

Taxation in South Carolina: Issues and
Challenges

Jim Self Center on the Future Policy Briefs

August 2010

By

Holley H. Ulbrich, Ph.D.

The Jim Self Center on the Future serves South Carolina and its communities by promoting awareness of important issues and trends facing the state. The Center advances public and private commitment to policies and actions that support the state's well being through collaborative research and information exchange among the state's citizens and leadership. Additional copies of this study and the earlier fiscal sustainability studies are available on our website at <http://www.strom.clemson.edu>.

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Taxes have always been a source of debate. While the political dialogue over taxes seems to have taken a heightened sense of purpose in recent years, efforts to reform the tax code with a comprehensive overhaul have been met with strong resistance from parties expecting to be harmed or to lose favorable tax status. Single issue changes to the tax code have at times resulted in unexpected consequences and cumulatively have added still more complexity to an already overly complex tax code.

In 2009, South Carolina policymakers named an independent commission to assess the state's tax structure for "balance" as well as "adequacy, equity and efficiency". Because of the importance of a sustainable tax system on the state's well-being and the Jim Self Center on the Future's mission to raise awareness of important issues facing the state, we sponsored a series of policy briefs intended to inform decision makers and citizens on the different variables to consider in sustainable tax systems. This compilation was authored by Dr. Holley Ulbrich, Ph.D., Alumni Professor Emerita of Economics at Clemson University and Senior Fellow of the Strom Thurmond Institute. It includes discussions of familiar as well as less well-known tax topics. We hope that these articles will provide useful information as South Carolinians consider appropriate means of funding state budget priorities in a fair and equitable manner.

Individual copies of these policy briefs as well as the compiled copy are available on our website at <http://selfcenter.clemson.edu/>.

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Principles of a Good Revenue System

Every state has a revenue system, which consists of the sources tapped to fund state and local public services. Ideally, public policy should be concerned with the design of the system as a whole, rather than focusing on one particular tax at a time. At the heart of the revenue system is the tax code, but states also rely on non-tax revenues to fund many important activities and programs. So fees and charges, licenses and permits, are part of the revenue system.

Every revenue source has positive and negative attributes. Some are more stable than others, or create fewer distortions in household and business decisions. Some are more costly to collect than others. Some are hidden, others highly visible. Some have broad bases, others narrower bases. Certain kinds of taxes are useful for encouraging "good" actions (like education) or discouraging "bad" actions (like drinking alcohol). Other taxes or fees may be designed to create a fairer distribution of the tax burden.

Two of the most important qualities of a tax (or a fee) are efficiency and equity. Efficiency means many things. It may mean minimizing the (negative) impact on household decisions about where to shop, where to live, how hard to work, whether to save and invest. It may mean encouraging (or discouraging) business location in the country or state or county, or encouraging investment and job creation in general. Efficiency may also mean minimizing the cost of collection and compliance, or annoyance to taxpayers.

In general, a higher tax rate causes more changes in decisions. A high sales tax encourages Internet and cross-border shopping. A high income tax rate may encourage high-income households to leave the state, and discourage others from moving in. High property tax rates discourage construction and improvements. So an important aspect of efficiency is to rely on several broad-based taxes with relatively low rates, rather than fewer kinds of taxes at higher rates. Most states rely on income, sales and property taxes to fund state and local governments, supplemented by excise taxes, licenses, fees and charges. States that have no income taxes (like Tennessee) tend to have sales and property tax rates, and the handful of states with no sales tax tend to have higher income and property tax rates.

Equity means fairness in distribution of the tax burden among households and firms. There is some general agreement among economists that the tax system should be at least proportional, so that it takes about the same share of everyone's income. There is less consensus about the idea that it should perhaps be even moderately progressive, taking a larger share of the income of wealthier households.

Equity is at least as important as efficiency, sometimes more so to policymakers, in designing and reforming tax systems. Every change in the tax base, the tax rate(s), or the tax rules alters the distribution of the tax burden between taxpayers. Substantial lobbying effort is expended on tax breaks for particular firms, individuals, or activities. Efforts to redistribute the burden, whether in the interests of greater equity or in response to lobbying by particular interests, are the source of much of the complexity in the tax system, especially the income tax.

The most widely used criterion for tax fairness is called ability to pay. Ability to pay as a determinant of one's tax burden implies that those who have more resources than others can and should make a larger contribution toward the cost of government and public services. How is ability to pay measured? The simplest measure is income—the amount of revenue flowing through the household in a month or a year. A second measure is consumption or spending, and a third measure is assets or property owned.

These three measures are the bases for the principal tax revenue sources in the U.S. economy and most other places as well—the income tax, some form of sales or consumption tax, and the property tax.

Some of these measures of ability to pay are more accessible to the tax collector than others. Consumption is the easiest measure to track because it involves transactions in the marketplace that can be tapped at the point of sale. Some income, particularly wage and salary income, is easy to track through payroll records, but other forms of income—self-employment earnings, interest and dividends, profits from proprietary businesses, capital gains—are much harder to uncover. Assets are the most challenging tax base of all. Few tax systems attempt to be broadly inclusive of all assets (household furnishings, stocks, bonds, jewelry, works of art, etc.) and just focus on certain kinds of property, such as real estate, automobiles and boats.

Another way to design taxes or fees is to apply the benefit principle. Unlike ability to pay, the benefit principle links the tax obligation to the value of the services received in exchange. The property tax is to some degree a benefit tax. Most local services (except for education) are fairly directly related to property. Police protection, fire protection, roads, streetlights, and garbage pickup are the most obvious examples. A case could be made that the value of those services to property rises with the value of the property being served or protected. The best-known example of a benefit tax is the tax on gasoline, which is earmarked for highway construction and maintenance. Those who purchase more gasoline either drive more miles or drive heavier, less fuel-efficient cars, but in either case they cause more wear and tear on the roads. Those who drive little do not have to subsidize those who drive a lot, and those who drive smaller, more fuel-efficient cars do not have to subsidize those who drive gas-guzzlers. Fees and charges ranging from impact fees for new development to recreation charges to dog licenses and hunting and fishing licenses also embody the benefit principle.

How do we measure equity? We start with describing the distribution of the tax burden. The measure used is to compute this burden as a percentage of income paid in taxes (and fees). Taxes and tax/revenue systems are then classified as regressive, proportional, or progressive according to whether that percentage decreases, remains the same, or increases as income rises. A regressive tax takes a smaller percentage of income as income rises. Some excise taxes are regressive, while others are not, depending on how consumption patterns for cigarettes, gasoline, alcohol, and other items subject to excise taxes vary with income. A proportional tax takes a constant fraction of income as income rises. Some states, such as Illinois, have simple, flat income taxes that take a constant percentage of all income (not just payroll or wage and salary) without any deductions or exemptions. A progressive tax takes an increasing percentage of income as income rises. The federal income tax and most state income taxes are moderately progressive. For states, the ideal system would be between proportional and mildly progressive. Individual taxes or fees may be progressive, proportional, or regressive, but it is the distribution of the burden as a whole that is the important measure.

Other important qualities of a tax system are adequacy, visibility, sensitivity to growth (versus stability), and administrative and collection cost. A revenue system has to generate adequate funds to pay for the desired level of public services. Some kinds of revenue systems could generate too much revenue. Legislators awash in funds are rarely without pet projects to fund, and will respond to a revenue windfall with additional spending, although sometimes they do respond to rapid revenue growth with tax cuts. At other times, revenue can fall short of the amount needed to fund basic services at the desired level. State governments had nearly a decade of steady revenue growth in the 1990s, a fiscal crisis at the end of the dot.com boom in the early 2000s, another period of revenue growth until 2008, and then a sharp drop in revenue starting in late 2008 and expected to continue for at least four years because of the financial crisis and high unemployment. In general, revenue needs to grow at least as fast as the increase in population and in the costs of inputs into providing public goods as well as public services.

(administration, regulation, etc.). It may need to also keep pace with real income growth, because demand for public services as a complement to private consumption can be expected to increase as the standard of living rises.

Ensuring and defending adequacy means that legislators must be sensitive to the dangers of eroding the tax base. Adding exemptions to the sales tax, increasing deductions on the income tax, or using corporate income tax breaks to lure industry all exact a cost in terms of not just current revenue adequacy but also future revenue flows.

Some of the revenue sources in the overall system need to offer a cushion of stability, particularly for state and local governments that must balance their budgets annually through recessions as well as periods of prosperity. Stability means that the revenue flow is not unduly sensitive to fluctuations in economic activity. For local governments, an important positive attribute of the property tax is its stability. The two major state taxes, income and sales, are responsive to growth in personal income (which also reflects population and inflation), but tend to fluctuate more than income during recessions and expansions. Stability has been a serious challenge for state governments in the last two decades.

