The Beacon Hill Institute

# *The Fiscal and Economic Effects of Phasing Out or Eliminating the Franchise Tax in North Carolina*

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## Table of Contents



## Table of Tables

## Executive Summary

North Carolina imposes a Franchise Tax on the wealth of the state's corporations, including both S and C corporations. The tax is collected on either of the company's apportioned net worth, 55 percent of the appraised value of all personal property in the state, or the business's total investment in state property.[1] Essentially, combined with the corporate income tax, corporations are double taxed in North Carolina. The Franchise Tax code contains numerous tax credits for specific industries or activities.[2] Companies with high values are especially burdened by the tax.

Two Senate Bills, S.B. 622 and S.B. 578, seek to implement reductions in the franchise tax rate. S.B. 622 reduces the franchise tax rate to $1.30 per every $1,000 of business's net worth effective in 2019 and reduces the rate to $1.00 per every $1,000 of a business's net worth in 2020.[3] The bill also calls for the elimination of the 55 percent appraised value base and maintains the $1.50 rate for utilities until 2026.[4] S.B. 578 reduces the franchise tax rate to $1.29 for every $1,000 of a business's net worth in 2020, and to $0.96 for every $1,000 of a business's net worth in 2021.[5] The bill also calls for the elimination of the 55 percent appraised value base.[6]

The Beacon Hill Institute (BHI) used its State Tax Analysis Modeling Program for North Carolina (NC-STAMP) to determine the economic effects of Senate Bills 578 and 622. The Senate passed S.B. 622 on May 20, 2019.

The NC-STAMP analysis shows that S.B. 622 would:

- Increase private sector jobs by 1,109 in the first full year of implementation (2021) and by 3,611 in 2025;

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1 North Carolina Legislature Article 3, Franchise Tax https://www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-114.html

2 North Carolina Department of Revenue, Franchise Tax https://www.ncdor.gov/taxes/corporate-income-tax-information/corporate-income-franchise-and-insurance-tax-bulletins/corporate-taxes-law/franchise-tax

3 S.B. 622, https://www.ncleg.gov/Sessions/2019/FiscalNotes/Senate/PDF/SFN0622v1.pdf

4 Ibid, 3.

5 S.B. 578 https://www.ncleg.gov/Sessions/2019/FiscalNotes/Senate/PDF/SFN0578v2.pdf

6 Ibid, 4.

- Increase real disposable income by $146 million in 2021 and by $497 million in 2025;
- Cause investment to rise by $347 million in 2021 and by $1.054 billion in 2025; and
- Increase real GDP by $484 million in 2021 and by $1.537 billion in 2025.

The increase in economic activity sparked by phasing out or eliminating the franchise tax would mitigate the loss of revenue to North Carolina and boost local tax revenue collections. Under the bill:

- Franchise Tax collections would fall by $91 million in 2021 and by $259 million in 2025;
- Other state tax revenues would rise by $21 million in 2021 and by $71 million in 2025; and
- Local taxes and fees would rise by $12 million in 2021 and by $40 million in 2025.
- Combined state and local revenue would fall by only $58 million in 2021 and by just under $150 million in 2025.

S.B. 578 and S.B. 622 would reintroduce sound tax policy to North Carolina. It would do this by reducing a tax on an important sector of the state's economy, resulting in considerable employment and investment gains while incurring trivial revenue losses. Eliminating the franchise tax entirely would have considerably larger positive impacts on the state economy than reducing it. North Carolina would be able to vastly improve its economic landscape, especially in the face of crisis related to the COVID-19 pandemic. This tax policy change would dramatically increase the attractiveness of investing in North Carolina.

