p>Child care, disability, property taxes on farm machinery, education expenses, charitable contributions, retirement and social security income, severance income, certain bond obligation interest, state tax returns, long-term care insurance premiums, earned income, adoption expenses, business income, property taxes paid on primary home, and mortgage interest. Maximum allowable itemized deductions matches the Federal Tax Code.</p>			<p>Credits & Deductions Available</p> <p>Very limited types of retirement income, social security income, severance income, certain bond obligation interest, state tax returns, and itemized deductions which are limited to mortgage interest (capped), property taxes paid on primary home (capped), charitable contributions (unlimited), and medical expenses (unlimited). Deductions for interest and property taxes paid together is capped at \$20,000.</p>		

North Carolina Tax Reform Broadened the Personal Income Tax Base by Eliminating More than Half of Its Tax Expenditures

Number of Individual Income Tax Expenditures, Before and After Tax Reform



An income tax expenditure is a tax preference (given via an exclusion, deduction, credit, lower rate, or some other means), making the tax on that income less than it would have been otherwise. There are tax expenditures that ensure a well-structured tax base, and there are those known as “policy decisions” that give preference to certain activities or income under the tax code. Policy decisions narrow the tax base, forcing the tax rate to be higher than it would be otherwise to raise the same amount of revenue.

North Carolina’s tax reform dramatically reduced the number of “policy decision” tax expenditures in the North Carolina individual income tax code. Eliminating existing tax preferences and broadening the tax base allowed lawmakers to lower the individual income tax rate for all taxpayers.

Note: Expenditures in existence “before tax reform” were taken from the December 2011 edition of the *Biennial Tax Expenditure Report*. “After tax reform” expenditures were taken from the December 2013 edition of the report.

Source: North Carolina Department of Revenue, Revenue Research Department, *Biennial Tax Expenditure Report* (2011 and 2013 editions).

How Does North Carolina's New Tax Code Impact Real People?

North Carolina's 2013 reforms had real impacts for real people. These six scenarios show how low- or high- income North Carolina taxpayers with or without children fare under the North Carolina income tax code, both pre- and post-reform.



Max

Income:
\$15,930
Filing Status:
Head of Household



State Income Tax
\$143
Effective Rate
0.9%

State Income Tax
\$101
Effective Rate
0.6%

Harold & Betty

Income:
\$36,252
Filing Status:
Married Filing Jointly



Retired

State Income Tax
\$0
Effective Rate
0%

State Income Tax
\$0
Effective Rate
0%

Danielle

Income:
\$28,916
Filing Status:
Single



State Income Tax
\$1,412
Effective Rate
4.9%

State Income Tax
\$1,231
Effective Rate
4.3%

Note: All calculations are made for the 2015 tax year and reflect state statutes and tax rates as of January 1, 2015. This assumes an equal split of income between spouses, that all income was earned in the state of filing, that no estimated tax payments were made in advance, and that there were no interest or penalties charted. Icons are meant to show the number of exemptions claimed in each household.

Source: State statutes and forms; Tax Foundation calculations.

Before Reform	After Reform
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Jason & Nicole

