OSBM
OFFICE OF STATE BUDGET AND MANAGEMENT

Putting More Money in Working Families' Pockets

Recommendation

Maintains current income tax rates while providing over $500 million annually in targeted tax cuts to working families. Governor Stein's Recommended Budget keeps the individual income tax rate at 4.25%, one of the lowest in the nation, and the corporate income tax rate at 2.25%, the lowest among states that levy this tax. Maintaining income tax rates provides more than $2.4 billion in revenue over the biennium to invest in public schools, make child care more affordable, build our workforce, keep North Carolinians safe, increase access to health care, and help western North Carolina recover from Hurricane Helene. These recommendations combine fiscal sustainability with critical support for working families struggling to keep ahead of rising costs.

Table 1. Revenue Changes for Putting More Money in Working Families' Pockets

Ensuring Adequate State Revenues	FY 2025-26	FY 2026-27
Maintain Individual Income Tax Rate at 4.25%	$386,300,000	$1,801,800,000
Maintain Corporate Income Tax Rate at 2.25%	$68,400,000	$166,200,000
Additional Revenues to Support State Investments	*$454,700,000*	*$1,968,000,000*
Tax Cuts for Working Families		
Refundable Child and Dependent Care Tax Credit	$59,000,000	$60,300,000
Replace Child Deduction with a Refundable Child Tax Credit	$23,000,000	$23,000,000
Refundable Working Families Tax Credit	$426,800,000	$425,800,000
Back-to-School Sales Tax Holiday	$29,000,000	$30,000,000
Total Tax Cuts for Working Families	$537,800,000	$539,100,000

Recommendation Detail

Sustaining Sufficient Funding for Critical State Investments

To invest in the high-quality public services that make our state successful, like first-rate education, safe communities, the ability to start or grow a business, and quality health care, the state must have sufficient revenue. Under current law and consensus revenue forecasts, the state's individual income tax rate will fall from 4.25% in 2025 to 3.49% in 2027, and corporations will pay no state income tax after 2029. This budget maintains the current individual income tax rate and keeps the corporate income tax rate at 2.25% to ensure that North Carolina can continue to invest in its people and its future.

North Carolina's corporate income tax rate is the lowest among the 44 states with a corporate income tax. The state's individual income tax rate is also among the lowest in the country and the region. Cutting income tax rates further will significantly reduce revenues and deliver disproportionate benefits to the state's wealthiest residents and out-of-state corporate shareholders. The result is that state revenues will fall short of what's necessary for state investments in education, health, and public safety to keep up with inflation and a growing population.

Supporting Working Families

Many working families across North Carolina are struggling to make ends meet due to the high cost of child care, housing, transportation, and groceries. In 2022, median child care costs for one infant in North Carolina ranged from $5,692 in the least expensive counties to over $14,000 in the most expensive counties, representing 9% to 18% of median family income. According to the NC Housing Coalition, more than one in four North Carolina households pay more than 30% of their income in rent or mortgage payments.[1] Families living below 200% of the federal poverty line spend nearly 75% of their income on necessities,[2] leaving little room in their budgets for their children's clothing, school supplies, and other investments necessary for school success.

This budget provides tax credits and a back-to-school sales tax holiday to target working families facing the most significant affordability challenges by:

- **Establishing a refundable Working Families Tax Credit (WFTC) equal to 20% of the federal Earned Income Tax Credit.** This credit supports low-to-moderate income workers (those earning up to $68,700) and their families with a credit worth up to $1,600. The WFTC's refundable structure ensures that even families with minimal state income tax liability can receive the full benefit, providing critical cost relief and helping to ensure that take-home pay exceeds the cost of maintaining employment.
- **Providing a refundable child and dependent care credit (CDCTC) equal to 50% of the federal credit.** This credit helps families afford high-quality child care by reimbursing a portion of eligible child and dependent care expenses. Working families with two or more children and $6,000 or more in child care expenses would receive a credit worth at least $600.
- **Converting the existing child tax deduction to a refundable Child Tax Credit (CTC) worth up to $150 per child.** The change provides greater benefits to families with children and extends assistance to lower-income families. The CTC increases the existing tax benefit for nearly 700,000 families with children and extends child tax benefits to nearly 200,000 more families.
- **Reestablishing a back-to-school sales tax holiday for three days in August**, with state and local sales tax exemptions for clothing and school supplies up to $100 per item, computers up to $750 per item, and computer supplies up to $250 per item. The state will hold local governments harmless for the loss of local sales tax revenues.