# Introduction

## The North Carolina Franchise Tax

North Carolina is currently one of 16 states that impose a franchise tax.[7] Franchise taxes are taxes on business investment and wealth accumulation. North Carolina's franchise tax rate is set at $1.50 per every $1,000 of a corporation's net worth.[8] After January 1, 2017, the minimum franchise tax was raised to $200, up from $35 previously.[9]

Under Article 3 of the North Carolina code of laws, a domestic or foreign general business corporation becomes subject to the state franchise tax.[10] Originally, in 1849, North Carolina enacted a tax on the capital stock of a corporation, and this has since become the franchise tax.[11] From 1901 through 1913, the North Carolina franchise tax was levied as graduated tax, ranging from $5 to $500.[12] After 1913, the tax was set at .001 percent of a corporation's total worth.[13] Starting in 1933, the franchise tax was levied at $1.50 for every $1,000 of a corporation's net worth where it remains presently.[14] The tax is levied on domestic corporations, foreign corporations, electric membership corporations or electric utilities, and any associations that is "organized for pecuniary gain, has capital stock represented by shares, whether with or without par value, and has privileges not possessed by individuals or partnerships."[15] In addition to C and S corporations, limited liability companies and partnerships who elect to be taxed as corporations are subject to the franchise tax.[16]

[7] "Will North Carolina Reduce its Franchise Tax?", The Tax Foundation (April 15, 2019) https://taxfoundation.org/north-carolina-franchise-tax/

[8] Ibid, 1.

[9] Franchise Tax Rate, https://www.ncdor.gov/taxes/franchise-tax-information/tax-rate

[10] Ibid, 1.

[11] Overview of North Carolina's Franchise Tax, Senate Tax Counsel (Accessed April 15, 2020) https://www.ncleg.gov/documentsites/committees/jhsfctr/Meeting%20Documents/4-7-2010%20Meeting/Franchise%20Tax%20Overview.pdf

[12] Ibid, 11.

[13] Ibid, 11.

[14] Ibid, 11.

[15] Ibid, 1.

[16] Ibid, 1.

The franchise tax is not broad-based. Banking insurance, utility cooperatives, home owning associations, rail transportation, electric, agricultural cooperatives, non-profits, telecommunication services, and public safety communications are not subject to the tax.[17] Also exempt are entities that receive a production credit under the federal Farm Credit Act.

The franchise rate applies to a business's apportioned net worth, 55 percent of the business's appraised value, or investment in tangible property within North Carolina.[18] Net worth is a firm or corporation's total assets. Net worth is deemed as "the total assets of the corporation without regard to deductions for accumulated depreciation, depletion, or amortization minus total liabilities."

A corporation's net worth is calculated by making the following adjustments:

(1) a deduction of accumulated depreciation,
(2) a deduction for the cost of reacquired stock,
(3) an addition for the debt owed to an entity such as a parent, subsidiary affiliate, or non-corporate entity if the corporation owns 50 percent or more of the non-corporate entity, and
(4) an addition for the debt owed to a parent, subsidiary affiliate, or non-corporate entity if the debt has been added by the debtor corporation under its franchise tax liability.[19]

If a corporation believes that if the state recognizes more of its net worth than reasonable, than it can ask the Secretary of Revenue to use an alternative apportionment formula to adjust its allocated net worth to the state.[20]

In sum, North Carolina has a tax code that imposes high rates and high compliance costs and discourages multinational corporations from repatriating profits. The North Carolina corporate franchise tax yielded approximately $749.62 million in

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[17] North Carolina Legislature, Franchise Tax Exempt Corporations
https://www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-125.html
[18] Ibid, 1.
[19] North Carolina Department of Revenue, Net Worth Base (G.S. § 105-122(b))
https://www.ncdor.gov/taxes/franchise-tax-information/net-worth-base-gs-ss-105-122b-applicable-tax-years-beginning-or-after-january-1-2017
[20] Ibid, 19.

FY 2019.[21] Franchise tax revenues comprise only 3.02 percent of the total state tax revenues.[22] According the Statistical Abstract of North Carolina Taxes 2019, 6.4 percent of total general fund tax revenues in the state are comprised of corporate and franchise tax revenues.