Income:
\$68,631
Filing Status:
Married Filing Jointly



State Income Tax
\$3,352
Effective Rate
4.9%

State Income Tax
\$2,884
Effective Rate
4.2%

Liz & Jack

Income:
\$311,294
Filing Status:
Married Filing Jointly



State Income Tax
\$16,551
Effective Rate
5.3%

State Income Tax
\$16,987
Effective Rate
5.5%

Heidi & Bret

Income:
\$1,837,582
Filing Status:
Married Filing Jointly

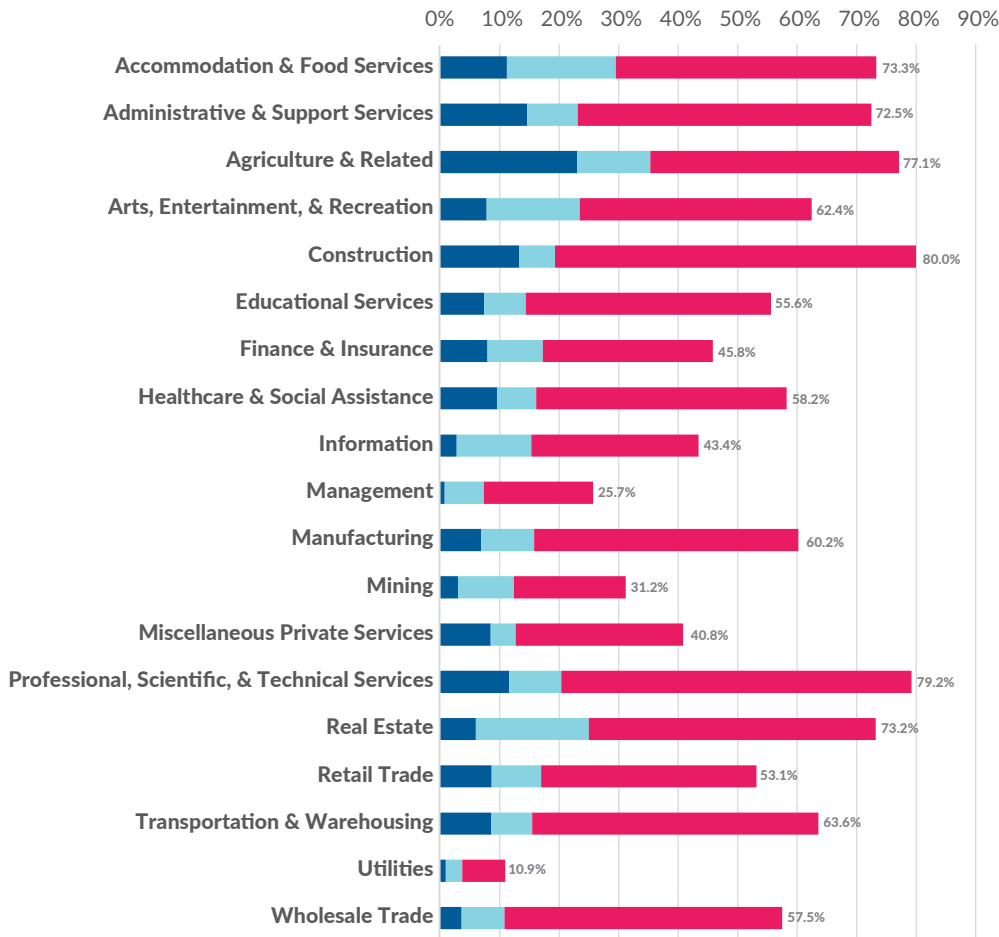


State Income Tax
\$113,784
Effective Rate
6.2%

State Income Tax
\$100,272
Effective Rate
5.5%

Individual Income Taxes Also Matter to Businesses

Percent of Employer Businesses that Are Pass-Through Entities by Sector, North Carolina Statewide (2013)



Firms that pay individual income taxes rather than corporate income taxes are known as “pass-through” or “flow-through” entities because business income “flows through” to the owner’s individual income tax return. Sole proprietorships, partnerships, and S-corporations are all types of pass-through businesses (note that LLCs are included in these categories by the Census Bureau).

Sixty-two percent of all employers with payroll in North Carolina are pass-through entities, but that share varies for specific sectors of the economy. It’s important to note, however, that when we consider the aggregate number of workers at businesses with payroll in North Carolina, most of them work at traditional corporations (known as C-corporations).

Sole Proprietorships

Partnerships

S-Corporations

Note: The chart does not include non-employer firms.
Source: Census Bureau, *County Business Patterns*.

How Will North Carolina's New Individual Income Taxes Compare?

State Business Tax Climate Index Individual Income Tax Component Rankings, North Carolina and Competitor States (Projected)

Breaking the *State Business Tax Climate Index* into its subcomponents allows us to compare the structure of each major tax type. Here, we look at the structure of North Carolina's post-reform individual income tax, after all tax changes have been phased in. Once all reforms are in effect, North Carolina will have the 14th best individual income tax code in the country. Among competitor states, it will be outranked by Florida and Texas (which don't levy individual income taxes), as well as Massachusetts (which has a lower flat rate at 5.15 percent).

North Carolina



Prior to the tax reforms, North Carolina's individual income tax was only the 42nd best in the country (in other words, it ranked better than only eight other states).

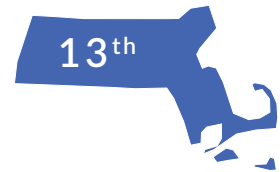
Florida



Georgia



Massachusetts



South Carolina



Texas



Virginia

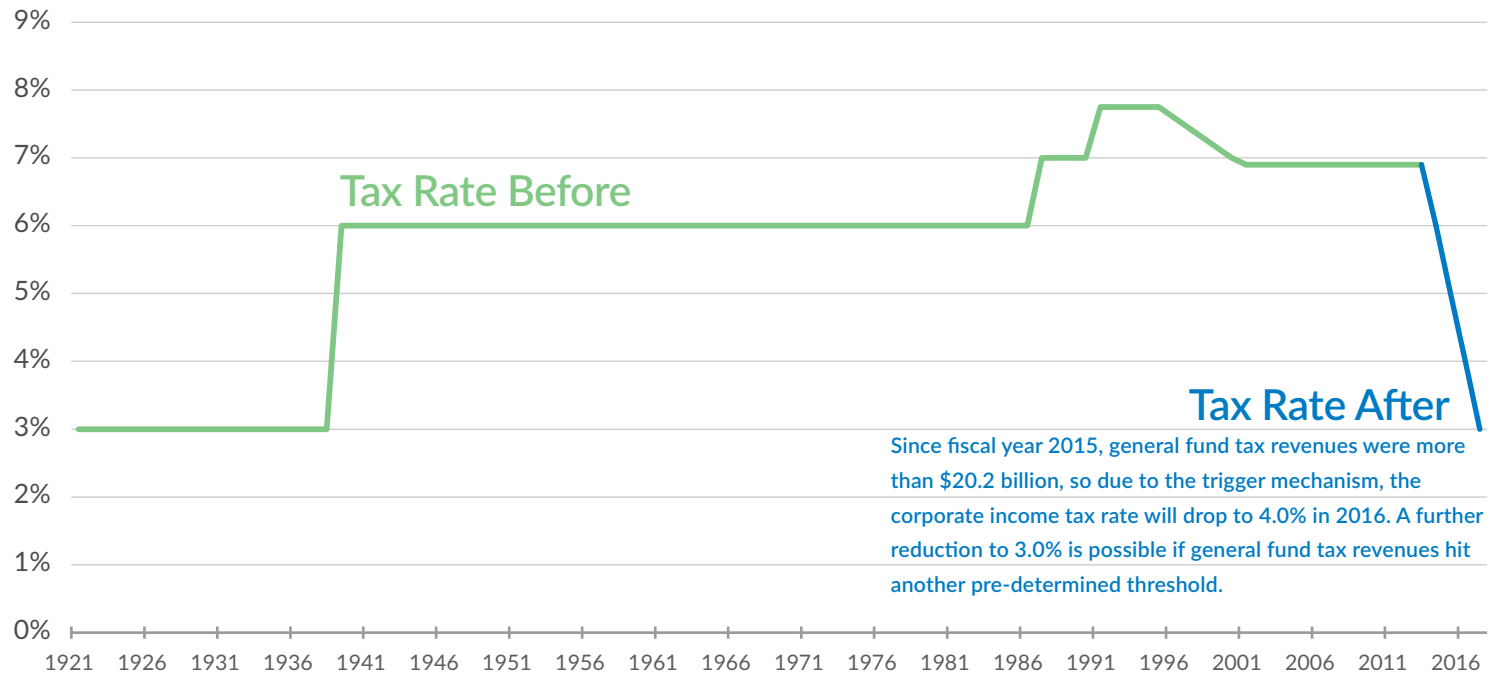


Note: The figure shows projected individual income tax component rankings once all North Carolina income tax changes are phased in (including the 5.499 percent rate in 2017). Florida ranks better than Texas because the *State Business Tax Climate Index* takes S-corporations and LLCs (which are taxed under the individual income tax code) into account, which are subject to taxation by the Margin Tax, a gross receipts tax in Texas.

