STATE OF NORTH CAROLINA

FINAL REPORT

GOVERNOR'S COMMISSION TO MODERNIZE STATE FINANCES

December 2002

OVERVIEW

In February 2002, Gov. Mike Easley issued an executive order creating the Commission to Modernize State Finances and named Thomas Ross, the executive director of the Z. Smith Reynolds Foundation, as its Chair. The Governor named 15 other North Carolinians with broad expertise to the Commission, which has met monthly since its appointment. The Commission members are listed in one of the appendices.

Governor Easley created the Commission out of a recognition that the state's fiscal system faces long-term challenges. Reform is crucial in order for the state and local governments to be successful at meeting the needs of their citizens. The Commission was charged with the task of modernizing state finances to ensure that the state's revenue system was more stable, fair and sufficient over the long term. Unlike the 2001 Efficiency and Loophole-Closing Commission, the Modernizing State Finances Commission did not have a specific revenue target to achieve. Rather, the Governor sought recommendations and insight as to crucial improvements for the long-term fiscal health of North Carolina.

THE GOALS OF THE COMMISSION

In order to guide its work, the Commission discussed and approved several principles as the goals of the Commission. These goals included:

1. *Equity.* A revenue system that ensures that all taxpayers pay a fair and equitable share of their income and wealth in state and local taxes. Those who benefit from services appropriate for user fees should pay the true cost.

2. *Competitiveness.* A revenue system that ensures that North Carolina remains competitive with other states in tax and revenue policy and promotes long-term, sustainable economic development, job creation and growth.

3. *Sufficiency.* A revenue system that provides enough resources over time to provide essential government services without wide variances from year to year.

4. *Simplicity.* A revenue system that is easier for taxpayers to understand and comply with and for administrators to administer.

5. *Efficiency.* A revenue system that does not interfere unduly with good economic decisionmaking.

6. *Appropriate Federalism.* A revenue system that provides both state and local government with appropriate tools for raising revenue to meet the growing needs of each level of government. The system should include consideration of federal tax policy for simplicity, uniformity and deductibility.

Various members of the Commission noted the tension among these goals.

CURRENT SITUATION

The State-Local Partnership

Due to the wisdom and foresight of Governors and legislators of an earlier generation, North Carolina in 1921-33 committed itself to the state financing of the essential services that all citizens need wherever they live and should not vary substantially in availability and quality from county to county. One consequence of that policy decision is that North Carolina relies more heavily than does almost any other state on state taxpayers to finance roads, schools, corrections, and courts. Because the state does not levy a property tax, income taxes (individual and corporate), franchise taxes, sales taxes, and motor vehicle fuel taxes and fees are relatively higher in North Carolina than they are in many states. Property taxes are correspondingly lower here than in most states, because less reliance is placed on that source than in most states. Therefore, in any comparison of tax burdens from state to state, it is essential that both state and local taxes be combined in order to gain a valid understanding of the subject.

In 1998-99 (the latest year available), North Carolina's state and local tax burden combined ranked 29th in the nation on a per-capita basis and 33rd as a percent of personal income. The state ranks 17th in per capita state taxes and 38th in per capita local taxes. In that year, North Carolina state government levied 71 percent of state-local taxes. Nationally, state governments levy 61 percent of the total. All of our neighboring states require local governments to fund a greater share of the state-local tax burden than our state.

The table below shows the source of major taxes as a percent of total state and local taxes for North Carolina, the Mid Southeast (which includes the four bordering states and Kentucky), and the nation. It shows that North Carolina is more reliant on the income tax, and less reliant on sales and property taxes, than states in the region and the nation as a whole. Nationally, the property tax is the largest major source of state and local taxes and is the most stable tax.

Certain Taxes as a Percent of Total State and Local Taxes,
North Carolina, the Mid-Southeast, and United States, 1998-99 Fiscal Year

	North Carolina	Mid Southeast	United States
Individual Income	32.5%	26.2%	23.2%
Sales and Use	21.7%	26.8%	24.6%
Property	21.5%	24.3%	29.4%
Other	24.3%	22.7%	22.8%
Total	100%	100%	100%

The Current Budget Situation

This report comes in the wake of two successive years of substantial revenue shortfalls. General Fund revenues fell short of projections by almost four percent (or over $500 million) in 2000-01 and an unprecedented $1.55 billion (or almost 11 percent) in 2001-02. This instability provides one reason for the need for reform.