The franchise tax thus represents only a small fraction of total state tax revenues. Serious reform is urgently needed to simplify and reduce the franchise tax's burden on capital investment in North Carolina.

**The Economics of Corporate Taxation**

The U.S. federal corporate tax was first imposed in 1909 after a previous law, the Revenue Act of 1894, was ruled unconstitutional.[23] States soon followed suit and implemented their own corporate income taxes.

The Revenue Act of 1894 established the principle of taxing a corporation's earnings independently of its owners. The Act defined taxable income and tax rates that were levied on corporations without consideration of the status of its owners. However, the courts ruled the 1894 Act unconstitutional and the United States remained free of corporate taxes until 1909. The passing of the 16th Amendment enshrined the personal income tax in the constitution. Since then, the United States has levied both personal and corporation income taxes.

Because corporations are owned, directly or indirectly, by individuals who (ultimately) receive a share of corporations' profits, the corporation income tax is a double tax. The same dollar of income is taxed once at the corporate level and again at the individual level.

Proponents counter this objection with the argument that corporate income taxes protect state revenues from overdependence on personal income taxes and from

[21] North Carolina Department of Revenue, Statistical Abstract of North Carolina Taxes 2019 https://files.nc.gov/ncdor/documents/reports/advanceabstract_2019.pdf

[22] Ibid, 21.

[23] U.S. Internal Revenue Service, Data Release, "Corporation Income Tax Brackets and Rates 1909- 2002," http://www.irs.gov/pub/irs-soi/02corate.pdf.

taxpayers sheltering personal income in corporations.[24] Proponents of state corporate income taxes do not explicitly state, but imply, that corporate taxes export the tax burden to out-of-state shareholders, similar to special hotel and car rental taxes.[25] They also assert that corporate incomes taxes reimburse states for public services utilized by businesses, such as transportation infrastructure, public safety, education and the judicial system. Finally, proponents contend that corporate income taxes are progressive because wealthy individuals are typically the largest shareholders of corporations.

Proponents like to perpetuate the myth that the corporate tax is paid by "big business," not real people, when, in fact, only people pay taxes. The corporate income tax is borne by shareholders insofar as it reduces the dividends that can be distributed to shareholders, who are then taxed a second time on the dividends they receive. There is, indeed, a firm argument that a large part of the corporate tax burden is borne by workers, not shareholders.[26]

State corporate income taxes are particularly inefficient ways of raising income. They generate only a small share of state revenue but consume an inordinate amount of intellectual and economic resources in terms of planning, compliance, and administration. A survey found that business costs of compliance with state corporate taxes are almost twice those of the federal corporate tax, in terms of tax revenue collected.[27] Table 1 displays the corporate income tax regimes for all fifty-states.[28]

[24] David Brunori & Joseph J. Cordes, "The State Corporate Income Tax: Recent Trends for a Troubled Tax," American Institute of Tax Policy. August 15, 2005.
[25] Ibid, 24.
[26] See Arnold Harberger, the ABCs of Corporate Income Taxation, *Tax Policy and Economic Growth*, American Council for Capital Formation, Washington DC, 1995.
[27] Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," Tax Foundation, (Accessed Aril 15, 2020).
http://taxfoundation.org/sites/taxfoundation.org/files/docs/a3a792509ccb161d00a8895e31cb90ba.pdf.
[28] Tax Foundation, "The United States' Corporate Income Tax Rate is Now More in Line with Those Levied by Other Major Nations" (Accessed April 15, 2020) https://taxfoundation.org/us-corporate-income-tax-more-competitive/