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

Corporate Income Tax Rate: Before and After Reform

North Carolina Corporate Income Tax Rate, North Carolina (1921-2015)

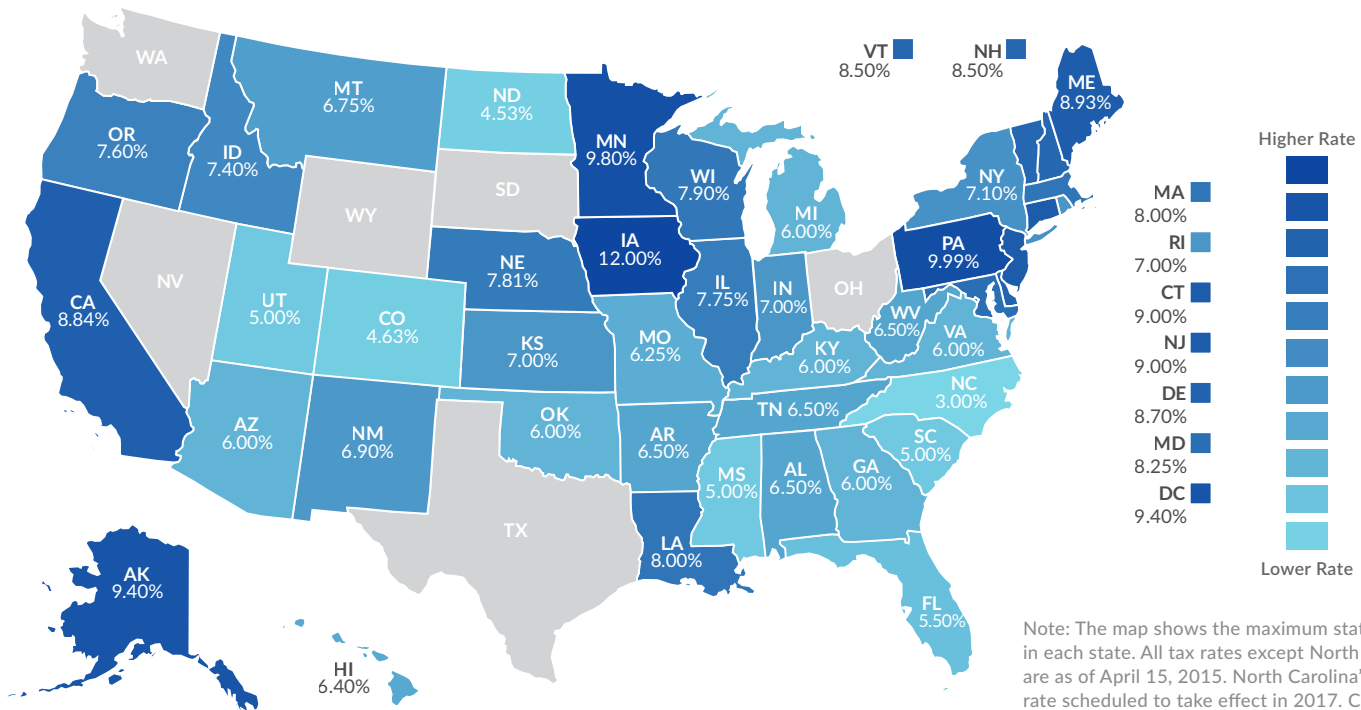


North Carolina's corporate income tax was enacted in 1921 at a rate of 3 percent. The rate increased over the years until it peaked at 7.75 percent in the early 1990s, then dropped to 6.9 percent in 2001. The rate did not change again until 2014, when it dropped to 6 percent, then to 5 percent in 2015. The tax reforms built in a "trigger mechanism," automatically reducing the rate in future years if revenue targets are met. The first target was met during the 2015 fiscal year, lowering the rate to 4 percent in 2016. If the next revenue target is met, the rate will drop to 3 percent, making North Carolina's corporate income tax rate the lowest in the country among the states levying corporate income taxes.

Source: State tax statutes; Interim Joint House and Senate Finance Committees, *Overview of North Carolina's Corporate Income Tax*, North Carolina General Assembly (Apr. 7, 2010).

North Carolina's Corporate Income Tax Rate Will Be the Lowest in the Country among the States that Levy One

Top State Marginal Corporate Income Tax Rates (as of April 15, 2015 unless otherwise noted)



Once North Carolina's new lower corporate income tax rate of 3 percent is phased in (assuming that the state meets the general fund tax revenue requirements outlined under the revenue trigger mechanism), North Carolina's tax rate will be the lowest in the country among states levying a corporate income tax.

Note: The map shows the maximum statutory tax rate in each state. All tax rates except North Carolina's are as of April 15, 2015. North Carolina's rate is the rate scheduled to take effect in 2017. Connecticut's rate includes a 20% surtax. Illinois' rate includes two separate corporate income tax rates. Nevada, Ohio, Texas, and Washington have statewide gross receipts taxes with rates not strictly comparable to corporate income taxes. Some states, including Virginia and Delaware, levy widespread local gross receipts taxes in addition to corporate income taxes.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare*; Tax Foundation, *North Carolina Budget Compromise Delivers Further Tax Reform*, Tax Policy Blog (Sept. 17, 2015).