However, the long-term tendency of revenue from income and sales taxes to reflect growth in income, population, and inflation has a plus side. As the population grows, revenue needs to grow in order to finance the additional services required by a growing population. Because taxable sales grow more slowly than income over the long haul, states that rely primarily on sales taxes have more difficulty-keeping pace with the cost of services than those that have an income tax.

Visibility means that taxpayers are aware of what they are paying. Is visibility desirable? Those who think that government is too large prefer that taxes be highly visible so that the pain of paying taxes will be weighed carefully against the benefits from government services. Others argue that, because many government services are low visibility, taxes should be equally low in visibility. In practice, there is a mix of taxes and revenue sources in the system that range from highly visible (property taxes) to moderately visible (sales taxes, payroll taxes) to low visibility (excise taxes included in the price). Likewise, government services range from high visibility (road repairs, trash pickup, schools) to moderately visible (national defense, parks, prisons) to low visibility (building inspection, financial administration).

Taxes can be made more visible in a variety of ways. Referenda, usually on bond issues for schools and other capital expenses, give taxpayers a chance to directly weigh an increase in taxes against an increase in services. Stating the retail sales tax separately from the price, a practice in most states with retail sales taxes, makes it more visible. Posting the excise tax on the pump at gas stations is another way to try to make consumers more aware of how much of what they pay is for the product itself and how much is tax.

Collecting taxes is not free. Bureaucracies must be created to interpret the tax laws and ensure that taxes are collected. The cost of printing forms, processing and auditing returns, and assessing tax liabilities is the collection cost. Taxpayers also incur costs. They have to keep records, fill out forms, go through audits, and pay tax accountants to make sure that they are in compliance. These costs that fall on the taxpayers are called compliance costs. Some taxes are costly to administer but not to comply with, like the property tax, while others are burdensome on both the tax collector and the taxpayer, like the individual income tax. In some cases, compliance costs fall on third parties—employers who must keep the records and file the returns for Social Security taxes or retailers who must collect and remit the retail sales tax. While compliance costs for property taxes are low, these taxes are quite expensive to administer because of the need to assess the market value of a variety of assets, and to

handle disputes and appeals over the values assigned. Being the property tax assessor is one of the more frustrating tasks in local government!

There are a few rules of thumb that provide some guidance in reducing these costs. As a general rule, it is cheaper in terms of collection costs to administer a tax centrally than locally, because each local government will need its own staff. There are substantial economies of scale in tax administration that result in counties collecting property taxes on behalf of municipalities and states collecting and distributing local sales taxes on behalf of their cities and counties. It is also less expensive to administer a broad-based income tax than one with many exemptions, exclusions, adjustments and deductions. For retail sales taxes, it is less costly to administer and to comply with a tax that is broad-based in terms of tangible goods, because neither the tax collector nor the retailer has to worry much about separating taxable from nontaxable sales. On the other hand, expanding the tax to include services could increase the cost of both collection and compliance because of the large number of very small firms that would have to be included in the process.

So the perfect tax, or the perfect revenue system, would include several broad-based taxes (income, sales, property) at relatively low rates as well as a variety of specialized taxes, fees that assign costs to those who benefit from specific services. It would offer a stable base of revenue that grows with the state's population and income, and would be collected at minimum cost and inconvenience to the government and the taxpayer, and its burden would be distributed fairly between business firms and households, old and young, rich and poor. That's a daunting challenge facing every legislator and public official as the state goes through the annual process of budgeting for public services and finding the money to pay for them.

These tax policy briefs describe a number of contemporary tax issues in South Carolina that will be facing policy makers in the next few years. We hope this is helpful in evaluating the options that you will be facing.

Tax Targeting: Is It Good Public Policy?

Some provisions of tax law apply generally to every taxpayer. Others single out particular groups for more (or less) favorable tax treatment. When a particular group—homeowners, the elderly, the disabled, small business—is singled out for special treatment, that practice is known as tax targeting.

Some provisions in the tax law are intentionally designed to encourage or discourage specific kinds of consumption or production activities, so they target those individuals and firms that produce or consume those products. Taxes on alcohol and tobacco, also known as sumptuary taxes, are intended to discourage the consumption of harmful substances. (There is a growing constituency in some states for adding marijuana to the list as a legal but taxed-and-discouraged substance.) Other targeted relief is offered to particular groups, but not to everyone, such as the \$50,000 property tax exemption for elderly homeowners or the exclusion of pension income from state income tax. The property tax relief for the elderly is funded by the state to the tune of almost \$200 million a year. The sales tax cap on cars of \$300, which costs the state more than \$100 million in revenue in an average year, targets auto dealers and buyers. It was intended to protect the state's retail auto industry from what was perceived as unfair competition from North Carolina (which has long since raised its cap). Other credits or exemptions target parents of pre-school children, college students and their families, small (unincorporated) businesses, newspapers, farmers, and even low-income families.

Tax targeting can be good or bad public policy depending on two factors: to what degree the targeted group is in need of help or the targeted activity is in need of encouragement (or discouragement), and what the alternative might be. In 2006, when Act 388 was being debated (the sales tax for property tax swap), the original goal was property tax relief for everyone. But that would have required too much of a sales tax hike to fund. So the goal was scaled down to only provide relief for homeowners and only from taxes for school operations. Even with that more targeted coverage, the revenue from the sales tax increase has not proved sufficient to replace the lost property taxes. The result was to shift most of the burden of local support for schools to the rest of the property tax base—commercial and rental property, personal property such as cars and business equipment, and older industrial and utility property. Since the tax relief was funded by an increase in the sales tax, Act 388 indirectly shifted more of the cost of paying for education to those who pay the most sales tax. Everyone pays sales tax, but the burden is higher on low-income families. Business firms also pay an estimated 43% of the sales tax, and got no property tax relief, so they picked up some of the tab.

During the debate over Act 388, a number of people who spoke at a series of public hearings around the state advocated targeting the tax relief to particular subgroups, such as those whose income was below a certain level, or those whose tax bills exceeded a certain percent of their income. Those options would have reduced the cost of Act 388, the revenue loss to schools, and shifting more of the cost of paying for education to low income households and business firms.

Targeted tax relief is cheaper than general tax relief—the revenue loss will be smaller. It can be used, like tax expenditures, to encourage or discourage certain activities as well as to provide help to particular groups like low income households and small businesses. But it also opens the door wide for special pleading for particular industries, property classes, age groups, or income groups to persuade legislators that they are somehow more deserving than others when it comes to paying their share of the cost of state and local public services. Tax targeting is a two-edged sword that should be wielded carefully and sparingly, with lots of input from those groups who will gain and those who will lose from specially crafted tax provisions.

Rethinking Tax Expenditures

When tax law exempts certain taxpayers, organizations, or activities from taxation, or allows a deduction or credit for spending on certain items, there is a loss of revenue. The exact amount of revenue lost depends on the tax rate, the amount of the activity prior to the exemption, and the responsiveness of the activity to the stimulus of the tax break. That revenue foregone is more or less equivalent to a direct expenditure on the same purpose, and is thus known as a **tax expenditure**.

Many tax expenditures favor charitable organizations. These nonprofit firms that meet certain tests (mainly not using their funds for lobbying purposes) are often exempt from paying state sales taxes and local property taxes, and contributions to such organizations are deductible for federal and many state income tax purposes. Their net income is considered "surplus" rather than a taxable "profit" and is not subject to income taxes at any level. The revenue lost from the federal income tax deduction for charitable contributions alone was estimated at \$56 billion in 2008. States like South Carolina that tie their income tax deductions to the federal code experience an additional state tax revenue loss. On the plus side, many of these organizations are doing good work that might otherwise have to be provided through government—soup kitchens, educational programs, and other kinds of assistance to people in need. It is cheaper for the government to subsidize these activities with a tax break than to bear the whole cost.

At the federal level, a list of tax expenditures has been included in the budget beginning with the Congressional Budget Act of 1974. These tax expenditures run to hundreds of billions of dollars, with the largest share coming from the Federal income tax. The largest category is exclusion of certain employee fringe benefits; particularly pension contributions and health insurance. Other significant contributors are deductions for mortgage interest, state and local taxes, and charitable contributions, special treatment of capital gains and accelerated depreciation, and exclusion of municipal bond interest, IRA contributions and Social Security benefits from income.

To Earmark or Not to Earmark

Earmarked revenues are dedicated to a particular use and are not available for general spending purposes. Earmarked revenues are a common practice among states. There are three arguments for earmarking, and two against this practice.

The first argument is that there is an element of *quid pro quo*, or a market-like exchange. Some taxes, are earmarked on the basis of who benefits from the service it supports—the gasoline tax for highway construction and maintenance being the most obvious case. Many fees and charges are payments for service, much like private sales, such as water and sewer service and use of recreational facilities. Good accounting practice suggests that these enterprise activities should segregate their revenue and spending streams from the general public budget.