**Table 1: Corporate Tax Regimes in the Fifty States**

| No Tax (2) | Flat Tax (30) | | Graduated Tax (14) |
|---|---|---|---|
| South Dakota | Alabama 6.5 | Minnesota 9.8 | Alaska |
| Wyoming | Arizona 4.9 | Missouri 4.0 | Arkansas |
| | California 8.84 | Montana 6.75 | Hawaii |
| **but Gross Receipts (4)** | Colorado 4.63 | New Hampshire 7.7 | Iowa |
| Nevada | Connecticut 7.5 | New York 6.5 | Kansas |
| Ohio | Delaware 8.7 | North Carolina 2.5 | Louisiana |
| Texas | Florida 4.458 | Oklahoma 6.0 | Maine |
| Washington | Georgia 5.75 | Pennsylvania 9.99 | Mississippi |
| | Idaho 6.925 | Rhode Island 7.0 | Nebraska |
| | Illinois 5.5 | South Carolina 5.0 | New Jersey |
| | Indiana 8.5 | Tennessee 6.5 | New Mexico |
| | Kentucky 5.0 | Utah 4.95 | North Dakota |
| | Maryland 8.25 | Virginia 6.0 | Oregon |
| | Massachusetts 8.0 | West Virginia 6.5 | Vermont |
| | Michigan 6.0 | Wisconsin 7.9 | |

The high compliance costs arise from the complex nature of a tax that arises from the different methods used by the 44 states that levy a corporate income tax. Thirty states, including North Carolina, levy a flat rate while the rest have multiple tax brackets with different marginal rates.

State corporate taxes are generally thought to have a negative effect on investment and capital formation within a state. The corporate income tax creates a wedge between the pre-tax rate of return and the after-tax rate of return on an investment. This wedge forces pre-tax, risk-adjusted rates of return higher and after-tax rates of return lower, with the net result of a reduced flow of investment. At the state level, higher corporate income taxes incentivize investors to seek jurisdictions with lower corporate tax rates.

Academic research provides evidence of these negative effects. Laurence Kotlikoff and Jane Gravelle found that the negative effect on economic welfare of the U.S. corporate tax is more than 100 percent of the revenue collected by the tax.[29] Djankov et al., in a study of 85 countries, found that a 10 percent rise in the effective corporate tax rate reduces the investment-to-GDP ratio by 2 percentage points.[30]

State corporate income taxes also, as mentioned, weigh negatively on wages as an indirect consequence of their stifling effect on investment. By reducing investment, they reduce the amount of capital with which labor is equipped to work and therefore the wage that labor commands.

Research indicates that a one "percentage-point increase in the marginal state corporate tax rate reduces wages by 0.14 percent to 0.36 percent" and that the magnitude of this effect has been increasing over time.[31] The evidence suggests that state corporate tax rates have larger negative effects on people with higher education. A one percent increase in the marginal tax rate reduces wages of college-educated workers by 0.44 percent, high-school educated workers by 0.31 percent and workers without a high school diploma by 0.26 percent.[32] Furthermore, the same one-percent marginal tax rate increase reduces the union wage premiums by about 0.36 percent.[33] States with higher corporate tax rates may have trouble attracting and retaining highly educated workers, and they punish unions.

## North Carolina Competitiveness

The BHI State Competitiveness Index employs 44 indicators that measure "the micro foundations of prosperity" and has been compiled annually since 2001. The

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[29] Laurence J. Kotlikoff and Jane G. Gavelle, "The Incidence of Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good, *Journal of Political Economy*, (August 1989): 749-780.
[30] Simeon Djankov *et al*., "The Effect of Corporate Taxes on Investment and Entrepreneurship," NBER *Working Paper* 137576, https://econpapers.repec.org/paper/nbrnberwo/13756.htm (January 2008).
[31] Corporate Tax Reform and Wages: Theory and Evidence, https://www.whitehouse.gov/sites/whitehouse.gov/files/documents/Tax%20Reform%20and%20Wages.pdf .
[32] Ibid, 30.
[33] R. Alison Felix & James R. Hines, Jr. "Corporate Taxes and Union Wages in the United States," National Bureau of Economic Research, Working Paper 15263, (August 2009), http://www.nber.org/papers/w15263 (Accessed April 21, 2020).