The Necessity of Change

The state's tax code was updated in the 1920's and 1930's, when agriculture and traditional manufacturing dominated the state's economy. Record numbers of local governments had defaulted on their bonds. Property taxes were the primary revenue source for state and local government, and the state faced massive budgetary shortfalls.

Much has changed in the decades since Governors Gardner and Ehringhaus confronted these tough issues. The state's economy has become increasingly service-based, with fully half of consumption from the service sector today. People shop over the Internet, not always at the local store. The manufacturing and agriculture sectors continue to shrink as a share of the state's employment. Once-dominant industries such as apparel manufacturing barely exist in the state any more.

The tax policy changes of the 1920s and 1930s have largely been beneficial. Today, more North Carolina local governments have AAA bond ratings, the highest possible, than in any other state. The state's per-capita income rose from 47 percent of the national average in 1929 to 90 percent of the national average in 2001, and the state has reversed decades of population decline and stagnation as more people choose to live and work in the Tar Heel state.

The expectations of government have changed as well over time. Medicaid, the fastest-growing and second-largest item in the state budget, was not even created until the 1960s. For the first time, North Carolina has eclipsed the national average in terms of the rate of college attendance, as new generations find that postsecondary education is crucial for success in the global economy and older generations find that their workplaces are disappearing and their skills need upgrading. The environment and urban growth management are relatively new concerns for North Carolina.

The late 1990s were an unprecedented good time for state governments across the country, and North Carolina was no exception. The combination of a soaring stock market and the increase in consumption over saving spurred rapid growth in income and sales tax yields. But now the subsequent decline and ongoing volatility of financial markets and the growth in personal debt raise questions about whether that pace of revenue growth will ever be seen again. Many believe that it will not.

North Carolina needs a finance system that reflects all of these new realities. The state must make changes to ensure that our economic growth can continue, that adequate services can be provided, that the burden for government spending is spread fairly, and that emergencies – both natural and economic – can be withstood.

Tax Reform Efforts

The Commission to Modernize State Finances is the latest in a long line of efforts to address tax reform issues. North Carolina's leaders of both parties have recognized the need to make changes, although these changes have been slow in coming. In the late 1980s, the state moved to conform its income tax more closely to that of the federal government, eliminating thousands of North Carolinians from the income tax rolls. In the early 1990s, the Economic Futures Study Commission noted:

> Modernization also requires that the state tax system be made more responsive to the future growth of income and consumption in North Carolina. If this goal is not achieved, then the General Assembly will be forced to result time and again to ad hoc measures to increase revenues or control spending. By their nature, ad hoc revenue and expenditure adjustments under severe budget pressure are unlikely to contribute to tax equity or tax modernization, except by accident (p. 17).

This quote is equally valid today. The 1991 Commission recommended taxation of services and a reduction in the use of corporate incentives, two items discussed by this Commission. Within the past few years, both the General Assembly and Governor Easley have appointed commissions to make recommendations about the improvement of the tax code. The 2001 Governor's Efficiency and Loophole-Closing Commission made several recommendations to end tax preferences, the vast majority of which were ultimately adopted by the General Assembly. The 2001 Commission, which met for two months, urged further study of many of the issues that this Commission examined in its work. Certainly this Commission's work will not be the final word on tax reform. But it continues the discussion on this important matter.

THE PROCESSES OF THE COMMISSION

The Commission has been organized into three subcommittees: the New Economy subcommittee, the Tax Simplification subcommittee, and the Intergovernmental Relations subcommittee. Due to staff and member time conflicts, most of the work in recent months has been done in full Commission meetings.

Subcommittees received input from state agencies, including the Departments of Revenue and Commerce; local government associations and officials; nongovernmental tax experts; and taxpayer representatives.

At its October meeting, the Commission authorized Chairman Ross, the three subcommittee chairs, and Commission staff to delineate a series of recommendations that meet the Commission goals and reflect the Commission's deliberations. Those recommendations have largely been amended or accepted, and some other recommendations are included in this report.

THE PROPOSED RECOMMENDATIONS – MOVE TO BROADER BASES AND LOWER RATES

The overall recommendation of the Commission is that state and local taxes have broader bases and, in some instances, lower rates. This general recommendation is the best way to ensure simplicity, fairness, sufficiency and stability.