Selected Business Taxes: Before and After Reform

Overview of Selected Business Tax Changes (2013, 2014, and 2015)

Business Taxes Before		Business Taxes After	
Local Privilege Taxes	Film Tax Credit	Local Privilege Taxes	Film Tax Credit
Municipal governments have the authority to levy license taxes on the privilege of doing business within a town or city, with no standard definition of “doing business” or the tax base across municipalities.	25% Of qualified expenses credited (\$20 million maximum)	None	Allowed to expire and replaced with a grant program

Source: Tax Foundation, *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform* (Jan. 2013); Tax Foundation, *North Carolina Builds on Tax Reform, Repealing Burdensome Local Privilege Taxes* (June 5, 2014); Tax Foundation, *2015 State Business Tax Climate Index*; North Carolina Department of Revenue, Revenue Research Department, *Biennial Tax Expenditure Report* (Dec. 2013).

How Will North Carolina's New Corporate Taxes Compare?

State Business Tax Climate Index Corporate Tax Component Rankings, North Carolina and Competitor States (Projected)

Breaking the *State Business Tax Climate Index* into its subcomponents allows us to compare the structure of each major tax type. Here, we look at the structure of North Carolina's post-reform corporate taxes, after all tax changes have been phased in. Once all reforms are in effect, North Carolina will have the 4th best corporate tax code in the country and will outrank all competitor states' corporate tax structures.

North Carolina



Prior to the tax reforms, North Carolina's corporate taxes were 30th best in the country.

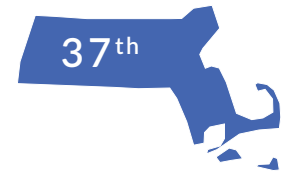
Florida



Georgia



Massachusetts



South Carolina



Texas



Virginia



Note: The figure shows the projected corporate income tax component ranking once all of North Carolina's corporate tax changes are phased in (including the 3 percent corporate income tax rate in 2017).

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

Sales Taxes: Before and After Reform

Overview of Sales Tax Changes (2013, 2014, and 2015)

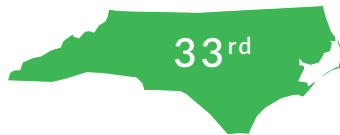
Sales Taxes Before	Sales Taxes After								
<table><thead><tr><th data-bbox="170 357 395 384">Sales Tax Holidays</th><th data-bbox="505 357 760 384">Sales Tax on Services</th></tr></thead><tbody><tr><td data-bbox="135 417 401 713"><p>Two tax-free weekends:</p><ul style="list-style-type: none">• Clothing, school supplies, computers, education software, and sports equipment (early August)• Energy Star appliances (early November)</td><td data-bbox="482 417 760 505"><p>Most service transactions exempted from the sales tax base</p></td></tr></tbody></table> <hr/> <p data-bbox="310 827 614 854">Miscellaneous Provisions</p> <p data-bbox="135 888 725 982">Lower tax rates for electricity, piped natural gas, manufactured homes, mobile homes, amusements, and entertainment</p>	Sales Tax Holidays	Sales Tax on Services	<p>Two tax-free weekends:</p> <ul style="list-style-type: none">• Clothing, school supplies, computers, education software, and sports equipment (early August)• Energy Star appliances (early November)	<p>Most service transactions exempted from the sales tax base</p>	<table><thead><tr><th data-bbox="933 357 1159 384">Sales Tax Holidays</th><th data-bbox="1274 357 1529 384">Sales Tax on Services</th></tr></thead><tbody><tr><td data-bbox="956 411 1130 532"><p>None</p><p>(Both repealed)</p></td><td data-bbox="1246 417 1555 572"><p>Limited expansion of base to certain services, including service contracts and services associated with the purchase of tangible personal property</p></td></tr></tbody></table> <hr/> <p data-bbox="1069 827 1373 854">Miscellaneous Provisions</p> <p data-bbox="887 888 1520 982">Electricity, piped natural gas, amusements, entertainment, manufactured homes, and mobile homes subject to the full state rate</p> <p data-bbox="887 1016 1555 1036">Note that 50 percent of the cost of mobile and manufactured homes is exempt.</p>	Sales Tax Holidays	Sales Tax on Services	<p>None</p> <p>(Both repealed)</p>	<p>Limited expansion of base to certain services, including service contracts and services associated with the purchase of tangible personal property</p>
Sales Tax Holidays	Sales Tax on Services								
<p>Two tax-free weekends:</p> <ul style="list-style-type: none">• Clothing, school supplies, computers, education software, and sports equipment (early August)• Energy Star appliances (early November)	<p>Most service transactions exempted from the sales tax base</p>								
Sales Tax Holidays	Sales Tax on Services								
<p>None</p> <p>(Both repealed)</p>	<p>Limited expansion of base to certain services, including service contracts and services associated with the purchase of tangible personal property</p>								

How Do North Carolina's New Sales Taxes Compare?

State Business Tax Climate Index Sales Tax Component Rankings, North Carolina and Competitor States (Projected)

Breaking the *State Business Tax Climate Index* into its subcomponents allows us to compare the structure of each major tax type. Here, we look at the structure of North Carolina's post-reform sales taxes. Once all reforms are in effect, North Carolina will have the 33rd best sales tax code in the country. Its sales tax structure is outranked by all competitor states except Texas—meaning North Carolina still has plenty of work to do in this category.

North Carolina



Prior to the tax reforms, North Carolina's sales taxes were ranked 47th in the country (meaning that they ranked more favorably than only three other states).

