

## A TAX STUDY THAT ISN'T *NC taxes are not among the friendliest to business*

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**Summary:** Some state politicians are touting the results of an Ernst & Young study that purports to rank North Carolina's business taxes as among the lowest in the nation. But this flawed study ignores basic principles of public-finance economics and most of the taxes that influence business decisions. More accurate studies that examine all relevant taxes and all types of businesses suggest that North Carolina's tax rates are high in regional rankings, thus discouraging economic growth.

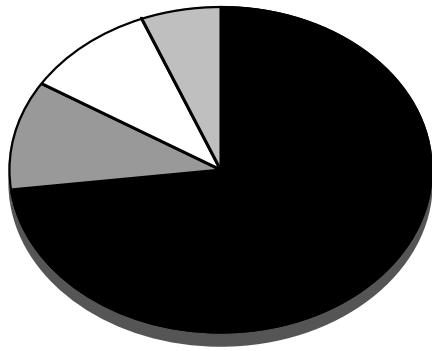
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**T**he Easley administration and its defenders on the editorial page of *The News & Observer* of Raleigh<sup>1</sup> are uncritically touting a new study recently released by the accounting firm of Ernst and Young and prepared for an organization called the Council on State Taxation.<sup>2</sup> This study purportedly showed that North Carolina was among the five most favorable states in the nation when it comes to tax burdens on business. The problem is that this study ignored entire categories of taxation paid by business and some of the most basic principles of public-finance economics in coming to its conclusions. It would not be an exaggeration to say that the Ernst and Young study is worthless as an analysis of the business-tax environment in North Carolina and other states.

The authors of the report tried to determine, on a state-by-state basis, the amount of state and local taxes being "paid" to governments by the business sector, although they also admitted that businesses actually act as tax collectors from three groups of individuals: 1) owners or investors, 2) customers, and 3) employees or contractors. The Ernst and Young study produced tables looking at business taxes for each state from several perspectives. These included the "total taxes" paid by business; taxes paid per employee; businesses' share of all state and local taxes; business taxes "per dollar of private sector activity;" and several others.<sup>3</sup>

The bases for these tables were the total tax collections from "property taxes [paid by businesses], sales and excise taxes paid by business on their business purchases, gross receipts taxes, corporate income and franchise taxes, license taxes, and unemployment and workers compensation payroll taxes."<sup>4</sup> Presumably, policymakers are to determine from this how burdensome their business tax policies are relative to those of other states. If this was indeed the purpose of the Ernst & Young study, it would

## HOW PRIVATE BUSINESSES ARE ORGANIZED



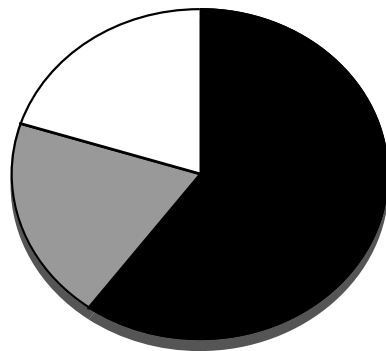
SHARE OF TOTAL U.S. FIRMS, 1997

SOLE PROPRIETORS	73%
C CORPORATIONS	11%
S CORPORATIONS	10%
PARTNERSHIPS	6%

Studies that examine the tax liability of businesses without taking account of the personal income tax won't adequately measure the tax burden of 89 percent of businesses.

SOURCE: U.S. Census Bureau

## WHERE NC EMPLOYMENT GROWTH OCCURS



SHARE OF NET NEW JOBS IN NC, 2000

1-19 WORKER FIRMS	60%
20-499 WORKER FIRMS	20%
500+ WORKER FIRMS	20%

About half of all NC employment is found at firms with fewer than 500 workers, many of them organized as non-corporate firms or subchapter S corporations as portrayed above. These firms account for 80 percent of job growth in the state.

SOURCE: U.S. Census Bureau

these firms is obviously of limited value in gauging whether a particular state is relatively congenial or hostile to business investment and growth.

In particular, since all capital gains in North Carolina are included as part of regular income and taxed at the usual rate — contrary to the practice of some states that offer differential rates to reduce the extent of double-taxation involved in investment returns — the capital gain from the sale of a North Carolina businesses is often taxed at the top rate, currently 8.25 percent. So, for example, imagine a small-business owner who builds a successful chain of pizza restaurants in the state. Each year his earnings from this business grow and are reported on his personal income tax forms. At the end of his career he decides to sell his business in order to retire on the net proceeds from the sale, i.e., the capital gain. As a result of the sale he is required to pay a hefty capital gains tax. According to Ernst & Young, these taxes are not “business taxes.” The study made the unsupportable assumption that personal income taxes have no bearing on business decisions.