Index identifies, for example, how well a state performs in its ability to cultivate a solid base of scientists and engineers and how well a state is doing in protecting its environment while holding down utility costs. The index can show whether a state can improve the productivity of its workers by cutting down on the time spent on daily commutes to work.[34]

**Table 2: BHI SCI Rankings for North Carolina (2018)**

| Competitive Advantages | | |
|---|---|---|
| | Index | Rank |
| Infrastructure | 5.78 | 13 |
| Business incubation | 6.25 | 5 |
| Technology | 5.64 | 9 |

| Competitive Disadvantages | | |
|---|---|---|
| | Index | Rank |
| State and fiscal policy | 5.25 | 23 |
| Openness | 5.23 | 23 |
| Human resources | 4.31 | 37 |

According to BHI's Seventeenth Annual State Competitiveness Report, North Carolina ranks 13th overall among all states, with high rankings for technology (9th), business incubation (5th) and infrastructure (13th). However, North Carolina needs to improve its state and fiscal policy performance (23rd), openness (23rd), and human resources (37th). Of course, one way North Carolina can dramatically improve their tax policy is by reducing and eventually eliminating its franchise tax.

The 2020 Tax Foundation's State Business Tax Climate Index echoes the BHI results by ranking North Carolina 15th out of 50 states.[35] The Tax Foundation ranks North Carolina 3rd in the corporate tax rankings. Elsewhere, North Carolina ranks 16th in induvial taxes, 21st in sales taxes, 34th in property taxes, and 10th in unemployment insurance taxes.

[34] Beacon Hill Institute, *17th Annual State Competitiveness Report*, (Accessed April 21, 2020) http://beaconhill.org/wp-content/uploads/2018/11/17thEditionBHIStateCompetitivenessReport181120.pdf
[35] Tax Foundation, 2020 State Business Tax Climate Index (Accessed April 21, 2020) https://statetaxindex.org/

Although North Carolina ranks highly in terms of its corporate tax system, one way to further improve the prospects for its long-term economic health is to maintain its favorable business tax climate.

## Economic Effects of Senate Bills 622 and 578

To determine the effects of S.B. 578 and S.B. 622 on the North Carolina economy, BHI used its State Tax Analysis Modeling Program customized for the state.[36] The North Carolina STAMP (NC-STAMP) model is a five-year, dynamic Computable General Equilibrium (CGE) model that simulates the economic effects of changes in tax law. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world and of how those relationships are affected by changes in state tax policy.

BHI assumed that S.B. 578 and S.B. 622 would be fully implemented beginning in Fiscal Year (FY) 2021. Table 4 displays the results that would occur against the baseline of no change to North Carolina tax policy.[37]

S.B. 622 would reduce the franchise tax rate to $1.30 per every $1,000 of business's net worth effective in the first year and reduce the rate to $1.00 per every $1,000 of a business's net worth the following year. The bill also calls for the elimination of the 55 percent appraised value base and maintains the $1.50 rate for utilities until 2026.

**Table 3: Economic Effects of S.B. 622 on North Carolina**

| **Economic Effects** | **2021** | **2025** |
|---|---|---|
| Private Employment (jobs) | 1,109 | 3,611 |
| Investment, ($ million) | 347 | 1,054 |
| Real Disposable Income ($ million) | 146 | 497 |
| Real Gross Domestic Product ($ million) | 484 | 1,537 |

[36] For a description of the STAMP model see http://www.beaconhill.org/STAMP_Web_Brochure/STAMP_HowSTAMPworks.html.

[37] We gather economic data from three sources: 1) The U.S. Department of Labor, Bureau of Labor Statistics provides employment and wage data; 2) the U.S. Department of Commerce provides income and investment data and 3) the *Statistical Abstract of North Carolina Taxes 2019* provides supplements to the other sources.

The NC-STAMP analysis shows that S.B. 622 would increase private sector jobs by 1,109 in the first full year and by 3,611 in 2025. Real disposable income in North Carolina would increase by $146 million in 2021 and by $497 million in 2025 as corporations took advantage of the lower business cost.

