Will budget crunch force tax reform?

States are currently facing one of the worst, if not the worst, fiscal periods since the Great Depression.

That is the opening line of a report released by the National Governors Association on Dec. 2. The report catalogs the formidable challenges facing states as they try to raise revenue to fund much-needed services for their citizens. States increased taxes and fees by a total of $23.9 billion in 2009. North Carolina enacted about $1 billion in new taxes, with more than $800 million coming from the 1 cent sales tax increase.

Even with this additional revenue, a potential budget crisis looms. To balance our current state budget, legislators relied on about $1.8 billion in federal stimulus funds. Those funds will no longer be available starting in July 2011. That means that unless the economy recovers or the federal government bailouts the states again, the General Assembly will face a difficult choice in 2011 of either severely cutting government services or substantially increasing taxes — hardly an enviable position for politicians.

Hoping to avoid a repeat of this year’s contentious budget negotiations, leaders in the General Assembly have been holding a series of meetings to discuss possible changes to the state’s antiquated tax system. All three of the full-day meetings so far have focused entirely on reforming the sales tax.

Despite the state’s relatively high sales tax rate (7.75 percent), North Carolina receives a disproportionately low percentage of its revenues from the sales tax. That’s because our tax applies to fewer items than most other states’. Our sales tax falls almost exclusively on the sale of tangible goods and, with a few exceptions, avoids taxing services.

The problem, of course, is that the consumption of services has increased dramatically over the last 40 years, while the consumption of goods has constantly declined. As a result, the state has to increase the sales tax rate every few years just to generate the same amount of revenue. Many other states tax those services with connections to the sale of tangible goods.

For example, automobile repair services in addition to automobile parts. Right now, North Carolina only taxes the sale of auto parts, not the installation of those parts. That may change soon.

Reconsidering our sales tax system is a good place to start tax reform, but our legislative leaders need to consider additional reforms if we are going to prepare adequately for the impending fiscal storm. Our corporate income tax, for example, is exceptionally volatile and has been a declining source of revenue for years.

Legislators should consider eliminating corporate tax preferences unless they are definitively shown to attract businesses to the state or create jobs. Likewise, the General Assembly adjusts the state tax code to conform to the federal Internal Revenue Code almost every time Congress changes a federal tax law. In 2009, this cost the state about $116 million. Legislators should take a hard look at whether these conforming tax changes are necessary — not all states make them.

Legislative leaders may have decided to limit their discussion of state tax reform to the sales tax for now because even considering changes to the tax code generates protests from whatever groups may be adversely impacted. Despite that political pressure, our leaders need to look at a broad range of reform options now if they are going to take a rational and long-term approach to tax reform.

Otherwise, the next time state coffers run empty — and that looks likely to be as early as 2011 — the General Assembly may resort to politically palatable but short-sighted decisions about how to raise revenue.

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