Second, there is an fairness argument for earmarking. Many fees are designed to ensure that the cost of additional service, or services to particular groups or areas, falls on those who demanded that service, rather than on taxpayers in general. Impact fees in particular are a way to share the cost of public capital among newcomers to the community, rather than imposing additional tax burdens on existing taxpayers.

Finally, the third and most important argument is political; earmarking may make a tax or fee more acceptable if people know it will all be spent on some desirable purpose. For example, states that have adopted lotteries almost always have had to have a referendum, because most states had anti-lottery provisions in their constitutions. To make a lottery more attractive, legislators promised to use the revenue for specific desirable purposes, such as education, economic development, local government, or senior citizen programs. If citizens have to vote on any kind of tax or revenue increase, earmarking increases the chances for approval.

Most economists support limited earmarking such as with fees for service or a clear benefit relationship between the revenue source and the object of the earmarking. However, earmarking usually extends far beyond the fee for service or benefit to ensure preferential treatment for certain groups or programs in the budget process. Sometimes schools or local governments are guaranteed the proceeds of a particular revenue source regardless of the competing demands on the state budget. Other times supporters of parks, or highways, or some service with a vocal and effective lobbying group within or outside of government that succeeds in obtaining an earmarked revenue source. When earmarking is not clearly justified in terms of some kind of “user pays” principle, then it needs to be reexamined.

The arguments against earmarking are powerful because they are grounded in fundamental economic principles about choices and tradeoffs. When revenues are earmarked, they are removed from that process of weighing one expenditure against another that lies at the heart of good budget practice. The amount of revenue going to a particular purpose, such as gasoline taxes for highways, may be too much or too little relative to how much would be spent if highways were funded through the general budgetary process. If it is too much, the surplus is not available for other uses. If it is too little, that spending category may find it difficult to compete for additional funding out of general revenue because it already has preferential access to its “own” funds. For example, lottery funding for education has made it more difficult in some states for public education to get increased funds from general revenue sources, even though most state lotteries generate only a modest portion of the funding needed to provide for public education. At the other end of the spectrum, tourism destination states have been involved in a costly and escalating advertising war simply because state tourism departments had preferential access to dedicated revenues from accommodations and admissions taxes.

Finally, earmarking can make a budget crunch even worse when the economy turns down. It is easy to earmark specific revenue sources for pet programs when revenue is rising and competition for public resources is not too severe. But with a revenue downturn, legislators may find that a big part of their revenue stream has been taken off budget and placed in special funds. That practice means that preferred projects cannot be cut because their revenues are protected. The burden of budget cuts then falls much harder on those public programs and services that do not have access to earmarked revenues. In the next budget upswing, there will be increased pressure to earmark revenue for some of these programs and services that suffered during the previous recession, further limiting the flexibility in making adjustments in future budgets.

In spite of its political popularity, most economists advise against earmarking as a general principle, although with some exceptions. The burden of proof is on those who are trying to make a case for earmarking. Most of the revenue needs to be available to the general fund so that legislators have the freedom to make tradeoffs among spending priorities.

Comparing Taxes Across States

People who like to complain about taxes—and that's almost everyone—look for evidence to support their contention that they are particularly and unfairly overburdened. Maybe they are in a higher income tax bracket than their neighbors, or their school district has a higher mill rate, or their cigarettes are taxed at a higher rate than in other states (not a problem so far in South Carolina). Before 2000, South Carolinians complained about property taxes on their cars that were, in fact, high in comparison to other states. That complaint did bring some relief in the form of a lower assessment rate on cars.

While it's true that the particular mix of taxes used by a state and its local governments will affect families in different ways, depending on age, family size, income, spending patterns, and other factors, the most honest and accurate way to compare taxes from one state to another is to look at the total tax burden. Property, sales, excise, and income taxes—add them up. It's important to include local taxes, because a state with relatively low state taxes, like Tennessee, usually leans pretty hard on the property tax to fund education.

The Tax Foundation makes that calculation each year in order to rank states on two measures, state and local taxes as a percent of state personal income and taxes per capita.¹ According to the Tax Foundation, South Carolina ranked 37th among 50 states and the District of Columbia in taxes as a percent of income in 2008. South Carolina's 8.8% of income paid in state and local taxes was lower than the U.S. average of 9.7%. Georgia ranked 16th at 9.9% and North Carolina ranked 20th at 9.8%.

Our two neighboring states with no broad-based individual income tax, Florida and Tennessee, paid a smaller percentage of income in taxes—7.4% in Florida and 8.3% in Tennessee. Alaska had the lowest taxes as a share of income (6.4%) because the state has a lot of natural resource-based nontax revenue to support public services. At the opposite end of the rankings were the top two states, New Jersey and New York, at 11.8% and 11.7%.

If you are trying to measure the "burden" of taxation—how much of their income individuals and households have to sacrifice to the state in order to pay for public services—then this is the correct measure to choose. But often people make their comparisons based on the second measure provided by the Tax Foundation and other sources, taxes per capita. How much tax was collected for each person living in the state? That's an interesting measure, too—one by which South Carolina ranks near the bottom, 46th, followed only by New Mexico, South Dakota, West Virginia, Alaska, and Mississippi. South Carolina collected only \$3,127 in state and local taxes per capita in 2008, compared to a U.S. average of \$4,283.

But per capita taxes do not measure tax burdens. Instead, per capita taxes offer a measure of tax resources—how much state and local governments have to work with in trying to fund public services. The cost of public services is largely driven by the number of people to be served. Other factors such as the age distribution (lots of elderly citizens or school children), poverty, population density and climate may figure into the cost of public services, but population is the primary driver of the cost of those services we expect in every state—highways, public safety, public education, parks and recreation, environmental protection, libraries, public health. So it makes sense to compare resources by adjusting for differences in population from state to state. Low per capita taxes, unless they are supplemented by

¹ The Tax Foundation, "State and Local Tax Burdens: All States, One Year, 1977-2008", August 7, 2008. www.taxfoundation.org.

nontax revenue sources such as fees, charges, and revenue from natural resources, are likely to mean low levels of services.

What citizens would like to have, of course, are a low tax burden and a high level of public services. Surprisingly, the state that earned one of the best ratings on that combined measure in 2008 is Massachusetts, which ranked 6th in per capita tax collections but only 23rd in taxes as a percent of income, slightly below the national average of 9.7%. When Massachusetts ranked number one, it was jokingly referred to as “Taxachusetts,” but that top rank “honor” now goes to New York and New Jersey. In general, wealthier states tend to rank higher in per capita taxes than in taxes as a percent of income, while poorer states will be the opposite—like South Carolina, which ranks 46th in per capita taxes and 37th in taxes as a percent of income.

What do these two measures tell us about taxes in South Carolina? The first thing both measures tell us is that our taxes are not high, whether you are complaining about the burden or complaining about quality of public services that we get from our below-average collections per capita. The second thing that these two measures tell us is that South Carolina has to try harder than other states to fund essential public services that are vital to a healthy economy and a healthy environment and quality of life, such as K-12 and higher education, infrastructure, and public safety. Our legislature and local governments are under greater than average pressure to spend their tax resources wisely because they don't have a lot to work with. Even if the state increased taxes to the national average as a percent of income, the state would still only have \$3,436 per capita to work with, about 81% of the U.S. average.

Neither of these measures gives a full picture of taxation. For example, neither measure tells us how the tax burden is distributed across individuals and households, or how much more or less it may cost to serve different kinds of households or communities. Neither measure gives any indication of where taxes might be increased with relatively little pain, or where tax cuts or adjustments would do the most good in terms of fairness or encouraging economic development. Neither measure tells us anything about the quality and mix of public services that those taxes are being used to fund. But as the newly created Tax Realignment Commission begins its work of reviewing the tax structure of South Carolina and making recommendations for improvements, these are two important numbers to keep in the forefront.

Taxing Income in South Carolina

South Carolina has both an individual income tax (like 40 other states) and a corporate income tax (like 46 other states). At various times, it has been proposed that the state do away with either or both of these taxes. So let's take a quick look at the pros and cons of these two taxes and see what, if anything, needs fixing.

Why does South Carolina have a corporate income tax? It doesn't generate a lot of revenue—usually between \$200 and \$300 million a year. The state competes with other states for business location, so we might gain a competitive advantage by doing away with the tax entirely instead of just cutting the rate, as we did about 10 years ago (from 6% to 5%).

The fact is that the corporate income tax is an international competitive issue, not a state one. With a rate of only 5% (lower than the maximum rate on individuals), with all kind of credits for new and expanding industry, corporations don't weigh this tax nearly as heavily in their decisions as the sales tax on many business inputs or the property tax on corporate-owned real and personal property. State corporate income taxes are also deductible by firms on their federal corporate income tax return, which reduces the cost of the tax even more.