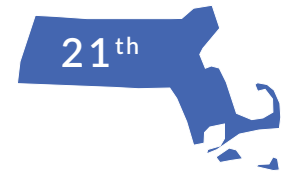
Florida



Georgia



Massachusetts



South Carolina



Texas



Virginia

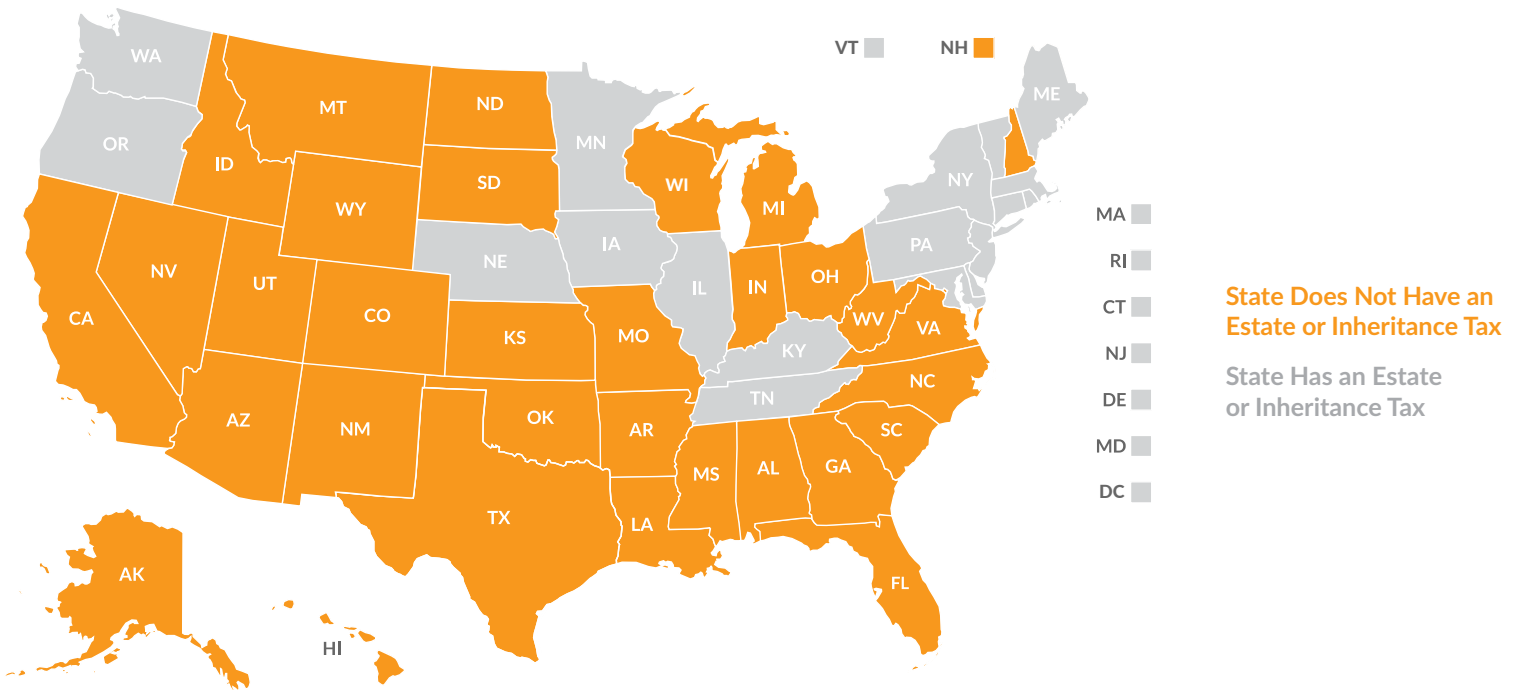


Note: The figure shows projected sales tax component rankings once all of North Carolina's sales tax changes are phased in.

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

North Carolina Joined 38 Other States without an Estate or Inheritance Tax

States without and with Estate or Inheritance Taxes (2015)



In addition to the federal estate tax, many states levy their own estate and inheritance taxes. Estate taxes are charged directly against the estate, while inheritance taxes are levied on inheritors, based on their relationships to the deceased. Fifteen states and the District of Columbia have an estate tax, and six states have an inheritance tax. Maryland and New Jersey have both. North Carolina repealed its estate tax—a smart policy move given death taxes' high compliance costs, detrimental economic effects, and low share of total state tax collections.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare?*

PART 3

What's Next for North Carolina?

The sweeping tax reforms made in the Tar Heel State shouldn't be the end of the road. North Carolina could still make improvements to its tax structure, especially when it comes to broadening bases.