Because the study includes property taxes paid by business but not personal income taxes it creates a bias in favor of high-income-tax, low-property-tax states like North Carolina. It also creates a bias against states with land-intensive industries such as those in the far West where oil production, mining and other extraction industries, or cattle ranching and other forms of agriculture make up a large segment of the tax base.

It should also be noted that ultimately all employers share part of the burden of the income tax paid by their employees. In reality the income tax is an excise tax, i.e. a sales tax, on the sale of labor services. A basic principle of public finance theory which the authors of the Ernst & Young study seem not to understand (more will be said on this later) is that the burden of all excise taxes are shared by both the seller and the buyer.

In this case the two parties are the employee, the seller of labor services, and the employer, the buyer of labor services. This means that part of the personal income taxes paid by workers will be reflected in a higher-than-otherwise wage. Since

have been a laudable one. Unfortunately, because of the assumptions the authors made in collecting the tax data, the research did not accomplish that purpose, while other studies — such as those published by the Tax Foundation and the Small Business Survival Committee using the same base year of 2003 — offer far more useful conclusions for policymakers.

### Where's the Personal Income Tax?

Perhaps the most glaring problem with the Ernst & Young study is that it failed to take into account either the rates or the amount of revenue collected from the individual income tax in the various states that have it. North Carolina has the highest top marginal tax rate on individual income in the Southeast and one of the highest in the nation. The owners of thousands of small businesses — sole proprietorships, partnerships, limited-liability companies, subchapter-S corporations, etc. — pay taxes on the incomes that they earn from their businesses through the personal income tax, not through the corporate income tax.

Such companies constitute nearly 90 percent of all business enterprises.<sup>5</sup> According to U.S. Census Bureau data, employers with fewer than 500 workers — a category that includes most non-corporate businesses subject to personal income tax — account for roughly half of all jobs in North Carolina and generate an astounding 80 percent of net job creation in the state.<sup>6</sup> A model for measuring business taxation that leaves out a major tax liability for

workers are concerned about their after-tax, take-home pay, employers in higher-income-tax states, then if everything else stays the same (such as cost of living) the employers will have to pay higher wages to attract workers than will employers in lower-income-tax states. That additional amount would be the part of the personal income tax paid by the employer. This is what economists call the “incidence” of the tax. While it would be difficult to calculate, to ignore it, once again, is to bias the analysis in favor of high-income-tax states like North Carolina.

### Then There's the Sales Tax

A second glaring omission in the Ernst & Young study is the retail sales tax. While the study does consider sales taxes that are paid by businesses on their direct purchases, it makes the unsupportable assumption that the entire burden of state and local retail sales taxes is borne by consumers. Again, this flies in the face of the most elementary tax analysis. As noted above, both the buyer and the seller pay some portion of all excise taxes, regardless of who the tax is directly placed upon. For example, does anyone think that a tariff on the importation of shoes, even though it is paid directly by the importing retailer, is not borne to some degree by the foreign producers of the shoes or the domestic purchasers of shoes? This is the kind of absurd assumption that is made in the Ernst & Young study.