Corporate income taxes have two advantages as a state revenue source. First, business firms use states and local public services. Roads, fire protection, an educated labor force, solid waste disposal, police protection—all these services are part of the necessary input into producing private goods and services, and the corporate income tax is a good way to collect some contribution toward the cost of these public services. Second, economists argue that a tax on net income or corporate profit falls primarily on the shareholders, not on workers, suppliers, and customers. So even though the rate is flat and the revenue is modest, the corporate income tax contributes toward making our state's revenue system a little less regressive.

The individual income tax is the workhorse of the South Carolina revenue system, along with its partner, the sales tax. While periodically someone proposes to eliminate the income tax, more often it is in the shop for fine-tuning. The state's individual income tax is mildly progressive with rates ranging from 4% to 7%, with personal exemptions and standard deductions borrowed from the federal income tax and brackets indexed for inflation.

South Carolina's individual income tax is somewhere in the middle of the pack of states in terms of rates and revenue as a percent on income. The tax is very generous to senior citizens in exempting Social Security benefits and a big chunk of pension income, which helps the state compete to attract or retain wealthier retirees who might otherwise migrate to states like Florida or Tennessee with no income tax. Like the corporate income tax, the individual income tax is deductible for federal income tax purposes, further assuaging the pain. And because tax liability starts from federal taxable income, once the taxpayer has completed his or her federal tax return, it's quick and easy to fill out the state form.

The biggest challenge to legislators in managing the income tax is to resist the pressure to tinker more. Why not tinker? First, there is some value in having stable tax rules, certainty and predictability that allows citizens to plan their finances. Second, there is no free lunch in passing out tax favors. Cut taxes for one group and either taxes have to be raised on another group, or cuts in state services will be needed, shifting the cost to those who use or rely on those services. Each tax favor or tax loophole also adds to the complexity and the cost of collection and taxpayer compliance.

Finally, tax breaks that target individuals (such as senior citizens or college students and their families) or activities (like making homes more energy efficient) don't come up for annual review in the way that direct spending does. Tax breaks can outlive their usefulness, but it takes a sharp legislative eye to notice them and a firm commitment to resist special tax treatment. It's possible for a state income tax to be both fair and simple, but it takes hard work and determination to get and keep it that way.

The corporate income tax and its partner, the individual income tax (with unincorporated businesses paying the flat 5% corporate rate instead of the 4-7% individual rates) play a useful role in a balanced revenue system. They respond quickly to changes in the economy, they produce a substantial amount of revenue, they are the main progressive elements in an otherwise fairly regressive tax system, and they are a good vehicle for targeting particular groups or particular goals (like job creation) with credits or deductions. As best we can tell, South Carolina's income tax ain't broke. So fixing it should be pretty low on the tax reform priority list.

Taxing Services¹

THE NATURE OF THE SERVICE SECTOR

Purchases of services by households, business firms, nonprofit entities and governments accounted for around 57 percent of the nation's Gross Domestic Product in 2008. "Services" is a catch-all term that covers a great variety of purchases.

For consumers, this category includes such items as utilities—gas, electricity, water, and telecommunications—lease or rental of housing, cars, and tangible goods like furniture, tools and equipment; education and recreation; household services such as cleaning, yard maintenance, pet care, pest control, painting, and repairs to household equipment; and transportation by car or taxi, bus or subway, train or airplane. Many services purchased by households are linked to the purchase of tangible goods, such as auto repair, catering, and computer installation, maintenance, instruction and software. In general, the purchase of services represents a larger share of consumer spending in higher income households.

Business firms are also major users of services, including education and training, installation and maintenance of business equipment, transportation of raw materials and finished products, conferences and catered events, and outsourced services such as accounting and human resource management. Major categories of services in the national income accounts include transportation and utilities, information and communications services, financial services, professional and business services, education and health services, and leisure services.

In South Carolina, the service sector accounted for about 47 percent of state GDP in 2008. South Carolina has a smaller service sector than many other states. Financial services are the largest single category nationally and in South Carolina. Only transportation and leisure services, reflecting tourism and a growing elderly population, represent a larger share of GDP in South Carolina than in the nation as a whole.

Forty-five states and the District of Columbia levy retail sales taxes. Most of them tax only a limited number of services, with the exception of Hawaii, New Mexico, South Dakota, and West Virginia, which extend the tax to a broad range of services. Some services that are not covered by the general retail sales tax are subject to a separate excise tax, such as the tax on admissions and amusements in South Carolina.

The service sector has grown more rapidly than the tangible goods production and distribution sectors, which includes retailers. From 1970 to 2007, services have grown from about 30 percent to about 45 percent of household consumption, while at the same time the typical sales tax base as a share of household consumption has fallen from just under 40 percent to slightly over 30 percent.² Part of that growth is the shift to services among higher-income households. But sales taxes on tangible goods have actually contributed to the growth of the service sector, which is largely untaxed. A study by two economists published in 2000 in the *National Tax Journal* finds that retail sales taxes in general, and

¹This policy brief was prepared as testimony to the South Carolina Tax Realignment Commission.

²Michael Maserov, Center on Budget and Policy Priorities, Washington, DC, December 1, 2009 presentation to the Interim Joint House and Senate Finance committees of the North Carolina General Assembly.

increases in retail sales tax rates, have contributed to the shift in consumption away from taxed tangible goods and toward untaxed services.³

CONSUMER SERVICES VERSUS BUSINESS SERVICES

Unlike some other states, South Carolina exempts few if any purchasers. Exemptions are defined in terms of the nature of the good or service being purchased rather than whether the purchaser is a household, business firm, nonprofit entity or governmental entity. This choice simplifies the administration of the tax but disadvantages business firms whose activities involve a high proportion of purchases subject to the sales tax. A broader base would discriminate less among different types of businesses.

According to several studies, business firms pay about 40 to 45 percent of retail sales taxes. Business firms are also consumers of a variety of services. Extending the retail sales taxes to cover more services would affect business firms as well as other purchasers, but the selection of services to tax could be a factor in how much of the tax falls on business firms.

Many business services are purchased by nonprofits. Nonprofits are frequently exempt from property taxation, so expanding the taxation of business services will generate some revenue from nonprofits, which use public services, especially at the local level (police and fire protection, sanitation, roads, etc.).

SERVICES THAT ARE CURRENTLY TAXED IN SOUTH CAROLINA

Although the retail sales tax is primarily levied on tangible goods, there are certain services that are subject to sales tax in South Carolina. They include laundry and dry cleaning services, some communications services, electricity, restaurant meals (which combine tangible goods with services), and leases of some personal property (but not automobiles). Maintenance contracts on production machinery are subject to sales tax, but not on other machinery and equipment, which includes computers, copiers, and other home and business office equipment and home appliances. This distinction shifts more of the sales tax burden to traditional manufacturing as opposed to households, nonprofits, government agencies and service-type businesses. Maintenance contracts offer a particularly good candidate for expansion of the sales tax base.

Admissions and amusements are not subject to a sales tax but are subject to a separate excise tax at a lower rate. This last category could be converted to a sales tax that would be subject to the same state rate as well as local option sales taxes.

SERVICES COMMONLY TAXED IN OTHER STATES

The Federation of Tax Administrators issued a report on taxation of services in 2005.⁴ A total of 168 different services were subject to sales tax in one or more states. The states with the highest number of taxed services were Hawaii (160), Washington (157), New Mexico (156), South Dakota (146), District of Columbia (143), and West Virginia (110). In Hawaii, New Mexico, and South Dakota, all services are taxed unless specifically exempt. South Carolina, with 34 services, ranked 28th out of 45 states and the District of Columbia in the number of services subject to tax.

³ Merriman, David and Mark Skidmore, "Did Distortionary Sales Taxes Contribute to the Growth of the Service Sector?" *National Tax Journal*, March 2000, pp. 125-142.

⁴ "Are You Being Served?" *Tax Administrator News*, May 2005, p. 34-38.

According to the Sales and Use Tax Answer Book⁵ among the more common services subject to retail sales taxes are:

- Transportation (including rental cars, airline departures, etc.)
- Household services (such as landscaping and lawn care, cleaning, pest control)
- Automotive services: repair, cleaning, etc. (20 states plus the District of Columbia tax repair services)
- Newspapers (some states consider it a service): taxed in 11 states and the District of Columbia
- Vending machine sales, which fall in that gray area between good and service (36 states and the District of Columbia)
- Transient lodging (taxed in SC)
- Amusements and admissions (subject to a lower excise tax in SC)
- Maintenance and repair services and maintenance contracts or warranty work
- Printing and photography
- Other utilities besides electricity
- Consulting
- Advertising
- Credit reporting
- Employment services
- Parking
- Janitorial services
- Health clubs
- Self-storage
- Telephone answering services

WHAT IS THE REVENUE POTENTIAL?