Taxes

1. Sales Taxation

The sales and use tax generated the most discussion by the Commission, perhaps because it has been widely recognized as one of the major taxes most impacted by structural changes in the economy and by economic downturns. Last year, the state sales tax generated over $3.7 billion in revenue, although sales tax revenues fell short of projections by over six percent. Most economists agree that sales tax revenues in recent years have been greatly aided by the increase in Americans' consumption patterns, a trend that many believe cannot continue.

Today, most North Carolina consumers pay six and one-half or seven percent on most tangible goods and a limited number of services. Currently, the state sales tax rate is four and one-half percent on most tangible goods and a very limited amount of services. Local governments receive two or two and one-half percent, distributed partially on a point-of-collection basis and partially on a per-capita basis. (Mecklenburg County levies an additional one-half cent sales tax). Effective December 1, 2002, counties were permitted to levy an additional one-half cent sales tax by action of their boards of county commissioners. A large majority of counties have done so.

The sales tax is levied at different rates on different items. Manufactured homes, utilities, satellite television, airplanes, boats, manufacturing machinery – all of these items are taxed at rates between one and six percent at the state level. These differential rates increase the complexity of the tax code.

The sales and use tax faces two major challenges. First, the economy is growing substantially more dependent on services, thereby diminishing the current sales tax base, which is primarily goods-based. Second, the growth in the use of the Internet and mail-order merchants to purchase taxable items makes compliance with sales and use tax more difficult, because many of these merchants do not have sufficient presence in North Carolina to be required to collect and remit the tax. Many taxpayers do not understand, or do not comply with, the longstanding law that they pay use tax on purchases consumed in North Carolina for which sales tax was not charged by the out-of-state merchant and it is virtually impossible to enforce this provision.

The original intent of the sales tax was to levy a tax on transactions. Because the economy has changed so much in the past seven decades, many transactions are not taxed or taxed at a partial rate. The Commission recommendations in this area are an attempt to comply with the original intent of the sales tax. The Commission does so with the recognition that many states have not accomplished such a restoration at this time.

The Commission makes the following recommendations regarding the sales and use tax:

- **Eliminate the differential rates of taxation of goods and services and remove caps on the sales and use taxes.** As explained above, there are eight different state sales tax rates. Caps, such as $80 on an "item" of machinery and equipment, are difficult to use in a fair and efficient manner. The Department of Revenue has noted that the existing system of rate and cap preferences is administratively burdensome. The Commission concludes that items should either be taxed fully or not at all, including sales-like taxes on amusements and entertainment.
- **Eliminate sales tax exemptions.** The sales tax specifically exempts numerous items in G.S. 105-164.13 and G.S. 105-164.14. The Commission recommends that each of these exemptions should be considered for elimination if appropriate, especially because many of these exemptions have not been reviewed in many years.

  The exemption of the state sales tax on food is an example of these exemptions. Currently, the North Carolina consumer pays two percent sales tax on food purchased for home consumption. The revenues from this two percent tax benefit only local governments, as it was only the state sales tax on food that was eliminated in the late 1990s. No change was made in the local effective sales tax rate of two percent on food to consumers. The additional one-half cent sales tax that most local governments have authorized (and others may authorize) after December 1, 2002 does not include food in the base. The Commission notes that the difference in base at the local government level over the tax of food must be changed in order to comply with the Streamlined Sales Tax agreement to which North Carolina is committed. The Commission also notes that the General Assembly recently acted to exempt food from the sales tax base.

- **Consider the expansion of the sales tax base to include more services.** The Department of Revenue's Tax Research Division has found that the possible tax base of services would nearly double the existing sales tax base of goods and utilities. As such, the estimated state sales tax rate could be reduced markedly if all goods and services were taxed at that rate. Because so few states tax services, the data used to perform these calculations may not be sufficiently reliable to use for revenue projections. The Tax Research Division has used gross receipts as a proxy for sales to customers, although such receipts may include some things not related to sales to consumers, such as earnings on investments or the sale of some asset.

  The Commission notes that the failure to tax services contributes to the discrepancies and inconsistencies in the sales tax code. The Commission cites the fact that a lawn mower is taxed, but lawn service is not, to support this observation.