Expected Impact

Fiscal Impact

- Generates additional net revenue of $1.4 billion in FY 2026-27, $3.0 billion in FY 2027-28, and $3.9 billion in FY 2028-29. The additional revenue will eliminate the multi-billion-dollar shortfalls projected under the current tax policy. Revenue projections under the proposed changes show revenue increasing from $34.7 billion in FY 2025-26 to $38.4 billion in FY 2028-29. This ensures that the state can maintain essential services while investing in policies to support working families and promote economic growth.

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[1] National Database of Childcare Prices 2019-2022, Women's Bureau. U.S. Department of Labor. Link

[2] Lisa A. Gennetian, Jordan Conwell, and Becca Daniels. "How Do Low-Income Families Spend Their Money?" Econofact. November 15, 2021. Link

- Provides more than $500 million per year in tax reductions for working families while ensuring sustainable growth in General Fund revenues.

Economic Growth and Workforce Participation

- Boosts workforce participation due to lower child care costs. A recent NC Department of Commerce and NC Child study found that helping young parents reenter the workforce has the potential to add up to $7.5 billion to North Carolina's GDP and create up to 68,000 new jobs statewide.[3]
- Raises employment among working parents, especially working mothers. Research shows a 10% increase in child care subsidies, like the Child and Dependent Care Tax Credit, correlates with a 0.68% rise in employment among low-income mothers with young children.[4] Other research has demonstrated that rising child care costs push mothers out of the workforce, with mothers' employment rates falling by a percentage point for every 10% increase in child care costs.[5]
- Raises incomes of North Carolina families, especially families with children:
    - The Working Families Tax Credit will raise the after-tax income of an estimated 686,000 families by an average of $419.
    - The Child and Dependent Care Tax Credit will raise the after-tax income of an estimated 214,000 families by an average of $303.
    - The Child Tax Credit will benefit 884,000 families with children, including an estimated 193,000 families who do not benefit from the current child deduction.
    - Families with school-age children spent an average of $875 on back-to-school supplies and clothing, according to the National Retail Foundation.[6] The 7% savings from a back-to-school sales tax holiday would enable these families to save up to $60 per year.

Health and Education

- Improve child and maternal health. One study found that state Earned Income Tax Credits exceeding 10% of federal levels reduced low birth weight by 2-3% and preterm births by 1.5%, with larger effects for refundable credits.[7]
- Keep more children with their parents and out of foster care. A study published in Child Maltreatment found that refundable state EITCs are linked to an 11% reduction in children entering foster care due to fewer cases of abuse and neglect.[8]
- Improve high-school and college completion. Harvard economist David Deming found that a $1,000 increase in EITC during adolescence increased high school completion by 1.3% and college completion by 4.2%.[9]

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[3] North Carolina Department of Commerce and NC Child. *Empowering Work: How Increasing Employment Among Parents of Young Children*. October 2024. Link

[4] U.S. Department of Health and Human Services, *The Effects of Child Care Subsidies on Maternal Labor Force Participation in the United States*, 2023.Link

[5] First Five Years Fund. "BLS Report Finds Price of Child Care 'Untenable for All Families.'" January 2023. Link

[6] National Retail Federation. "Holiday and Seasonal Trends: Back-to-School" Link

[7] Markowitz S, Komro KA, Livingston MD, Lenhart O, Wagenaar AC. Effects of state-level Earned Income Tax Credit laws in the U.S. on maternal health behaviors and infant health outcomes, 2017.

[8] Rostad WL, Ports KA, Tang S, Klevens J. Reducing the Number of Children Entering Foster Care: Effects of State Earned Income Tax Credits. Child Maltreat. 2020 Nov;25(4):393-397. Link

[9] Deming, David J. *The Growing Importance of Social Skills in the Labor Market,* Harvard University, 2017. Link