There are no direct statistics showing the percentage of sales tax revenue that derives from taxing services in addition to goods. There are a few estimates available for specific categories. For example, in a recent report to the North Carolina General Assembly, it was estimated that taxes on installation and repair of tangible personal property alone would generate \$253 million in that state in 2010-11.⁶

However, there are some indications that can be drawn from the experience of the five states that tax the broadest range of services. Table 1 shows the tax rates, sales tax revenue, and population of South Carolina and those five states. Also shown is the revenue per capita per one percent of the sales tax rate, and the revenue as a percent of personal income per one percent of the sales tax rate.

Hawaii is probably an outlier with its very high sales tax revenue because it is an extremely popular tourist destination. South Dakota is an outlier in the opposite direction, a very lightly populated state with only 800,000 people and no significant urban centers. The three states that tax a broad range of services and offer more meaningful comparisons are New Mexico and West Virginia, with a little less than half the population of South Carolina, and Washington, with a population that is 50 percent larger. West Virginia's revenue results are not encouraging, with slightly less revenue per capita and slightly more revenue as a percent of personal income at the same 6 percent rate as South Carolina in 2008. (West Virginia also taxes a significantly smaller range of services than either New Mexico or Washington.)

⁵ Kozub, Robert M. James T. Collins and John C. Healy, Sales and Use Tax Answer Book, Aspen Publishers, 2001.

⁶ Michael Maserov, Center on Budget and Policy Priorities, Washington, DC, December 1, 2009 presentation to the Interim Joint House and Senate Finance committees of the North Carolina General Assembly.

The other two states offer more encouraging revenue numbers. New Mexico generated 73 percent more revenue per capita from sales taxes per one percent of the sales tax rate than South Carolina in 2008. Revenue as a percent of personal income, also adjusted for the difference in sales tax rates, was 71 percent higher. Washington generated 131 percent more revenue per capita from sales taxes per one percent of the sales tax rate than South Carolina in 2008. Revenue in Washington as a percent of personal income, also adjusted for the difference in sales tax rates, was 117 percent higher.

Table I
State Sales Tax Revenue Comparisons, 2008

	SC	HI	NM	SD	WA	WV
Sales Tax Rate	6%	4%	5%	5%	6.5%	6%
Revenue (billions)	\$3.05	\$2.62	\$1.95	\$340	\$11.35	\$1.11
Population (millions)	4.4	1.3	2.0	0.8	6.6	1.8
Sales Tax Revenue						
--Per capita per 1% of tax rate	\$114	\$509	\$197	\$85	\$264	\$103
--Percent of personal income, per 1% of tax rate	0.35%	1.2%	0.6%	0.2%	0.76%	0.38%

Source: U.S. Bureau of the Census and author's calculations.

ADVANTAGES OF TAXING SERVICES

There are many advantages to broadening the tax base through increased taxation of services. The biggest advantage is that taxing services makes it possible to generate more revenue at a lower tax rate with a broader tax base. The additional revenue will provide some relief to hard-pressed local governments, which also rely on the sales tax, and help ensure more adequate funding for public education, which depends heavily on sales tax revenue to fund property tax relief.

With expanded coverage of services, the burden of the sales tax could be distributed more fairly, depending on the mix of services taxed. In general, low-income households tend to consume a smaller proportion of services. It is difficult to determine whether expanded coverage of services will increase or decrease the share of the sales tax paid by business firms, because it would depend on what services are subject to tax. Broader coverage would also treat consumers more equally when they choose to substitute a good for a service or vice versa (buy a washing machine or use the Laundromat, for example).

Growth of sales tax revenue has lagged behind growth of personal income in South Carolina and nationally. Inclusion of more services in the tax base will bring sales tax revenue growth more in line with growth of personal income.

As indicated earlier, including more services will reduce the distortion of consumer choice that has favored nontaxed services over taxed tangible goods. For a state like South Carolina that still is heavily invested in tangible goods production, broadening the coverage of services reduces the handicap faced by our goods producing industries.

The sales tax is a particularly good tool for generating revenue from the nonprofit sector, which generates no local property tax revenue and very little income tax revenue but does use state and local public services. Nonprofits, including churches, private schools, hospitals, and other charitable organizations, do pay taxes on their purchases of tangible goods in South Carolina, which is not the practice in some other states. Nonprofits are also significant consumers of a variety of services, such as

building and equipment maintenance and repair, automotive services, cleaning services, accounting service, landscaping and lawn maintenance services. Also, many nonprofits sell services, such as education and health care, which are not subject to sales tax even with fairly broad coverage of services, so at least some sales tax would be collected.

One current challenge to the sales tax as a state revenue source is Internet and catalog sales. Services are less vulnerable to competition from Internet and catalog vendors than tangible goods, so a broader coverage of services might add some longer-term revenue stability.

Taxes on tourism services are a good way to shift some of the cost of providing public services to nonresidents, who use many of those services during their visits to the state. Focusing on services that are used by transients is a good way to shift that burden, a step that South Carolina has already taken with sales and accommodations taxes on transient accommodations and with local hospitality taxes on restaurant meals. Expanding tourism taxes to transportation is a logical next step.

DRAWBACKS OF TAXING SERVICES

The chief drawback of taxing services is that it will be more expensive for the state to collect and more expensive for vendors to comply, because there are many small service firms, typically smaller than the retailers who sell the bulk of tangible goods. The challenge of bringing many small service providers into the tax system may be mitigated by selecting services to tax that are typically provided by larger firms or services that are provided by firms that also sell tangible goods. Maintenance contracts, for example, are usually sold in conjunction with purchase of tangible goods. Auto repairs already involve sales tax on parts but not labor, so extending coverage to repair services would not increase compliance costs.

While expanding coverage to services will increase long term stability of revenue, in the short run revenue may be more volatile, declining more sharply in recessions and increasingly more rapidly during economic expansions. Many services are considered luxuries that can be cut back when household or business income declines and reinstated when income improves. Revenue stabilization is an issue that the General Assembly is attempting to address in other ways, so this objection is not insurmountable, but it is a relevant consideration.

PROCEEDING WITH CAUTION

Two decades ago, the state of Florida attempted to make a major expansion of sales tax coverage of services. Unfortunately, two of the services they included in the taxable list were legal services and advertising services. Those two groups teamed up to generate a campaign to repeal the expansion of the tax. Today Florida taxes 64 kinds of services, substantially more than South Carolina but ranking only 19th among the 46 sales tax jurisdictions.

There is a lesson from the Florida experience to move more gradually and thoughtfully in the direction of expanded coverage of services in order to avoid active and organized resistance. At the same time, the package needs to be sufficiently broad and diverse so that no single service or cluster of services feels that it is being singled out for additional taxation.

Cross-border shopping to avoid the tax is always a concern of tax administrators. Services are less vulnerable to cross-border shopping because many services are performed on site, but there are some services that can be purchased across state lines, particularly outsourcing of business functions such as payroll and accounting. Twenty of South Carolina's 46 counties border either Georgia or North Carolina.

One place to begin is to explore what services are subject to tax in those two states that are not taxed in South Carolina. Both presently have a limited number of services subject to tax, 36 in Georgia and 30 in North Carolina. However, expanded coverage of services is currently under consideration by the North Carolina General Assembly.

A second area to explore is the purchase of services that accompany tangible goods, because taxes on those services are easier to administer. The mechanism for recording and reporting payments is already in place. Maintenance contracts, repair services, and landscaping services all fit into this category.

South Carolina's sales tax, like that of many states, is a product of an earlier era. Most state sales taxes came into being in the 1930s and 1950s when tangible goods made up a much larger share of spending. As the economy has changed, the base of the sales tax needs to be adjusted to reflect that change. Expanded coverage of services in order to broaden the base and distribute the burden more equitably among taxpayers would represent a significant improvement in our state's tax structure.

Taxing Internet Sales

In-state retailers, whether downtown or at the mall, compete directly with on-line and catalog retailers for customers. A healthy local retail sector is an important source of local government revenue and local service employment. It is also an important dimension of quality of life that attracts and retains business firms and higher income residents. But the Internet and catalog vendors with whom local retailers compete are in many cases not required to collect and remit sales taxes to state and local governments. The customer has an obligation to pay use tax, but the state has no power to require these out-of-state vendors to collect sales tax on its behalf under several Supreme Court decisions. Some online retailers have warehouses and retail outlets that create a physical presence of nexus in the state that allows a state to require them to collect the sales tax—Barnes and Noble, for example, or Sears or Target, which have both on-line retailing as well as many local stores. Some use tax is also collected through the state income tax with a line for voluntary declaration by individuals. The revenue loss is substantial. A 2009 University of Tennessee study estimated that uncollected sales taxes on e-commerce cost states \$7.7 billion in 2008—about \$170 million a year for the average state.¹

In-state retailers are operating under a 6% price disadvantage compared to their Internet competitors—7% in the 29 counties with local option sales taxes. While Internet vendors argue that they have to incur shipping costs, local retailers also have high costs for maintaining a physical facility (including parking) and a local sales staff. There is no reason why the state of South Carolina should consent to creating a 6% to 7% handicap for our retail firms, who also create local jobs and contribute property tax revenue, business license fee revenue, and sales tax revenue to the South Carolina public sector.