  However, the taxation of services is very complicated and changes should not be made without further analysis. The Commission notes several issues that merit closer consideration than our time has allowed. These include:

  Appropriate exemptions. Some observers have noted that some services, such as medical care, are so important and basic that an exemption may be merited. Moreover, the Commission is wary of taxing business inputs, which are goods and services used in the production of a final good or service, as this results in a cascading effect and reduces efficiency. Many services that could be taxed, such as legal and accounting services, are used by businesses, and thereby complicate the efficiency problem. However, this issue is not new in North Carolina tax policy. An Office of State Budget and Management study showed that businesses paid almost 25 percent of the general sales tax (excluding food bought for home consumption) in 1990-91.

  Competitiveness. The taxation of services varies across states. Many states tax the repair of tangible personal property, while very few tax professional services. Any future analysis should benefit from experiences of other states in approaching service taxation.

  Representatives of service industries testified that such taxation would be burdensome and add to the regressivity of the system as a whole.

Services have become such an important part of the economy that any examination of a tax on consumption – the goal of the sales tax – should consider the inclusion of services in the tax base. Further, the services sector of our economy is expected to continue to grow at a much greater rate than that of goods.

- **Adopt changes required to comply with the Streamlined Sales Tax Agreement.** Representatives from 35 states, including North Carolina, recently completed a historic agreement to simplify state and local sales tax systems across the nation. Charles Collins, the former director of the Sales and Use Tax Division, was one of the co-chairs of the commission that negotiated this agreement after several years of work. The General Assembly has approved several interim steps to ensure our participation in the agreement. This Commission recommends the adoption of further measures to ensure equity among competitors and ease administrative burden on merchants and their customers.

- **Simplify the administration of local sales taxes.** The Department of Revenue has noted that it is difficult for taxpayers and the Department to determine the source county for local sales taxes. A state formula for distributing sales tax revenues to counties and municipalities would be the easiest way to ensure fairness and compliance.

2. Individual Income Tax

The individual income tax is the workhorse of the state tax system. It generates over one-half of all General Fund revenue. However, its actual yield has fallen short of projections in recent years. In 2001-02, it fell almost 13 percent – over $1 billion – short of its projection. This volatility is largely due to the drop in income from capital gains, bonuses and other such nonwage income. Currently, the state ranks 11th nationally in individual income tax burden, primarily because the state pays for a greater share of education, court, and correctional expenses than most other states. Local governments pay a smaller share of these expenses, leading to lower-than-average property tax burden described earlier.

The Commission has identified several major issues surrounding the income tax. First, North Carolina's income tax marginal rates are significantly higher than those in other states, especially for higher-income taxpayers. However, most of these taxpayers can deduct state income taxes paid from federal taxable income, thus reducing the real burden of their state income tax paid by nearly 40 percent. Second, the income tax has grown increasingly complex in recent years, due to a proliferation of tax credits and the growing gap between federal exemptions and deductions and state exemptions and deductions. Third, North Carolina's state and local tax system is regressive, and a strong individual income tax helps offset that regressivity. Fourth, the state has higher marginal income tax rates than most Southeastern states, giving rise to a concern that the state has difficulty competing for crucial economic development and job creation opportunities. . The Commission also noted that a significant number of taxpayers have very little taxable income and pay a very small share of the income tax. In 2000, taxpayers with less than $10,000 in taxable income represented one-third (almost one million) of the taxpayers, but less than four percent of income taxes paid.

The Commission recommends the following:

- **The state income tax should tie more closely to the federal tax code**. The federal income tax code is progressive. The state could simplify the state income tax by eliminating most adjustments to federal definitions of income. Some adjustments, such as those required by the *Bailey* decision, would have to remain. The Commission notes that the simplest solution would be to use the federal definition of taxable income. However, that use would result in a substantial increase in the value of standard deductions and personal exemptions, and therefore would reduce state income tax receipts. An alternative would be to use a broader version of income, such as federal adjusted gross income or total income. The state could also use its own values for standard deductions and personal exemption. These changes would broaden the base and allow the tax rates to be lowered to levels similar to those in other states. There are 16 tax credits (outside of business tax credits) in the individual income tax code, many of which have very high error rates.

- **Adopt strategies to help low-income taxpayers.** Several Commission members believe an earned income tax credit, such as proposed by Gov. Easley last year, would provide targeted relief that offsets regressivity elsewhere in the system. The earned income tax credit is part of the federal tax system. Families with children and earnings below $30,000 are the primary recipients of the credit. However, the creation of a new credit when others are repealed adds some new administrative difficulty, although the tie to the federal credit may mitigate substantial enforcement issues. The Commission also discussed other alternatives to achieve the goal of relief for low-income income taxpayers. These include: a “no-tax” threshold for those with taxable incomes below $10,000 or a reduction in the beginning marginal income tax rate from six percent to a lower number.