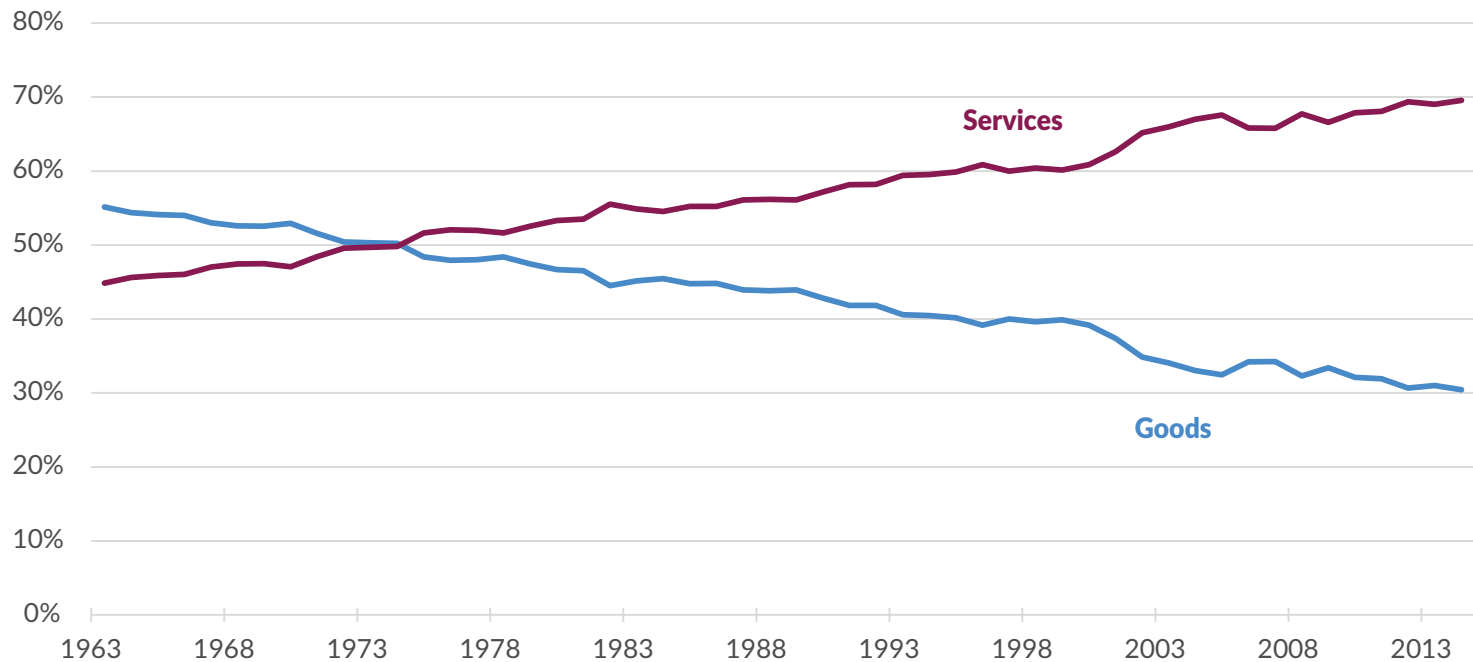
In particular, North Carolina still has narrow sales and corporate income tax bases. By broadening both of these, overall rates could be reduced, making North Carolina even more competitive nationally. The state has made moderate strides toward sales tax base broadening in the last several years, but a main component of the modern economy is still missing from the base: consumer services.

On the corporate income tax side, North Carolina still has several business tax incentive programs that narrow the tax base and make the tax code less neutral, forcing the overall tax rate to be higher than it would be otherwise.

Finally, North Carolina still has a capital stock tax, a tax that less than half of the states impose and that's a deterrent to capital formation—which is no way to encourage economic growth.

North Carolina's Sales Tax Base Doesn't Reflect the Modern Economy

Goods and Services as a Percent of Total State Private Gross Domestic Product (1963-2014)

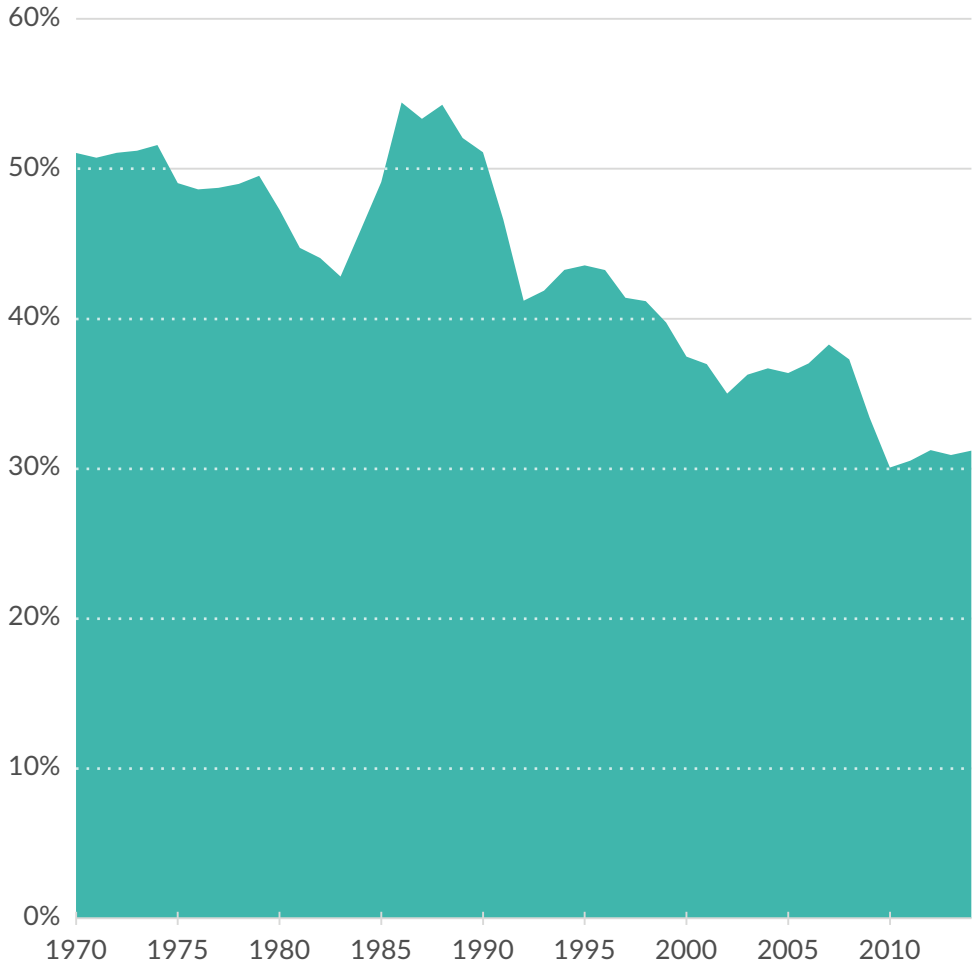


North Carolina has historically been more dependent on goods production than the U.S. as a whole due to its more pronounced manufacturing sector. But like all states, the share of the total economy that involves the production of goods has declined over time as the services share has grown. Fifty years ago, 55 percent of the North Carolina economy was derived from goods production, while only 30 percent came from goods in 2014. This has far-reaching implications for the sales tax base, which traditionally focuses on the taxation of transactions involving the exchange of tangible goods, not services.