The sales tax is a destination principle tax. That is, economic theory supports the contention that most of the burden of this tax falls on the buyer rather than the seller, even if it is the responsibility of the seller to collect and remit the tax. The sales tax is also a measure of ability to pay taxes, based on consumption spending. Those buyers who evade sales taxes by purchasing through catalogs or over the Internet are not contributing their fair share to the cost of the public services that they enjoy, shifting that burden to other citizens and other taxes, such as the property tax. Because Internet access is less available to low income households they are more likely to shop locally, so the exemption of most Internet sales from state and local sales taxes makes those taxes even more regressive.

The Supreme Court decision in the Quill case (1994) turned the issue of permitting taxation of interstate mail order and internet sales back to Congress to decide by saying that it was not a due process issue, merely regulation of interstate commerce. In other words, Congress has the power to permit states to require Internet vendors to collect sales tax. The Multistate Tax Commission has worked hard to make state sales tax bases more uniform in order to facilitate compliance with state and local sales taxes by catalog and Internet vendors. The State of South Carolina could take part in this effort to equalize the playing field between in-state retailers and Internet vendors by urging our Congressional delegation to support legislation that would allow states to collect sales taxes on Internet and catalog sales in their respective jurisdictions.

¹ <http://www.newrules.org/retail/rules/internet-sales-tax-fairness>. Accessed March 31, 2010.

Updating Excise Taxes

After many unsuccessful efforts, the General Assembly finally passed an increase in the excise tax on cigarettes from seven cents a pack to 57 cents—over the governor's veto. The seven-cent tax, set in 1972, would be 36 cents today if adjusted for inflation. The other 21 cents represents a tax increase. The state still ranks 42nd among the 50 states in cigarette taxes, with a national average of \$1.42 per pack.

South Carolina, like most other states, has a group of excise taxes which are taxes imposed on particular commodities and services. The admissions/amusements tax, the accommodations tax, local hospitality taxes, the lottery, taxes on bingo, and most important, taxes on alcohol, tobacco and gasoline all fall into the general category of excise taxes. The first three—admissions, accommodations, and hospitality—all follow the same model as the general sales tax. Tax due is computed as a percent of the amount of sale. Admissions and amusements were taxed at the same rate as the general sales tax until that rate was raised from 5% to 6% in 2006. They not only are levied at the lower 5% rate but also are not subject to local option sales taxes. Taxes on accommodations and restaurant meals (hospitality) are levied for the benefit of local governments and are in addition to the general retail sales tax. The rationale for these latter two taxes is that both business and tourist visitors use public facilities and impose costs on local government than can be recouped by taxing these two services that are more likely to be used by visitors.

The other major excise taxes—on alcohol, tobacco, and gasoline—have been around much longer and follow a different pattern. Alcoholic beverages and tobacco products are subject to both general sales taxes and specific excise taxes. Gasoline is only subject to an excise tax. In all three cases, the tax is stated, not as a percentage of the price, but as an amount per unit. Fifty-seven cents per pack of cigarettes. Sixteen plus cents per gallon of gasoline; \$2.72 per gallon of distilled spirits (plus some other taxes), 77 cents per gallon of beer, 90 cents per gallon of wine. These taxes have a different justification from tourism taxes. The tax on gasoline is dedicated to the maintenance and repair of roads, so it is more or less a user tax. Those who pay the tax benefit from the services it supports. Taxes on alcohol and tobacco are intended to discourage their use because these products are considered harmful.

South Carolina's taxes on alcohol of all kinds are above the national average, but when it comes to cigarettes and gasoline, South Carolina is still on the low end for cigarettes and ranks 47th among the 50 states at 16.8 cents per gallon. The U.S. average is 29.3 cents per gallon. Since gasoline tax revenue from interstate truckers is shared among states based on miles driven in the state and the state's gasoline tax rate, South Carolina is losing revenue from that source without getting any particular benefit in return.

Because these taxes are computed on a basis of physical units rather than price, the revenue doesn't go up with inflation, unlike the general sales and income taxes. Between 1995 and 2009, overall general state revenue grew 71%, but revenue in the category of "other taxes" (mostly excise taxes) grew only 11%. Sales volume tends to keep pace with population, but if the tax is not linked to the price, revenue from these per-unit excise taxes grows more slowly than revenue from other sources. The seven cents per pack tax on cigarettes, set in the early 1970s, would have to be about 37 cents today to represent the same purchasing power. In other words, if the tax rates for alcohol, tobacco and gasoline are not adjusted regularly for inflation, consumers are actually getting a tax cut—and no one in the General

Assembly gets to take the credit! So one possible way to keep pace with the price of everything else is to index these excise taxes for inflation.

It's true that these excise taxes are not major revenue sources. Taxes on alcohol, including beer and wine, only provided about \$109 million out of more than \$5 billion in South Carolina general revenue in 2008-09. Taxes on tobacco generated only \$28 million a year prior to the 50 cents per pack increase, which is expected to increase revenue by about \$100 million a year. But in times of economic downturn, every revenue source matters. When we, as a state and nation, are trying to discourage consumption of alcohol and tobacco, the rate itself matters. When South Carolina's roads and bridges are in poor repair because of inadequate funding for the highway trust fund, the gasoline tax rates matters. Whether the goal of an excise tax is to raise revenue or to discourage consumption (or both), low rates that are rarely adjusted don't accomplish either of those goals.

Assessment Caps and Point of Sale Provision

In 2006 a companion bill to Act 388 (the sales tax for property tax swap) created assessment caps on real taxable property of all kinds. An assessment cap is a maximum percentage increase in the market value of property for tax purposes. The cap is often a maximum percentage increase per year. South Carolina, with five-year reassessments, has a cap of 15 percent over the period between assessments.

The assessment cap was enacted in response to complaints from property owners about huge jumps in assessed valuation at reassessment, and thus, in their property tax bills. The particular concern was for people who had purchased homes many years ago and might be forced to sell them because their incomes had not kept pace with the increase in property value—and in tax bills. Despite questions about the actual extent of the problem and proposals to provide targeted relief for affected individuals, the pressure for widespread property tax relief won out. The resulting legislation created not only assessment caps but also millage caps for local governments and property tax relief for homeowners from taxes for school operations.

Assessment caps originated in 1978 in California as part of the famous Proposition 13. Since that time, they have spread from California to at least 11 other states, most recently South Carolina in 2006. South Carolina's 15 percent cap over five years is approximately equal to the rate of population growth plus inflation in recent years, between 2.5 percent and 3 percent a year.

Other states have responded to the problem of property values and tax burdens rising faster than income by identifying those households for whom that is happening and providing targeted property tax relief to just those individuals. About two-thirds of states offer some kind of state-funded property tax relief, most of them targeting households based on income, age, disability or other criteria. South Carolina provides blanket property tax relief regardless of income.

ASSESSMENT CAPS AND LOCAL GOVERNMENT REVENUE

Through 2007, a major source of revenue growth for local governments in South Carolina was rising property values, especially rising homeowner property values. Schools don't get much out of growth of homeowner property values after Act 388 replaced homeowner taxes for school operations with state-funded property tax relief, but they do benefit from growth in commercial and rental property values. Cities and counties get more tax revenue from growth in all categories. Prior to assessment caps, local governments were able to generate more revenue without increasing the mill rate, because the tax base grew along with the housing boom. Assessment caps took part of that revenue growth away.

Until 2008, the market value of taxable real property, especially residential property, had been rising faster than the rate of inflation. The overall tax base grew at an average annual rate of 6.5 percent between 2001 and 2007, with owner-occupied property increasing by 9.5 percent a year and commercial and rental property at 11.4 percent a year.¹ Some of that growth was new construction, but a significant part of the growth was accounted for by rising market values of residential and commercial property. The result was a potential revenue windfall to many local governments at the time of

¹ S.C. Budget and Control Board, Local Government Report 2007.
<http://www.ors.state.sc.us/economics/economics.asp>, accessed September 10, 2009.

reassessment. Local governments are required to roll back millage to reduce the amount of such a windfall, but the rollback provision has loopholes that keep it from being very effective.