The elimination of the franchise tax on corporations would lead to a reduction in the after-tax burden on income derived from capital investments, creating a powerful incentive for in-state businesses to invest more in North Carolina and for out-of-state businesses to move into the state. It would cause investment to rise by $347 million in 2021 and by $1.054 billion in 2025. The additional in-state production of goods and services would push real Gross Domestic Project (GDP) in North Carolina higher by $484 million in 2021 and $1.537 billion in 2025.

S.B. 578 would reduce the franchise tax rate to $1.29 for every $1,000 of a business's net worth in the first year, and to $0.96 for every $1,000 of a business's net worth in the following year. The bill also calls for the elimination of the 55 percent appraised value base.

**Table 4: Economic Effects of S.B. 578 on North Carolina**

| Economic Effects | 2021 | 2025 |
|---|---|---|
| Private Employment (jobs) | 1,164 | 3,893 |
| Investment, ($ million) | 364 | 1,135 |
| Real Disposable Income ($ million) | 153 | 535 |
| Real Gross Domestic Product ($ million) | 508 | 1,693 |

S.B. 578 would increase private sector jobs by 1,109 in the first full year and by 3,611 in 2025. Real disposable income in North Carolina would increase by $146 million in 2021 and by $497 million in 2025 as corporations took advantage of the lower business cost. It would cause investment to rise by $364 million in 2021 and by $1.135 billion in 2025. Real GDP in North Carolina would increase by $508 million in 2021 and $1.693 billion in 2025.

BHI completed a separate simulation that seeks to phase out and eventually eliminate entirely the North Carolina franchise tax. We assume a reduction of the franchise tax rate to $1.00 for every $1,000 of a business's net worth in the first year, to $.50 for every $1,000 of a business's net worth in the second year and eliminates the franchise tax for each year thereafter.

**Table 5: Economic Effects of Phasing Out and Eliminating Franchise Tax**

| Economic Effects | 2021 | 2025 |
|---|---|---|
| Private Employment (jobs) | 2,748 | 10,333 |
| Investment, ($ million) | 848 | 2,960 |
| Real Disposable Income ($ million) | 401 | 1,396 |
| Real Gross Domestic Product ($ million) | 1,179 | 4,383 |

The economic impacts of eliminating the North Carolina franchise tax would be substantially higher than the ones that would materialize under S.B. 622 and 578. Private sector employment would increase by 2,748 jobs in the first full year and by 10,333 in 2025. Real disposable income in North Carolina would increase by $401 million in 2021 and by $1.397 billion in 2025. It would cause investment to rise by $848 million in 2021 and by $2.960 billion in 2025. Real GDP in North Carolina would increase by $1.179 billion in 2021 and $4.383 billion in 2025.

## Fiscal Effects

NC-STAMP calculates the dynamic revenue effects of tax changes. These effects are distinct from static effects, which are calculated on the assumption that there is no change in underlying economic activity in response to a change in tax law. For example, a static estimate of a cut in a corporate income tax, say, from 10 percent to 5 percent, would cause revenues to fall by 50 percent (= (10 - 5)/10)). A dynamic estimate would show a smaller drop in revenue because it would capture the positive effect on the tax base of the cut in the tax rate. One of the principal purposes of STAMP is to capture such dynamic effects. Table 6 displays the results for S.B. 622.