Source: Bureau of Economic Analysis, *Gross Domestic Product (GDP) by State*, "GDP in current dollars."

As the Economy Has Shifted toward Services, the North Carolina Sales Tax Base Applies to Less and Less of the Economy

North Carolina Sales Tax Breadth (1970-2013)



An ideal sales tax is one that is levied on all final consumer purchases. By taxing a large number of transactions, the rate can be kept low and still raise sufficient revenue.

When sales taxes were created in the 1930s, they were levied on tangible goods, which at the time comprised the lion's share of the overall economy. However, the economy has become increasingly service based, and as a result, the sales tax is not nearly as productive as it once was. Furthermore, by failing to tax consumer services, the sales tax inherently favors the service sector of the economy over the goods sector—a major obstacle to tax neutrality. A solution to this problem is adding more final consumer purchases to the sales tax base.

Note: Sales tax breadth is defined as the ratio of the implicit sales tax base to state personal income.

Source: Professor John Mikesell, Indiana University.

North Carolina's Sales Tax Doesn't Apply Broadly to Most Services at the Expense of Goods Industries

Taxability of Common Types of Services, North Carolina and Competitor States (as of July 1, 2014)

	North Carolina	Florida	Georgia	Massachusetts	South Carolina	Texas	Virginia
Dry Cleaning Services	✓				✓	✓	
Gym & Fitness Club Services		✓				✓	
Barber Services						✓	
Janitorial Services		✓				✓	
Landscaping Services						✓	
Parking Services		✓				✓	
Repair Services	✓*					✓	
Legal Services							
Medical Services							
Real Estate Services							
Veterinary Services							
Information Services		✓			✓	✓†	
Financial Services							
Accounting Services							

Expanding the sales tax to services can be politically difficult, but it is still smart policy. North Carolina has moved in the right direction by adding certain service contracts and services purchased with goods (like repair services bought alongside parts) to the sales tax base. But there's still plenty of work to do to expand the sales tax to many common consumer purchases, like landscaping, parking, and gym memberships. Any sales tax expansion to services needs to include a robust business-to-business exemption to ensure that services purchased by businesses aren't taxed. When a business pays taxes on inputs, the final good or service purchased by consumers is taxed multiple times.

On this chart, a check mark indicates the service type is taxable under a given state's sales tax.

A blank space indicates the service type is exempted from the sales tax base.

Note: (*) indicates that only repair services bought in conjunction with tangible personal property are subject to the sales tax. In Texas, 20 percent of information services are exempted, which is denoted by (†) in the chart.

Source: State tax statutes; Commerce Clearing House, State Tax Smart Charts.

North Carolina Has 51 Base-Narrowing Corporate Income Tax Expenditures

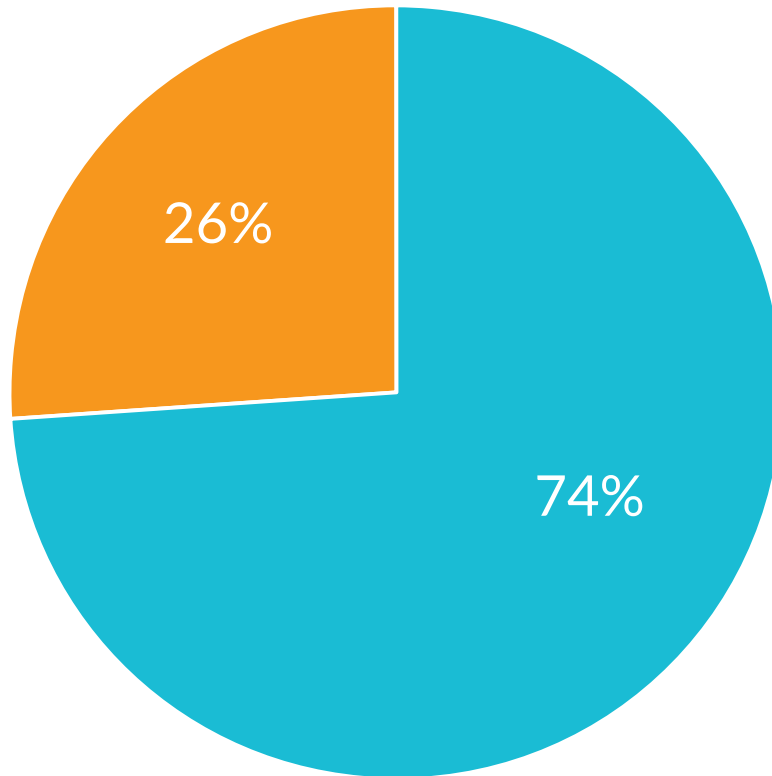
Number of Corporate Income Tax Expenditures (December 2013)