If general inflation—not just property values—increases more than 15 percent over five years, the assessment cap will make it difficult for local governments to keep pace with increases in the cost of services that they purchase or provide. Even if inflation is within that range, there will be some properties that appreciate very little. The maximum allowed increase may be 15 percent, but the average increase will be much less when older or deteriorating property is factored in. If property values had continued on their upward trajectory, the assessment cap would have succeeded in slowing the growth of property tax revenue, perhaps to less than the rate of growth of the cost of government purchases and the size of the population being served.

POINT OF SALE REASSESSMENT

Like California, Florida, and other states with assessment caps, South Carolina allows for an assessment cap exception. This exception is known as point of sale reassessment, or just point of sale. When property is sold, it is assessed at the new market value with no cap on the increase. The stated purpose of the assessment cap was to protect homeowners from losing their homes to rising property taxes that were driven by rising home values (although it also applies to other property as well, mainly commercial and rental property). If the property, owner-occupied or other, is sold at a higher value, there is no good reason to protect the new owners from higher property taxes, since they know that a higher assessment comes with the property transfer.

It's true that the higher tax burden may enter into the price negotiations and the seller may get a lower price for the property, but there is still a significant capital gain at the time of sale—usually more than the maximum 15 percent increase in assessed value over five years. It's also true that the new owners will be facing a higher tax bill and that the point of sale provision means that similar properties will have different tax liabilities, depending on how recently each was sold. Realtors aren't too happy with the exception, because it discourages real estate transfers. But for local governments feeling the effects of state aid cutbacks, declining local sales tax revenue, millage caps, and a sharp drop in new construction that adds to the property tax base, the point of sale provision offers at least one way to generate additional revenue.

In rapidly growing areas of the state like the coastal counties and the Midlands, public officials consoled themselves with the knowledge that there would be a fair amount of property turnover and that with the point of sale provision, turnover would result in higher assessments. In poorer areas, the assessment cap isn't all that restrictive, because property values aren't growing much anyway. But in between the boom areas and the declining rural counties are a lot of areas of the state that were and are impacted by assessment caps. If point of sale is eliminated, as is proposed in pending legislation, these places would lose the one area of growth in tax base and revenue that can make up for tax base losses elsewhere or provide extra funds to offset state cuts.

The point of sale provision has been a focus of controversy in other states with assessment caps. In California, where it has been in effect the longest, there are very large differences in assessed value and tax bills between similar properties. Point of sale encourages people to stay put—a good thing in some respects, creating more stable neighborhoods and communities, a bad thing from the perspective of mobility and response to market signals and opportunities. In Florida, seniors who are downsizing want

to somehow carry their assessment cap with them so they can trade down without seeing their new property subjected to a higher tax bill.

The issue of reassessing based on the new market value when an assessable transfer (excluding transfers within families and other special cases) takes place is not an easy one. From the perspective of local government, the point of sale is the only ray of hope for generating more local revenue under an assessment cap that will probably not keep pace with the growth of population and inflation. The complaint of those who demanded the assessment cap ceases to exist when they make an assessable transfer of a property, because they are no longer liable for the property tax bill. From the perspective of the new owner and the real estate industry, assessment caps are a boon but the increased assessment associated with point of sale does result in a one-time increase in the tax liability, which will affect sales and sale prices of homes being transferred. From the perspective of equity among property owners, a fair distribution of the tax burden, it is true that as long as point of sale revaluations are part of the system, similar properties will bear different tax liabilities.

PENDING LEGISLATION

A bill (H. 3272) to eliminate the point of sale provision and to apply the 15 percent assessment cap to property transfers was introduced in the 2009 legislative session. It is on the fast track and likely to be passed early in the 2010 session. However, there is no particular urgency to addressing point of sale in the current economic climate. Given the state of the housing market, assessments are as likely to fall as to rise when property is reassessed, resulting in lower tax bills. So this is a good time to reflect, to look at the experience of other states, to get a sense of the current and potential impact of retaining or changing point of sale, and to move deliberately forward with a more thoughtful approach.

It is true that, if local governments had other revenue sources that kept pace with demand for services, then hobbling the growth of revenue from the property tax would be less problematic. It is true that, if legislators were willing to target property tax relief just to those whose home values and property tax bills have grown much faster than their income, the problem with point of sale reassessment would not exist and the entire system would be more equitable. It is true that, if the state were more generous and more dependable in providing aid to education and to local governments, there would be less need to protect the growth of the property tax from continuing legislative tinkering. But as long as local governments rely on the property tax, citizens demand public services, and the General Assembly refuses to consider targeted tax relief, the problem that the General Assembly is attempting to resolve is one that they themselves have created with the assessment cap.

Property Tax Assessments Rates

Taxation of real (land and buildings) and personal (equipment) property in all states and throughout the world is based on its market value in some way. Some countries tax the income from the property (including an estimate of rental value for property that is used by the owner), but most base the tax on what this property or a similar property would sell for or has recently sold for in the market. The property is then entered on the tax rolls at its full market value in some places, or at some percentage of its market value in others. If the value entered on the tax rolls is some percentage less than 100%, that percentage is called the assessment rate.

In South Carolina, different classes of property have different assessment rates for tax purposes. Seventeen states have similar systems, although none of them have as many classes and rates as South Carolina. The purpose of a classified assessment system is to distribute the tax burden according to some additional criteria besides just the market value of property owned. Preferential assessment is given to owner-occupied residential property and farm and forestland, both of which are assessed at only four percent of market value (or for farm and forest land, use value, which is much less than market value). A higher rate of six percent is applied to rental and commercial property and personal vehicles. Even higher rates of 9.5% and 10.5% apply to utility and manufacturing property and business equipment, including business vehicles. In practice, most manufacturing property pays less than the 10.5% would imply, because of favorable depreciation schedules for older manufacturing property and fee in lieu agreements on newer manufacturing property that reduce the effective assessment rate to 4% or 6%.

The assessment rates and property classes have been embodied in the Constitution since the mid-1970s. Prior to that, they were simply common practice, but a lawsuit by manufacturers forced the state to formalize this practice of differential assessment. The purpose of differential assessment is to alter the distribution of the property tax burden so that more of it falls on business property and less on households. The argument for this arrangement is that business firms generate a cash flow from their use of property with which to pay the property tax, whereas households do not. A weakness in this argument is that the property tax on residential rental property is reflected in the rent, so that even if renters don't write a check for property taxes, they do pay those taxes in their monthly rent.

Since Act 388, the difference in taxes on owner-occupied and rental homes that resulted from different assessment rates has been magnified. Owner-occupied homes are exempt from taxes for school operations, while rental property is not. A \$100,000 home that is owner-occupied would be assessed for \$4,000 and pay about \$538 in city and county taxes at 2006 average mill rates, while the same home rented would be assessed for \$6,000 and pay \$1,786 in city, county and school taxes. Since renters are often younger, lower-income households, this very large tax difference between owner-occupied and rented homes makes the property tax more regressive.

Any preferential treatment for one group automatically becomes discrimination against all other groups that are not favored. Some of the negative impact of higher assessment rates on utility and manufacturing property have been mitigated by fee in lieu agreements and rapid depreciation as well as tax breaks on their corporate income taxes for job creation, although these benefits accrue mainly to new or expanding firms. The categories of property that are most adversely affected by differential assessment in South Carolina are rental and commercial property, which are important to the state's tourism industry and to local governments, because of the additional local revenue generated by sales taxes, accommodations taxes, and business licenses. It is claimed that this adverse effect is particularly

significant in the state's urban border areas (near Charlotte, Augusta and Savannah) because the tax burden is higher on commercial and rental property and lower on owner-occupied property in South Carolina than it is in the adjacent states of North Carolina and Georgia. Firms considering location on one side of the border or the other could be influenced by the tax difference for rental property, office space and commercial facilities.

The other harmful effect of a classified system is the incentive created to qualify for a lower assessment ratio. Owners of vacant land seek to get an agricultural classification so that they will be taxed at the much lower use value rate. Owners of rental property seek to get it reclassified as owner-occupied to not only reduce the assessment rate but also qualify for exemption for taxes for school operations. There has been significant conversion of property to an owner-occupied classification since the passage of Act 388, sometimes by putting the property in the name of another family member. The result of these reclassifications is a substantial loss of local government revenue, particularly to schools.

Because the classifications are in the Constitution, they are difficult to change and rarely come up for review. But in a competitive interstate business environment, and with local governments (especially schools) struggling to pay the bills, a review of the rationale for and effects of the state's classified property tax system may be worth the effort.

Why Should You Care About the Index to Taxpaying Ability?

The index of taxpaying ability is a very important number. The index, or ITA for short, is the main tool used in South Carolina to partly equalize education funding across school districts. It is used to determine what share of education costs in each district is paid by the state, and how much has to be raised locally by that district. A district with a high index has to rely more on local funding, while a low index entitles a district to more state aid.