3. Corporate Income/Franchise Taxes

The corporate income tax is one of the most volatile of all revenue sources. Its General Fund yield fell 30 percent below expectations last year, and was about half of its 2000 high. There are a number of reasons for the decrease in liability, such as declining corporate profits, the increased use of tax planning schemes by multistate corporations and the use of tax credits.

The state's corporate income tax rate of 6.9 percent is higher than rates in most of our competitor states. Because economic growth and job creation are so crucial to the ability of a state to meet its financial needs, changes to business taxation must be thoroughly analyzed so as to maintain a good business climate.

The Commission recommends the following:

- **Elimination or simplification in the use of tax credits.** Since 1996, the state has enacted a series of tax law changes geared to promote economic development (the William S. Lee Act). In 2002, the General Assembly enacted legislation to tighten eligibility for these tax credits, especially in urban counties. Gov. Easley has argued for reduced use of tax subsidies, replacing these subsidies with performance-based grants designed to increase efficiency. The Commission finds these efforts should be continued in order to help maintain our competitiveness.

  The Commission finds that a research and development tax credit should remain, due to its substantial economic benefits. The Department of Commerce and some taxpayers contend that North Carolina's tax incentives are less generous than those provided in other states.

- **Simplify taxation by moving to combined reporting by related entities, as required at the federal level.** In the past two years, the General Assembly has acted to limit the ability of related corporations to reduce their North Carolina tax liability. The move to a combined reporting system, required in many other states, may clarify the rules for both taxpayers and tax administrators. Combined reporting is required at the federal level and may help simplify the administrative burden for business taxpayers. The Commission recommends that this move be done carefully, as the effects on state revenues are not easily determined. Department of Revenue staff would have to be trained to handle this shift.
- **Modernize the franchise tax.** The Commission finds that the evolution of new forms of business organization has led to inequities in the imposition of franchise

taxes. The Commission recommends that the state impose the franchise tax on all types of business organizations, not just on traditional corporations. The Commission recommends that the revenues generated from this base broadening could be used to establish a minimum net worth threshold for payment of the tax. The franchise tax rate could also be reduced in the process.

- **Consider the effect of establishing a throwout provision**. held that all income of a multistate corporation should be taxed, and taxed only once, among states where the corporation conducts business. The majority of the states with corporate income taxes have a "throwback" or "throwout" provision to ensure that all of a corporation's income is taxed. A "throwout" rule provides that the corporation's sales to customers in states where it has no nexus, and therefore is not taxed, are not included in the calculation of state tax liability. However, the Commission recognizes that North Carolina's border states do not have a throwback or throwout rule, and that the General Assembly did not adopt the throwout provision that was approved by the House of Representatives as part of their original 2002-03 budget proposal.

- **Conform more closely to the federal definition of corporate income.** This simplifies tax administration and computation. There are now several dozen adjustments to the federal income in determining state income, and each should be evaluated on its merits. The interest expense deduction for financial institutions is the best-known example of these types of adjustments. The Commission also finds that North Carolina is one of the few states to use net economic loss rather than net operating loss in the calculation of state corporate income tax, and that the effects of using federal net operating loss instead of net economic loss be considered.

- **Consider the effects of a move back to the equal weighting of payroll, property and sales in determining the share of income taxed by North Carolina.** Currently, multistate corporations calculate their North Carolina income tax liability by determining their shares of property, payroll, and sales in North Carolina. In the late 1980s, the formula was changed from equal weighting of these three factors to a double-weighting of the sales factor. This change was made in order to provide relief to companies that own significant property and employ a significant portion of their total workforce in North Carolina. This weighting formula results in a net loss of approximately $60 million to the state coffers when compared to the previous formula. Other corporations, especially those that conduct all of their business within North Carolina, have to pay higher corporate income taxes in order to compensate for this loss. For this reason, the Commission recommends consideration of the effects of returning to the previous formula. Most states, however, have moved to North Carolina's current system of "double-weighting" the sales factor in order to maintain competitiveness.