**Table 6: Fiscal Effects of S.B. 622 on North Carolina**

| | 2021 | 2025 |
|---|---|---|
| **State Taxes** ($ millions) | | |
| Sales and Use Tax | 5.11 | 18.62 |
| Personal Income Tax | 8.21 | 28.66 |
| Franchise Tax | -90.74 | -259.26 |
| Other Revenue and Fees | 7.64 | 70.58 |
| Subtotal | -69.78 | -188.68 |
| **Local Taxes** ($ millions) | | |
| Sales Tax | 2.60 | 11.72 |
| Property Taxes | 0.37 | 1.84 |
| Other Revenue and Fees | 8.88 | 28.81 |
| Subtotal | 11.85 | 40.12 |
| **Total State and Local Taxes** | **-57.93** | **-148.56** |

Under S.B. 622, we find dynamic revenue gains to the sales tax, property tax and personal income tax. Sales tax revenues, at both the state and local level, would increase by almost $8 million dollars in 2021 and by over $30 million in 2025. Increased employment and higher manufacturing profits would increase personal income tax revenues by over $8 million in 2021 and by almost $29 million in 2025. Overall, total state taxes would fall by $58 million in 2021 and by $149 million in 2025.

Table 7 displays the results under S.B. 578.

**Table 7: Fiscal Effects of S.B. 578 on North Carolina**

| | 2021 | 2025 |
|---|---|---|
| **State Taxes** ($ millions) | | |
| Sales Tax | 5.36 | 20.06 |
| Personal Income Tax | 8.62 | 30.87 |
| Franchise Tax | -95.29 | -280.15 |
| Other Revenue and Fees | 8.03 | 25.13 |
| Subtotal | -73.28 | -204.09 |
| **Local Taxes** ($ millions) | | |
| Sales Tax | 2.72 | 12.63 |
| Property Taxes | .38 | 1.98 |
| Other Revenue and Fees | 9.32 | 31.09 |
| Subtotal | 12.42 | 43.27 |
| **Total State and Local Taxes** | **-60.86** | **-160.82** |

Under S.B. 578, we again find dynamic revenue gains to the sales tax, property tax and personal income tax. Sales tax revenues, at both the state and local level, would increase by over $8 million dollars in 2021 and by over $32 million in 2025. Increased employment and higher manufacturing profits would increase personal income tax revenues by over $8 million in 2021 and by over $30 million in 2025. When added together the dynamic changes to state and local tax revenues, total tax revenues would fall by $61 million in 2021 and by $161 million in 2025.

Table 8 displays the fiscal effects of phasing out and eliminating the franchise tax in North Carolina. See below.

**Table 8: Fiscal Effects of Phasing Out and Eliminating North Carolina Franchise Tax**

| | 2021 | 2025 |
|---|---|---|
| **State Taxes** ($ millions) | | |
| Sales Tax | 12.52 | 52.75 |
| Personal Income Tax | 20.14 | 80.62 |
| Corporate Income Tax | -227.68 | -787.64 |
| Other Revenue and Fees | 18.83 | 66.35 |
| Subtotal | -176.19 | -587.92 |
| **Local Taxes** ($ millions) | | |
| Sales Tax | 6.37 | 26.83 |
| Property Taxes | 0.89 | 5.01 |
| Other Revenue and Fees | 22.03 | 51.44 |
| Subtotal | 29.29 | 116.21 |
| **Total State and Local Taxes** | **-146.90** | **-471.71** |

If North Carolina were to phase out and eliminate the franchise tax by the third year of reform, we find substantial dynamic revenue gains to the sales tax, property tax and personal income tax. Sales tax revenues, at both the state and local level, would increase by over $19 million dollars in 2021 and by nearly $18 million in 2025. Increased employment and higher manufacturing profits would increase personal income tax revenues by over $20 million in 2021 and by over $80 million in 2025. When state and local tax revenues are combined, total revenues will only fall by $147 million in the first year, and by $472 million in 2025.

# Conclusion

There are two approaches to this problem. The first is to stay the current course of having an outdated and punitive tax on the state's corporations. The second is to either reduce or eliminate the tax entirely, which is to say, eliminate distortions in the tax code brought about by the North Carolina franchise tax, and introduce further certainty and rationality into the state policy environment.

Senate Bills 578 and 622 helps bring about a change in direction in favor of job creation and growth. They do so by reducing a punishingly high tax on a vital sector of the state economy and with revenue losses that are trumped by economic growth. The bills address the fact that the tax is widely viewed as violating most principles of tax equity and efficiency. The reduction of the franchise tax would provide a boost to the state's economy leading to an increase in private employment, disposable income and investment.