The primary source of state funding for general school operations is the Education Finance Act (EFA). The ITA was created by the EFA. The EFA isn't the only source of state funding for school districts, but it does account for about 22 percent of total school operating revenues. Other state funds are distributed using the same formula, mainly for employee benefits and transportation, so the total share of operating funds affected by the EFA formula is about 30 percent.

The EFA provides for shared state and local education funding based on the number of pupils multiplied by the base student cost. The base student cost is the amount of money needed to achieve minimum standards in a basic elementary and secondary education program. Set in 1977, it has been adjusted for inflation since then in most years.

The EFA base student cost is set by the General Assembly each year. For 2008-09, base student cost was originally set at \$2,578 per pupil, but was later cut to \$2,190. The number of pupils is adjusted using weights that reflect grade, special needs, and other factors. So for a district with 5,000 (weighted) pupils, the total EFA part of education funding in 2008-09 would have been:

$$(\text{Base student cost} \times \text{weighted pupils}) = (\$2,190 \times 5,000) = \$10,950,000$$

For the average school district, the state pays 70 percent of total EFA funding, while the local school district must raise the remaining 30 percent from property taxes. Some districts get more than 70 percent of their EFA formula funding from the state, while others get less. The share for a particular district is determined by its index of taxpaying ability.

The ITA is simply the assessed value of taxable property in the district divided by total assessed value of taxable property in the state. In other words, the index tells us what percentage of the total taxable property in the state is in this particular district. The larger the district's tax base, the larger the district's ITA, and the more local property tax revenue the district can afford to raise toward the total cost of education. Districts with very small tax bases have small ITAs and aren't expected to raise as much revenue.

So the ITA is pretty important, because it's the main tool for redistributing revenue from richer districts to poorer districts in order to level the education playing field. It's not perfect. The state still sees lower mill (property tax) rates in richer districts than in poorer districts for the most part. But at least the ITA does some equalizing among districts.

WHAT IS WRONG WITH THE ITA?

When EFA was enacted in 1977, the index of taxpaying ability was a reasonable way to assign local responsibility for helping to pay for education. Unfortunately, the ITA has run into some problems in the last two decades. The first problem came from fee in lieu of tax agreements, or FILOT, which counties can negotiate with new and expanding business firms that create jobs. FILOT agreements were introduced in the 1990s.

Instead of paying property taxes, firms with FILOT agreements pay a fee that is negotiated with the county, including a share for school districts. These properties were generating school revenue, but the revenue they produced didn't change when the mill rate changed. Somehow FILOT agreements had to be reflected in the ITA. Otherwise, the ITA would be understating the revenue capacity of districts with FILOT property.

The South Carolina Department of Revenue solved that problem by adding something to the property tax base to reflect the revenue generated from FILOT property. The figure added was the assessed value that FILOT property would have to have in order to generate that much revenue.

Suppose, for example, that a firm was paying a fee of \$100,000 a year. The Department of Revenue treated that figure as the property tax payment for that property. Suppose, further, that the mill rate in that district for school operations was 80 mills, or \$80 per \$1,000 in assessed value. The DOR would calculate the assessed value of the property generating the fee as follows:

$$\text{Property tax (FILOT) revenue} = \text{Assessed property value} \times \left(\frac{\text{Mills}}{1,000} \right)$$

Or restated:

$$\text{Assessed property value} = \frac{\text{Property tax (FILOT) revenue}}{\left(\frac{\text{Mills}}{1,000} \right)}$$

In this case:

$$\text{Assessed property value} = \frac{\$100,000}{.08} = \$1,250,000$$

So \$1.25 million would have been added to the value of taxable property that is used to compute the ITA in that school district and in the state.

A much larger problem with the ITA came about as a result of Act 388, passed in 2006. This legislation abolished school operating taxes on homeowner property and replaced it with property tax relief payments from the state, funded by sales taxes. After the first year, the value of state property tax relief payments is no longer related to the value of homeowner property. Instead, it depends only on inflation and population growth statewide, and on student population growth in a particular district.

So building additional homes—or increases in the value of existing homes—doesn't increase the property tax revenue (including property tax relief) of a school district. But the property is still in the tax base, because the owner still has to pay city and county property taxes as well as taxes to repay school bonds (debt service). A district might have a high ITA, but a lot of the property in that index might be homeowner property that doesn't represent the district's ability to generate more school operating taxes. So the ITA would overstate the district's ability to raise additional revenue. The opposite would be true of a district with a smaller share of homeowner property.

WHAT SHOULD BE DONE?

Why not just take owner-occupied property out of the ITA? That sounds too easy, and it is. The percentage of property that is owner-occupied varies greatly from district to district, from a low of about nine percent to a high of about 42 percent.

A district with a lot of owner-occupied property will be getting a higher initial property tax relief payment from the state, although that payment grows slowly after the first year. But if the district has to increase the mill rate, that homeowner property won't generate any more tax revenue. A district with a very low percentage of property tax in owner-occupied homes doesn't get much property tax relief from the state, but when it raises the mill rate, that district will see more of an increase in revenue.

The ITA no longer measures local ability to pay, for two reasons. First, the ITA doesn't take into account the district's property tax relief payments from the state. Second, the ITA doesn't reflect the fact that part of the district's tax base doesn't generate more property revenue when the mill rate is increased, and that the share varies greatly from district to district.

A short term fix can be made to the index ITA by adjusting it in the same way that the Department of Revenue did for FILOT payments. If a particular district is getting \$4 million in property tax relief payments, what would be the assessed value of owner-occupied residential property that generated that much revenue? Again, it depends on the mill rate. A tax rate of 80 mills would have generated \$4 million in revenue from property worth \$50 million in assessed value before Act 388:

$$\text{Assessed property value} = \frac{\text{Revenue (tax relief payments)}}{\left(\frac{\text{Mills}}{1,000}\right)}$$

$$\text{Assessed property value} = \frac{\$4,000,000}{.08} = \$50,000,000$$

So \$50 million in owner-occupied residential property would be counted in the property tax base of the school district and the state in place of the actual assessed value of homeowner property.

In the long run, the state of South Carolina will need a better and simpler measure of the ability of a local school district to contribute to the total cost of education. But fixing the index of taxpaying ability to correct for the effects of Act 388 would be a good place to begin.

Using Fees and Charges to Fund Government

Critics of government are fond of saying that government should be run more like a business. Parts of government can be run like a business, with customers and payment for services. In fact, local governments in particular use enterprise funds to separate their business activities, like water and sewer service and sometimes electricity or public transit, from those services that are funded mainly through taxes and available to all citizens. Many state agencies are supported by a combination of fees for services and general fund financing, like public colleges and universities and state parks. Fees make sense when it is easy to identify who benefits, from college students to households and businesses using water. For many government services, however, it's harder to make that direct connection between the service and the user or customer. Who benefits from public schools? Mainly families with children, but we all benefit from having public schools in one way or another. Putting the entire cost on the families with children would greatly increase the burden of having and raising children. We all have an interest in the health and well being, including education, of those who share our communities with us and those who will be working, voting, and paying taxes in our later years.

Fees for water and sewer, park use and college, are easy to understand. General taxes, like income and sales taxes that go into a common fund to pay for government administration, public safety, and other public services are also pretty easy to understand. What's harder to deal with are those gray areas between a pure tax, like the sales or income tax, and a fee that is only paid if you use the service. As South Carolina and other states (and local governments) have shifted from depending mainly on taxes to relying more heavily on fees and charges to support general public services, the distinction has become blurred.

South Carolina relies much more heavily on fees and charges than most other states. As a percentage of own source revenue (revenue excluding federal aid), fees and charges make up 28% of South Carolina state revenue, compared to an average of 14.2% nationwide. Per person, South Carolina collects an average of \$873 per person in fees and charges, compared to \$493 in the average state.

Some fees, and some taxes, are pretty close to a payment for services. Gasoline taxes at the state level and road use fees added to your property tax on vehicles both go to maintain the roads that cars use. Dog licenses support animal shelters and animal control officers. Others, however, are just a different way to raise revenue. Some local governments charged on restaurant meals before they were authorized by the state to levy a hospitality tax. There is no meaningful difference between a hospitality tax and a hospitality fees that except that local governments have more flexibility in spending the revenue from fee than from the tax.

Fees and charges have benefits and drawbacks as a revenue source. They implement the principle that users should pay for those particular services that they need or want while others do not. They control demand for services that would otherwise skyrocket if it was available to all for free, and they determine who gets the use of the city tennis courts or the state park cabins based on willingness to pay. But fees and charges are regressive; that is, they are more burdensome on low-income families. When the city offers a summer recreation program based on fees, a poor family with several children is less able to take advantage of the program because of the cost, even though it would be of greater benefit to them than to children in higher income families who can afford other kinds of summer programs. Fees for immunizations and library use may discourage poor families from taking advantage of such services. The



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