4. Other Tax Issues

The Commission notes that the state receives substantial revenue from taxes on specific products, such as alcohol, cigarettes, and gasoline. Some Commission members noted that these types of taxes may result in economic inefficiencies, as the singling out of certain products and industries violates the principle of broad bases and low rates. North Carolina alcohol taxes are generally higher than those in other states, while its cigarette taxes are far below the national average. The state has a higher than average gasoline tax, resulting from the fact that the state pays a higher than average share of the costs of road and highway construction than do other states.

The Intergovernmental Relations Subcommittee spent substantial time on local government finance issues. Because state-local roles were generally set in the 1930s, it is time for some updated changes. For this reason, the Commission recommends the following:

- **Shift Medicaid program costs from counties to the state government.** Medicaid expenditures are highest in the poorest counties in the state, because the program provides health care to low-income families, the aged, and the disabled. Because counties have no policy authority over Medicaid and many do not have the tax base to continue to fund a substantial share of this rapidly growing program, the state should pay all of the nonfederal costs of the program, as do over 40 other states. The Commission notes that the state half-cent sales tax levied in 2001 and due to expire on June 30, 2003 could be extended to pay for most of the current county share of Medicaid costs.
- **Establish a new State-Local Relations Commission.** In May, the Commission approved a recommendation to the Governor that he request that the General Assembly establish a Commission on State-Local Relations. This Commission should re-examine the ability of counties to provide crucial public facilities such as courthouses and public schools, the status of current functions of state and local governments, the ability of local governments to levy certain taxes from a menu authorized by the General Assembly, the

content of such a menu, and other issues that this Commission felt important, but beyond its scope and time. This Commission should have a definite sunset date and report back to the Governor and General Assembly as soon as possible.

- **Review the state unemployment insurance tax laws.** Although not part of the General Fund, unemployment insurance taxes should be examined as well in any comprehensive examination of the tax code. The Commission recommends that N.C. unemployment tax laws be reviewed and changed as needed to avoid the possibility that some entities may adopt techniques that artificially and unfairly reduce state unemployment insurance tax collections.

Other Nontax Finance Issues

1. Fees

The Commission believes that fees should be routinely evaluated to determine if they are covering the appropriate share of the cost of government services to which they apply. The Office of State Budget has produced a 359-page report on the various fees assessed by state government agencies and boards. The Commission recommends that the State Budget Office recommend an increase in fees to cover the cost of selected services, especially for those that have not been increased in several decades. This analysis should include consideration of the cost of collecting fees and perhaps recommend some fees to be eliminated.

For instance, some Commission members argued that some fees – or fee-like revenues such as privilege license taxes and installment paper taxes – are administratively burdensome for both state officials and taxpayers. The average privilege license tax is $185, with the average professional privilege license tax of $45. Repeal of some such fees that are not directly related to services, serving as *de facto* taxes, may also be appropriate.

2. Rainy Day Fund

North Carolina's Executive Budget Act requires that the state deposit 25 percent of the General Fund money remaining unspent at the end of the fiscal year into the state's Savings Reserve Account (the "rainy day" fund), until the fund reaches five percent of the prior year's general fund spending. While the state was able to reach this five percent target for some time, lawmakers decided to use rainy day funds for Hurricane Floyd relief and recovery and for payment of court judgments and have not maintained the fund at an appropriate level.

Recent research on economic downturns in North Carolina history showed that the recessions in recent years have resulted in increased severity of the revenue gap. The research concluded that a five percent rainy day fund would fall far short of the likely need, if the goal were to maintain the same level of expenditures in times of shortfall, while making no change in revenue laws.

The Commission recommends that the rainy day fund cap be raised substantially above the level of five percent. The Local Government Commission requires that local governments maintain a fund balance of at least eight percent in order to issue debt, far above the state's present cap of five percent. The Commission believes that the state should replenish the fund as quickly as possible after its expenditure. Rather than relying exclusively on monies left over at the end of the year to replenish the fund, as is the current case, the General Assembly should appropriate monies to ensure that the fund remains healthy. Moreover, the state should more strictly limit the uses of the rainy day proceeds; specifically, to stabilize the general fund in an economic downturn.

3. Future Tax Changes

A number of observers have attributed the state's current budget problems to the $1.5 billion in permanent annual tax cuts enacted by the General Assembly in the late 1990s. These tax cuts were not accompanied by commensurate reductions in state spending, which have contributed to a structural deficit.

