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Another way to win tax reform

By John Hood

North Carolina politicos have known for nearly a year that a major battle over tax reform is coming in 2013. They figured that because of voting trends, redistricting and other advantages, Republicans would maintain control of the state egislature. And they figured Republican Pat McCrory would win the race for governor, adding a chief executive who endorses fundamental tax reform to a set of legislative leaders who feel the same way.

As a result, lawmakers and public officials have spent the past few months preparing for the tax-reform battle. So have trade associations, interest groups and lobbyists. Most have focused on expanding North Carolina's retail-sales tax to include most or all services, using the proceeds to reduce or eliminate the state's personal- and corporate-income taxes.

Here's the rub: The more I study the lay of the land and talk to interested parties, the more I suspect we aren't about to witness a tax-reform battle at all. It will be a battle re-enactment. That is, it will be a colorful event. Participants will play their roles well. But the ending is written into the script. The forces of tax reform will raise their banners, give a full-throated yell, charge into the line of the status quo and get slaughtered. Observers will shake their heads in resignation at the power of vested interests and credit the wounded reformers for trying. They'll note that efforts at tax reform always seem to fall short. Then everyone will move on to the next political drama.

But North Carolina can't afford to. Our uncompetitive tax structure really is a factor inhibiting our success in the 21st-century economy. Our marginal tax rates on work, savings and investment are high by national and international standards. Our corporate tax is needlessly complex and riddled with inefficiencies. We also have one of the country's worst-designed sales taxes, particularly as it affects business-to-business transactions. We need pro-growth tax reform. Here's a different way to do it.

Those who advocate an expanded sales tax are correct in principle. Consumption is the right tax base to target. If you think about it, income is the total of three things: the money you spend today (consumption), the money you save to spend later (investment) and the money you give away to support someone else's consumption (charity). If government taxes all income at the same rate, it actually creates a bias in favor of you consuming your income today rather than saving to consume tomorrow or giving money away for others to consume because the last two result in some double taxation (or even triple taxation, in the case of investment earnings from owning stock in taxable corporations).

That's why a sensible tax code exempts household savings and charitable giving from the tax base. These policies aren't special favors. They are useful tools for eliminating bias in the tax system and making sure it doesn't discourage the savings and investments that power the creation of economic value and jobs.

It's true that abolishing income taxes and replacing the revenue with a broad-based sales tax could address these concerns. But this strategy has significant drawbacks. It would compel professions and entire new industries to collect and remit sales taxes for the first time. This is a costly and unwelcome burden that they will fight tooth and nail. Moreover, unless there is some immediate resolution of the dispute over taxing online and catalog sales across state and national borders, the resulting state sales-tax rate of 9.5% or higher would drive more consumers away from North Carolina's brick-and-mortar retailers.

A better strategy is to reform the income tax to remove its anti-investment bias. The concept is sometimes called a consumed-income tax or a USA tax (for unlimited savings allowance). North Carolinians would take their adjusted gross income from their federal tax form, deduct some personal exemptions and charitable giving and then deduct their net savings — that is, the amount they put into savings accounts, mutual funds, education accounts for their kids and other investments minus the amount they take out of savings to spend on goods and services.

By definition, what would be left is consumption to be taxed. My team of analysts at the John Locke Foundation are finishing a model tax plan for 2013. Right now, it looks like North Carolina could replace our current personal- and corporate-income taxes with a 6% USA tax and yield roughly the same amount of state revenue (about $11 billion). Such a system would give North Carolina one of the most pro-investment, pro-growth tax codes in the nation. Over time, it would create tens of thousands of new jobs and reduce paperwork burdens for North Carolina businesses of all shapes and sizes. Let's not watch another tax-reform re-enactment. Let's win the battle.

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