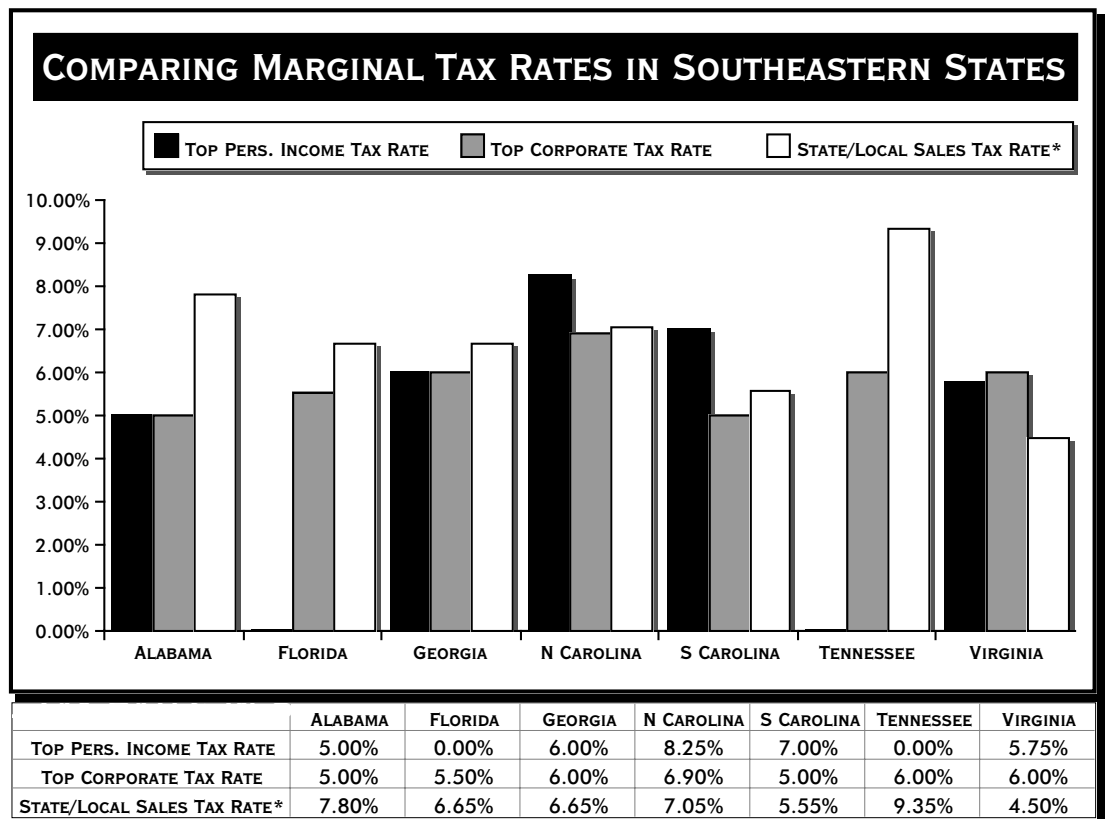
Even though sales taxes are superficially simply added to the final purchase price of a product, they are always paid in part by the stores selling the products. This tax payment by the seller comes in the form of a lower price received. The higher the sales tax that a customer has to pay, the lower the price the seller will be able to charge. No seller can charge more than the total amount a customer is willing to pay, which includes the price plus the tax. This does not mean that the entire retail sales tax will be offset by lower prices. What it does mean is that there will be a “sharing of the burden” to some degree, which will vary from product to product depending on conditions of supply and demand. To assume that retailers bear none of the burden of the retail sales tax is no less absurd than to assume that they bear all of it.

As with the income tax, North Carolina now has a relatively high 7 percent combined state and local tax on retail sales (with a 7.5 percent rate levied in the state’s most populous county, Mecklenburg). Again, because the Ernst & Young study includes property taxes but completely ignores the business tax burden that is imposed by income and sales taxes, it is severely biased in favor of states like North Carolina. This probably also explains why a state like New Hampshire, which has neither an income tax nor a sales tax, does very poorly in the study. Common sense should have flagged this result as indicating a fundamental problem with the analysis, since virtually no one familiar with tax competition among the various states considers New Hampshire to have a tax climate that is inhospitable to business. Clearly, any study that omits sales and income tax in assessing the business tax burden should not be used as an indicator of that burden for North Carolina.

### Conclusion

It should be made clear that these omissions and shoddy practices are not the only problems with the Ernst & Young study, only the most glaring and the ones with the most potential for seriously biasing the results.

For example, the study included “workers compensation payroll taxes” as part of the business tax burden. The problem with this is that it automatically excludes states like North Carolina where employers are forced to pay a workers compensation premium to a private insurance company rather than a tax payment into a state-run system. In the former case, the compulsory payment is no



SOURCES: Tax Foundation, Sales Tax Clearinghouse, both for 2003 \* Indicates a weighted average of state plus local sales taxes.

less a tax than in the latter case. Yet, the forced premiums paid by North Carolina businesses were not included in the study.