Given the current circumstances faced by state and national economy associated with the COVID-19 pandemic, state legislature needs to seriously consider reducing and or eliminating the North Carolina franchise tax, as it would provide substantial economic growth to the state economy.

## Methodology

To identify the economic effects of the tax changes and understand how they pass through a state's economy, BHI utilized its STAMP (State Tax Analysis Modeling Program) model. STAMP is a five-year dynamic CGE (computable general equilibrium) model that has been programmed to simulate changes in taxes, costs (general and sector specific) and other economic inputs. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world.[38]

A CGE tax model is a computerized method of accounting for the economic effects of tax policy changes. A CGE model is specified in terms of supply and demand for each economic variable included in the model, where the quantity supplied or demanded of each variable depends on the price of each variable. Tax policy changes are shown to affect economic activity through their effects on the prices of outputs and of the factors of production (principally, labor and capital) that enter into those outputs.

A CGE model is in "equilibrium," in the sense that supply is assumed to equal demand for the individual markets in the model. For this to be true, prices are allowed to adjust within the model (i.e., they are "endogenous"). For instance, if the demand for labor rises, while the supply remains unchanged, then the wage rate must rise to bring the labor market into equilibrium. A CGE model quantifies this effect.

Finally, a CGE model is numerically specified ("computable"), which is to say it incorporates parameters that are believed to be descriptive of the actual relationships between quantities and prices. It produces estimates of changes in quantities (such as employment, the capital stock, gross state product and personal consumption expenditures) that result from changes in prices (such as the price of

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[38] For a clear introduction to CGE tax models, see John B. Shoven and John Whalley, "Applied General-Equilibrium Models of Taxation and International Trade: An Introduction and Survey," *Journal of Economic Literature* 22 (September, 1984): 1008. Shoven and Whalley have also written a useful book on the practice of CGE modeling entitled *Applying General Equilibrium* (Cambridge: Cambridge University Press, 1992). See also Roberta Piermartini and Robert Teh *Demystifying Modeling Methods for Trade Policy* (Geneva, Switzerland: World Trade Organization, 2005) https://www.wto.org/english/res_e/booksp_e/discussion_papers10_e.pdf(accessed April 21, 2020).

labor or the cost of capital) that result from changes in tax policy (such as the substitution of an income tax for a sales tax).

Because it consists of a large number of interrelated equations, a CGE model ordinarily requires the application of a nonlinear computational algorithm, typically some variation on Newton's method. STAMP requires and utilizes the development and application of a sophisticated computer program for the solution of its equations.

In order to simulate the implementation of S.B. 578, S.B. 622, and the elimination of the North Carolina franchise tax, BHI needed to estimate the amount of overall franchise tax revenue that would be cut under the bill and distribute that revenue to the effected industries in the model.

BHI started with data from the Statistical Abstract of North Carolina Taxes 2019 (the latest report available) from the North Carolina Department of Revenue's Financial Services Division Revenue Research Section. The report contains historical data and detailed reports on North Carolina's General Fund tax revenues by source, classifications of different taxpayers, and the distribution of taxes by geography. We obtain data for franchise tax revenues for FY 2005 through FY 2019. For FY 2019, franchise tax revenue collections were $749.6 million, representing 3.02 percent of North Carolina's total state tax revenues.

We use the Compound Annual Growth Rate in total franchise tax revenues from 2010 to 2019 to grow the revenues to $787 million in 2025. This serves as our baseline estimate for franchise tax revenue collections in North Carolina. We use these estimates as inputs to our model in order to produce static estimates of revenue changes under the simulations of changes to the franchise tax.

Finally, we distribute these tax cuts to the appropriate industries within the NC-STAMP model, based on each industries portion of the total tax collections.

## The Beacon Hill Institute Team

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