Administrative & Structural

18 Tax Expenditures

Policy Decisions

51 Tax Expenditures

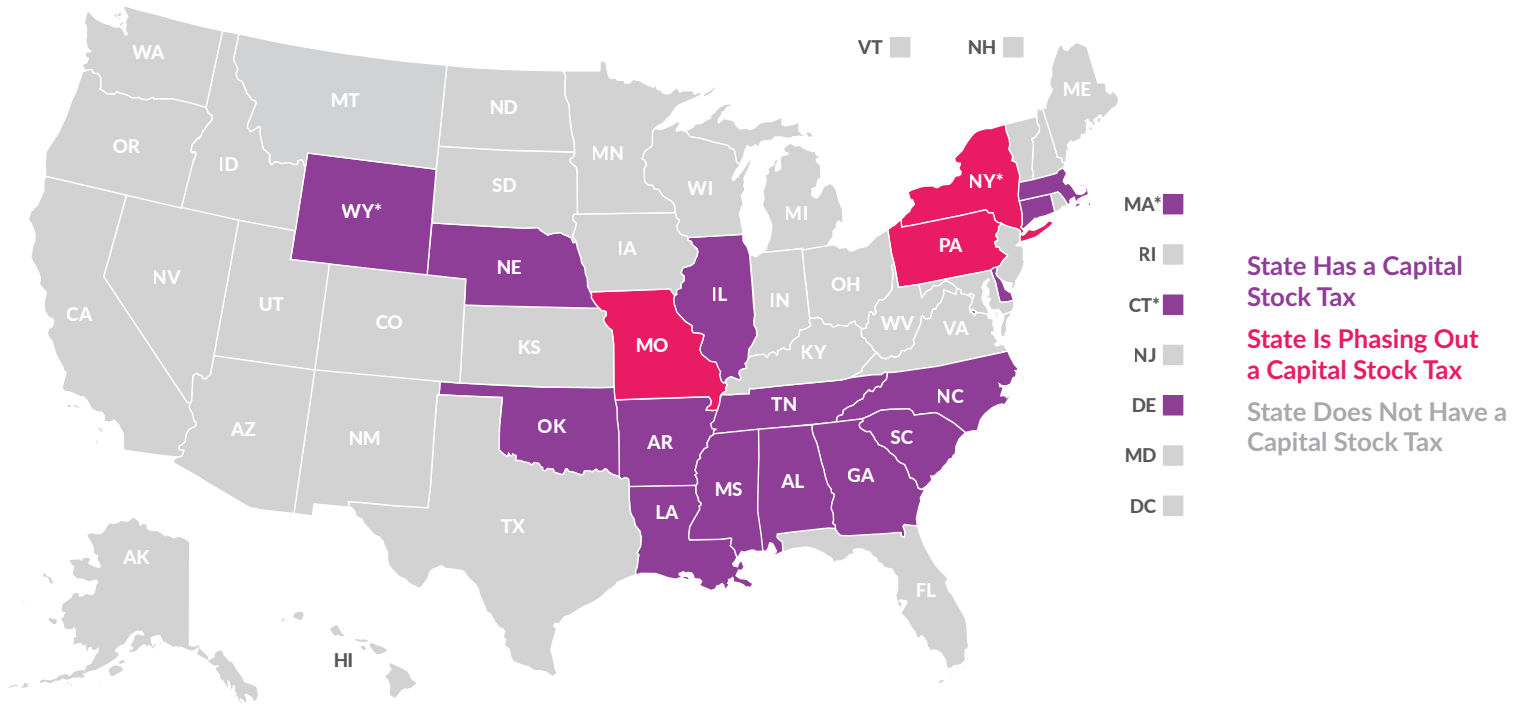


While North Carolina had a total of 69 corporate income tax expenditures on the books in their most recent *Tax Expenditure Report*, it's important to distinguish between different types of expenditures. Administrative and structural provisions are tools used to ensure the proper definition of income, avoid double taxation, and account for intergovernmental transactions. Approximately 26 percent of North Carolina's corporate income tax expenditures fall into this category. The remaining expenditures are carve-outs that are meant to encourage certain behaviors by businesses (such as moving toward renewable energy or creating jobs), but ultimately narrow the tax base, lead to a non-neutral tax code, and frequently fail to bring about the desired outcomes. A better approach to tax policy is to eliminate these types of tax expenditures so that the rate for all firms can be reduced.

Source: North Carolina Department of Revenue, Revenue Research Division, *North Carolina Biennial Tax Expenditure Report 2013* (Dec. 2013); Tax Foundation categorization of tax expenditures.

North Carolina Is One of Only 18 States that Levies a Capital Stock Tax

States with and without Capital Stock Taxes (as of January 1, 2015)



Fewer than half of the states in the U.S. levy a capital stock tax, an economically damaging tax imposed at a low rate but directly on business capital. These taxes are levied on the net assets or market capitalization of a business entity. The North Carolina capital stock tax is formally known as the “Franchise Tax” and is levied at a rate of 0.15 percent, with no limit on the maximum payment. These taxes discourage capital formation and are a deterrent to economic growth and development.

Note: Missouri, New York, and Pennsylvania are in the process of phasing out their capital stock taxes. Rhode Island and West Virginia just finished phasing out their capital stock taxes. (*) indicates that taxpayers pay the greater of corporate income tax or capital stock tax liability, but not both. See Table 33 of Tax Foundation, *Facts & Figures 2015: How Does Your State Compare* for more information on each state's capital stock tax rate and maximum payment.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare?*

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The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our principled research, insightful analysis, and engaged experts have informed smarter tax policy at the federal, state, and local levels. Our Center for State Tax Policy is routinely relied upon for presentations, testimony, and media appearances on state tax and fiscal policy, and our website is a comprehensive resource for information on tax and spending policy in each U.S. state.

About the North Carolina Chamber Foundation

The North Carolina Chamber Foundation works to promote the social welfare of North Carolina and its citizens by identifying, studying, researching, and analyzing, in a nonpartisan manner, the factors that enhance the business climate, workforce development, and quality of life in the state. This includes prospects for the creation and retention of jobs, and educating the business community and general public by disseminating the knowledge gained as a result. For more information, visit www.ncchamber.net/foundation.

Through a series of charts and maps, *North Carolina Illustrated: A Visual Guide to Tax Reform* puts North Carolina's recent state tax reforms in perspective and provides insight on several key questions. First, what did North Carolina's tax code look like before the reforms, in terms of the tax code but also in terms of the broader state economy? Second, what were the details of the tax changes, and how did they impact the state's tax code? And finally, what can North Carolina do to further improve its tax code in the future to make it an even better place to live and do business?

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