The state tax cuts were permanent in nature. This permanent loss of taxes through elimination of entire tax schedules makes a future increase in taxes even more difficult.

The Commission recommends that future tax relief be provided through one-time rebates or temporary rate reductions. Minnesota, Oregon and Colorado are among the states that provided rebate checks to their taxpayers when times were good and have ceased to do so during these challenging times, thus mitigating the need for tax increases.

4. Tax Procedure Reforms

Any discussion of the tax code should include discussion of tax procedures. The complexity of the economy and the tax code make tax administration more difficult for tax administrators and taxpayers. The Commission finds that it is important to reduce the possibility of conflicts over interpretation of state tax laws.

- **Clarify the Secretary of Revenue's authority to address inappropriate tax planning strategies by taxpayers.** The Commission recommends clarification of the Secretary of Revenue's power to ensure that it is clear that the Secretary can void intercompany and other accounting transactions that are distortive, do not properly reflect state taxable income, or serve no legitimate business purpose.

- **Review tax hearing and appeal processes.** The Commission recommends a review of the administrative tax hearing process within the Department of Revenue, the appeal process to the Tax Review Board, and the Property Tax Commission for opportunities to streamline and otherwise improve the process, including the possibility of a new tax court.

5. Other Tax Policy Ideas

The Commission also heard testimony on, but did not have time to consider fully, some other tax policy proposals. The Commission makes no recommendations in regard to these ideas, other than to identify them as worthy of mention.

- Increase the cigarette tax in order to reduce the burden of other taxes. North Carolina's cigarette tax is third-lowest in the nation and the revenues from an increase could be used to replace revenues lost from a reduction in burden of other taxes.
- Adoption of "green taxes and fees." Testimony from environmental advocates found that "green taxes and fees" could result in increased revenue, better environmental outcomes, and improved adherence to the Commission's goal that those who benefit from a service pay for its cost.

CONCLUSION

The budget crisis may provide the motivation for necessary changes in how our state and local governments obtain the revenues to provide an appropriate level of public services. The last wholesale revision of North Carolina's government finances took place during the Great Depression. Perhaps these important recommendations will be accomplished in a similar manner. The Commission is one of a long line of groups to recommend crucial changes to the tax code. This long recognition that long-term systemic changes are required will help ensure that North Carolina emerges with a more stable, fairer and simpler system of raising revenue for important public services.

APPENDICES

Appendix 1 - List of Commission Members

Appendix 2 – Sources for General Fund Revenue, as a Pie Chart

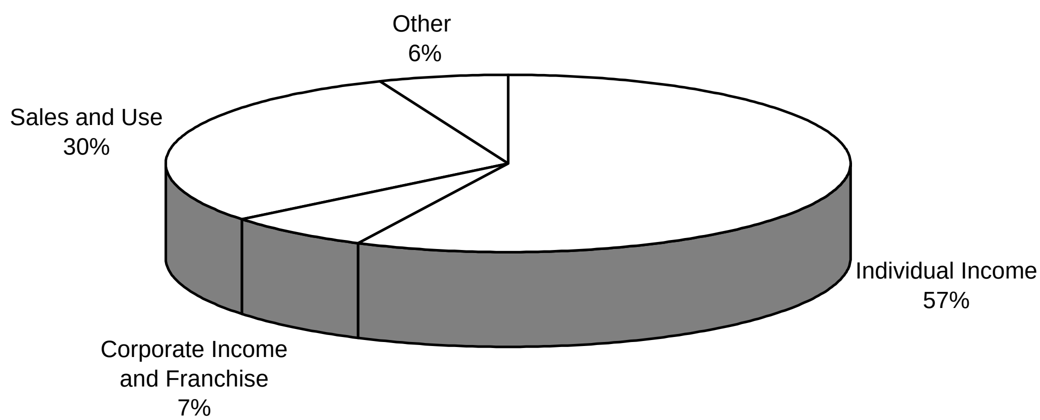
Appendix 3 – General Fund Sources of Revenue Over Time