To gain a different perspective on North Carolina's business taxes, the Ernst & Young study can be compared to two others studies of business-tax burdens conducted for the same tax year of 2003. First, the Washington-based Tax Foundation decided in 2003 to supplement its longstanding comparisons of state tax burdens with a study that examined not only tax collections per capita and as a percentage of income but also the marginal tax rates and tax bases defined in the various state tax codes. The purpose of this new study was to rank the 50 states according to their "business tax climate."<sup>7</sup>

Instead of ignoring retail sales and personal income taxes, the Tax Foundation sees them, along with the corporate income tax, as "the three major taxes" that affect the business tax climate. In this study, North Carolina's performance was — not surprisingly, given the previous analysis — substantially different from

the rankings provided in the Ernst & Young study. The Tax Foundation ranked North Carolina close to the national average in business-tax climate. Regionally, North Carolina ranked among the worst states in the Southeast in this regard.

Another study released in 2003, from the Washington-based Small Business Survival Committee, zeroed in on fiscal policies affecting entrepreneurs, investors, and small businesses in the 50 states.<sup>8</sup> Because of this study's focus on marginal rates, particularly in areas such as capital gains, North Carolina was clearly identified as the least-attractive fiscal environment for small-business growth in the Southeast, and among the top 15 least-congenial business environments in the country.

As is easily seen in the table above, the results of the Tax Foundation study and Small Business Survival Index for 2003 track fairly closely together, and they differ markedly from the findings of the more-limited Ernst & Young study. For example, North Carolina is ranked by Ernst & Young as having the lowest business-tax costs among the Southeastern states, but is much higher in relative costs in the Tax Foundation ranking and clearly the most costly in the Small Business Survival Index. States that Ernst & Young ranked as most costly — such as New Hampshire, Texas, Washington, and Wyoming — are among the least costly in the other measures. Obviously something is seriously wrong with at least one of these measures, and the evidence overwhelmingly points to the Ernst & Young study as being a flawed and misleading outlier.

North Carolina policymakers should take no comfort from the Ernst & Young study. In every case where assumptions in the study create a bias, this bias cuts in favor of North Carolina. There remains compelling evidence that our state imposes excessive and damaging layers of taxes on business activity and economic growth; that such taxes do influence economic decisions about investment, entrepreneurship, and corporate relocation<sup>9</sup>; and that policy initiatives to reduce the tax burden would have significant and positive effects on North Carolina's prospects for economic recovery and development.

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## COMPARING BUSINESS-TAX RANKINGS, 2003

State	Rank of Tax Policy (in Ascending Order of Attractiveness)		
	Ernst & Young* (2003)	Tax Foundation (2003)	Small Business Survival (2003)
<i>Southeast</i>			
Alabama	38	35	40
Florida	17	44	46
Georgia	43	26	28
North Carolina	48	27	14
South Carolina	40	25	35
Tennessee	32	41	44
Virginia	45	30	37
<i>Other Key States</i>			
Alaska	4	46	29
Maryland	40	20	27
Nevada	29	48	49
New Hampshire	10	49	47
Texas	16	38	45
Wyoming	7	50	48
Washington	5	43	43

SOURCES: Ernst & Young/Council on State Taxation, Tax Foundation, Small Business Survival Committee  
\* Average ranking in three categories.

### NOTES

1. "Creating Tax Cuts," *The News & Observer*, Feb. 17, 2004. Found at [newsobserver.com/editorials/editorials/story/3339110p-2975045c.html](http://newsobserver.com/editorials/editorials/story/3339110p-2975045c.html).
2. Robert Cline, et. al., "Total State and Local Business Taxes: A 50 State Study of the Taxes Paid by Business in FY 2003," Prepared for the Council on State Taxation by Ernst and Young, January, 2004.
3. *Ibid.* pp. 8-14.
4. *Ibid.* p. 1.
5. "Company Survey," 1997 *Economic Census*, U.S. Bureau of the Census, September 2001, p. 12.
6. "2003 State Small Business Profile: North Carolina," U.S. Small Business Administration, Office of Advocacy, p. 2.
7. "State Climate Business Index 2003," Tax Foundation, Washington, D.C., executive summary, [www.taxfoundation.org](http://www.taxfoundation.org).
8. Raymond Keating, "Small Business Survival Index 2003: Ranking the Policy Environment for Entrepreneurship Across the Nation," Small Business Survival Committee, Washington, D.C., September 2003, p. 2.
9. John Hood, "The Best Incentives: Targeted policies fail while tax rates, services matter," *Spotlight* No. 239, Locke Found., Dec. 8, 2003.