

## South Carolina Taxation Realignment Commission ('TRAC')

### 'Fair Tax' Draft Findings and Recommendations

#### 'Fair Tax' Overview:

- Implementing a state level 'Fair Tax' would require elimination of the following state taxes: Income Taxes (Individual and Corporate), Income Tax Withholding, Income Tax on Banks, Income Tax on Savings and Loans, and the Estate Tax.
- According to proponents, the purpose of implementing a Fair Tax System is to make state tax systems more simplified and hospitable to economic development while also taxing individuals at an equal level (in terms of rate/percent).
- The taxes eliminated would be replaced with a single-rate personal consumption tax. Essentially, this is a sales tax on goods and services.
- All goods and services would be taxed once with absolutely no exemptions, exclusions, or maximum tax caps allowed for purchases by South Carolina's households.
- Rebates (or 'Prebates') are used within the Fair Tax concept to ensure that no individual or family pays tax up to the poverty level based on household size for low-income taxpayers.<sup>1</sup>

#### 'Fair Tax' Proponents would say:

- This is a more efficient and fair way to collect taxes.

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<sup>1</sup> Americans for Fair Taxation, January 2010. *Fair Tax*, Presentation made January 6<sup>th</sup>, 2010 by Jack Johnson to the South Carolina Taxation Realignment Commission.  
<http://www.scstatehouse.gov/citizensinterestpage/TRAC/TRAC.html>

- The Fair Tax broadens the tax base and removes exemptions while also minimizing and equalizing tax burdens for individuals.
- Provides for no net revenue loss for state (e.g. “revenue neutral”).
- The Fair Tax prevents multiple taxation.
- Removes disincentives for business growth by removing the Corporate Income Tax.
- Individuals would be taking home the majority of their paycheck (if adopted on a state level) with the exception of federally implemented taxes.<sup>2</sup>

### **‘Fair Tax’ Opponents would say:**

- To replace revenue lost from the elimination of other taxes, sales tax rates would have to be higher than they are now and often higher than what is claimed to be needed to be revenue neutral.
- While many states should and need to broaden their tax base to include a larger variety of services and goods, the rate needed to generate a revenue neutral system would be hard to obtain without going beyond what would be considered optimal.
- The goods and services that now go untaxed that would be subject to the new tax include health care services (e.g. doctors visits, medical procedures, etc.), legal and accounting services, child care, school tuition, new home sales (including taxation on lumber, land, etc), etc. This could cause technical, economic, and political problems.
- The high consumption tax could hurt in-state businesses as residents shift purchases to neighboring states or the internet.

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<sup>2</sup> Americans for Fair Taxation, 2009. [http://www.fairtax.org/site/PageServer?pagename=about\\_main](http://www.fairtax.org/site/PageServer?pagename=about_main)

- Eliminating all taxes but the sales tax could lock the state into its current levels of revenue which are quite low at this point in the economy.
- Elimination of income taxes will benefit the wealthiest of citizens while the rebate will protect the poorer citizens, the middle class will bear the brunt of these taxation changes.<sup>3</sup>

## **TRAC Findings and Recommendations:**

### **Findings**

- While the Commission believes that there are some positive aspects to the 'Fair Tax' concept, there is very little research for TRAC to study the ramifications and benefits of implementing such a tax structure.
- South Carolina currently has a well balanced tax structure between income, sales and property taxes. At roughly 40% each, income and sales taxes represent a shared portion of the state's general fund revenue. Entirely eliminating income taxes significantly disrupts this balance and could be considered questionable public finance policy.
- Such significant changes could be volatile especially in the current economic climate.
- Implementing such a tax structure could potentially make South Carolina more susceptible, not less, to the next economic downturn or recession.
- A main focus of the 'Fair Tax' ideal is to eliminate all sales tax exemptions. This is a very admirable concept as not all citizens benefit equally, if at all, from some of the current SC sales tax exemptions.

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<sup>3</sup> McNichol, Elizabeth and Nicholas Johnson, September 7, 2010. "FairTax" Proposals to Replace State Income and Business Taxes With Expanded Sales Tax Would Create Serious Problems. Center on Budget Policy Priorities, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3285>.

- As such, these sales tax exemptions have been one of many primary focuses of TRAC. The TRAC Sales and Use Tax Exemption Report eliminated almost \$700 million of exemptions.<sup>4</sup>
- As noted in the recommendations TRAC has adopted regarding the State's sales and use tax exemptions, TRAC's recommendations are based on long-term structural reform that will, by broadening the base and lowering the rate, promote revenue stability and most importantly, promote enhanced fairness for both individuals and businesses, who, absent reform, will otherwise face continued pressure from a tax base that continues to narrow.
- In its effort to recommend long-term and sustainable structural reform, TRAC makes thoughtful decisions by continuing full exemptions on certain items, imposing substantially lower rates on others, and fully exempting certain segments of the population from tax liability out of a desire to achieve the difficult balance between a system that is fairer for all South Carolinians on the whole, while not overly burdening the most vulnerable portions of populace.
- TRAC has also recommended increasing the number of services currently subject to sales tax in South Carolina, recognizing the distinct and fundamental shift in the nation's (and South Carolina's) personal consumption patterns that have seen our economy move away from a "goods" based to a "services" based economy.
- TRAC recommends using 100 percent of any additional revenue that may be generated under its services proposal (which broadens the base) to lower the state sales and use tax rate from its current 6% (one of the nation's higher rates) to a commensurately lower level. This action, in concert with TRAC's recommendations regarding sales and use tax exemptions as discussed above, have the real opportunity to substantially lower the State's sales tax rate, thereby promoting a fairer, more stable, and more competitive sales tax base and structure.

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<sup>4</sup> June, 29, 2010. TRAC Sales and Use Tax Exemption Subcommittee - Draft Revenue Table (unofficial estimates). <http://www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/TRACSalesandUseExemptionSubDraftRevenueTable.pdf>

- TRAC feels these actions will help make South Carolina's sales tax rate and structure more competitive nationally while also allowing the State to maintain its important balance of revenue streams.
- The 'Fair Tax' elimination of Income Taxes (Individual and Corporate), Income Tax Withholding, Income Tax on Banks, Income Tax on Savings and Loans, and Estate Taxes could cause South Carolina to raise the current sales tax rate to make up for the lost revenues making South Carolina less competitive as the current sales tax rate is one of the higher in the country.

## **Recommendations**

Simply put, the 'Fair Tax' system, while no doubt well intended, has not been adopted by any state and has only been considered by three other states to date (MO, AR, and MI). The lack of research and examples make understanding benefits and drawbacks to the 'Fair Tax' difficult and therefore difficult for TRAC to fully recommend during an already unstable economic climate.

As such, The South Carolina Taxation Realignment Commission recommends that the SC Legislature conduct further review and analysis of this concept in order to better understand if this significant structural change would be beneficial to South Carolina, its citizens, and its businesses.