Appendix 1: List of Commission Members

The Honorable Thomas Ross, Chairman	Winston-Salem
The Honorable Gordon Allen	Roxboro
The Honorable Daniel Clodfelter	Charlotte
The Honorable Wilma Sherrill	Asheville
The Honorable David Hoyle	Dallas
Mr. John Medlin, Jr.	Winston-Salem
The Honorable Lucy Allen	Louisburg
Mr. Charles Mercer, Jr.	Raleigh
Mr. Michael Hannah	Raleigh
Ms. Kay Hobart	Raleigh
Mr. James Talton, Jr.	Raleigh
Mr. John Sanders	Chapel Hill
Mr. Jack Cummings, Jr.	Raleigh
Dr. Ben Russo	Matthews

Appendix 2

NORTH CAROLINA GENERAL FUND TAX COLLECTIONS
(2001-02)



Individual Income	$7,134,629,832
Corporate Income and Franchise	855,593,220
Sales and Use	3,705,769,832
Other	749,616,899

Total	$12,445,609,783

N. C. Office of State Budget and Management
Summary of Actual Tax Revenue Collected by Category
For Fiscal Years 1980-81 Through 2001-2002

FY	Ind Income	%	Sales	%	Corporate	%	Franchise	%	Other	%	Total
1980-81	1,303.5	45.8%	737.1	25.9%	279.8	9.8%	235.3	8.3%	290.2	10.2%	**2,845.9**
1981-82	1,449.4	47.1%	777.4	25.3%	277.4	9.0%	269.8	8.8%	303.7	9.9%	**3,077.7**
1982-83	1,550.1	47.3%	823.4	25.1%	306.5	9.3%	298.6	9.1%	300.4	9.2%	**3,279.0**
1983-84	1,785.0	46.8%	999.0	26.2%	367.8	9.6%	326.8	8.6%	335.8	8.8%	**3,814.4**
1984-85	2,023.5	46.7%	1,155.8	26.7%	490.0	11.3%	310.1	7.2%	357.3	8.2%	**4,336.7**
1985-86	2,206.8	47.0%	1,380.4	29.4%	510.7	10.9%	197.6	4.2%	399.1	8.5%	**4,694.6**
1986-87	2,565.9	49.5%	1,451.6	28.0%	563.5	10.9%	206.5	4.0%	392.9	7.6%	**5,180.4**
1987-88	2,686.8	48.4%	1,555.3	28.0%	626.0	11.3%	234.8	4.2%	448.5	8.1%	**5,551.4**
1988-89	3,002.3	50.6%	1,681.7	28.4%	549.4	9.3%	236.3	4.0%	458.9	7.7%	**5,928.6**
1989-90	3,390.4	51.7%	1,762.7	26.9%	557.8	8.5%	262.8	4.0%	587.8	9.0%	**6,561.5**
1990-91	3,534.5	52.8%	1,682.3	25.1%	493.2	7.4%	372.9	5.6%	609.7	9.1%	**6,692.6**
1991-92	3,583.0	48.2%	2,161.4	29.1%	606.2	8.1%	407.0	5.5%	680.9	9.2%	**7,438.5**
1992-93	3,992.0	50.6%	2,344.1	29.7%	429.8	5.5%	420.0	5.3%	697.1	8.8%	**7,883.0**
1993-94	4,254.5	50.0%	2,578.9	30.3%	487.8	5.7%	439.3	5.2%	756.2	8.9%	**8,516.7**
1994-95	4,665.5	49.8%	2,781.7	29.7%	649.4	6.9%	458.1	4.9%	811.2	8.7%	**9,365.9**
1995-96	4,800.0	50.7%	2,958.1	31.3%	673.9	7.1%	355.9	3.8%	670.8	7.1%	**9,458.7**
1996-97	5,330.0	52.1%	3,127.7	30.5%	717.8	7.0%	387.8	3.8%	675.9	6.6%	**10,239.2**
1997-98	6,028.9	54.4%	3,255.4	29.3%	696.3	6.3%	407.3	3.7%	704.6	6.4%	**11,092.5**
1998-99	6,606.5	55.2%	3,376.2	28.2%	848.5	7.1%	409.6	3.4%	724.4	6.1%	**11,965.2**
1999-00	7,080.1	57.1%	3,354.9	27.1%	903.2	7.3%	307.0	2.5%	745.8	6.0%	**12,391.0**
2000-01	7,391.4	58.8%	3,435.6	27.3%	460.3	3.7%	580.4	4.6%	705.4	5.6%	**12,573.1**
2001-02	7,134.6	57.3%	3,713.1	29.8%	409.3	3.3%	446.3	3.6%	748.6	6.0%	**12,451.9**