

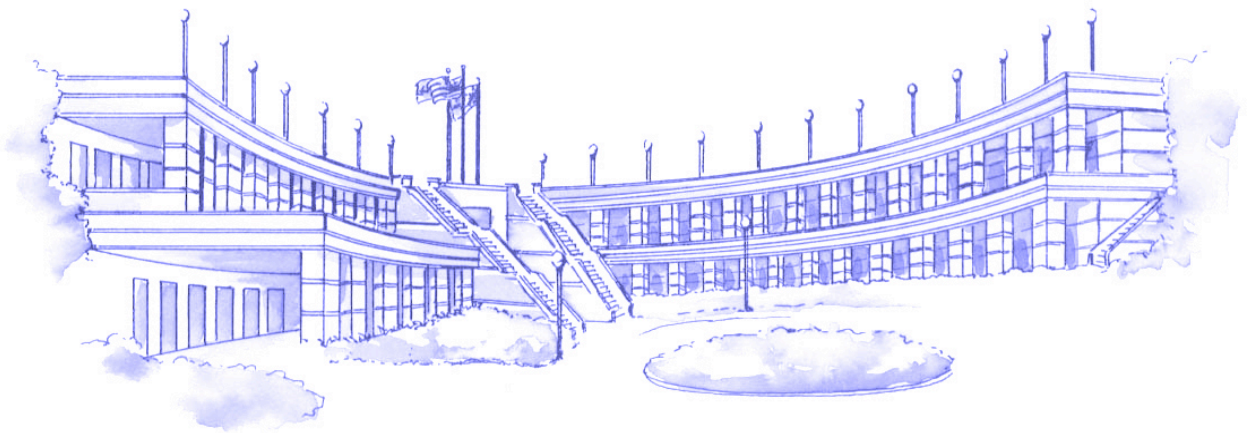
ENSURING A COMPETITIVE REVENUE SYSTEM FOR SOUTH CAROLINA

FINDINGS AND CONCLUSIONS FROM AN EVALUATION OF THE SOUTH CAROLINA REVENUE SYSTEM

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Research Project

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Project Report

Ensuring a Competitive Revenue System for South Carolina

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ENSURING A COMPETITIVE REVENUE SYSTEM FOR SOUTH CAROLINA

PROJECT GOALS AND METHODS

A revenue system is one of many elements that contribute to a state's *competitiveness*. Competitiveness means maintaining and enhancing South Carolina's attractiveness as a place to work, invest, and live in comparison to other locations. The state and local government revenue system of taxes, fees, and debt management has an important role to play in competitiveness—not in the narrow sense of how low can the tax burden be but rather in a broader, more complex sense that considers the role of public revenue as part of a larger system.

What level of revenue do state and local governments need to provide the public infrastructure and services that households and businesses seek? How do governments raise that revenue in ways that are both equitable (fair distribution of the burden) and efficient (encouraging productive activities and discouraging undesirable ones)? How do these choices compare with choices made in other states? How is the state's revenue system impacted by changes in the underlying economy? What adaptations must be made to keep the revenue system adequate, equitable, and efficient over time?

In addressing these questions, the Strom Thurmond Institute explored government revenue in South Carolina from multiple perspectives: theoretical, historical, institutional, economic, political, and statistical. The research compared levels and distribution of revenue sources with those in other states, especially neighboring states. This exploration resulted in seven working papers by six researchers. This paper is a summary of the major findings.

STATE AND LOCAL REVENUE AS A SYSTEM

State and local revenue make up a single integrated revenue system. States create local governments, provide some of their funding, share service responsibilities with them, and determine what revenue sources they can use. Interstate comparisons of tax burden or tax effort have to use combined state and local taxes (or revenue) because states differ in how they divide tax and revenue collection between state and local levels.

Individual taxes and fees are also part of an integrated revenue system, so changes in particular taxes or fees should be evaluated in the light of how they affect the system as a

whole. A revenue source that has flaws when considered by itself may still make a useful contribution to the efficiency, equity, and adequacy of the revenue system as a whole. A progressive tax may offset regressivity¹ elsewhere in the system. Fees and charges may make a system more regressive but also more accountable. Sales taxes and excise taxes on tourism may shift some of the tax burden to nonresidents.

South Carolina's general revenue from state and local governments combined was \$21.2 billion in fiscal year 2002, according to the U.S. census.² Of that \$21.2 billion, \$5.3 billion was federal aid and \$15.9 billion was from revenue sources internal to the state. Total state and local taxes in South Carolina for the same year were \$9.8 billion, while non-tax revenue from fees, service charges, and other miscellaneous sources came to \$6.1 billion. Figure 1 shows the distribution of state and local revenue between these major sources. Tax revenue provides the largest share of revenue at nearly 46 percent of the total.

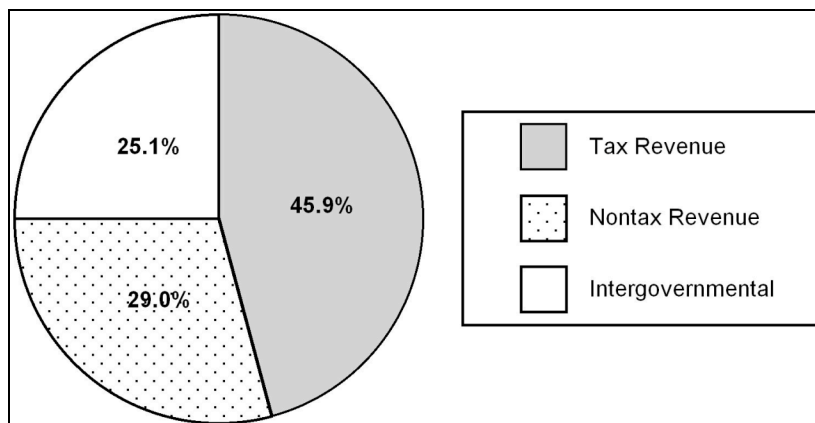


Figure 1. Combined State and Local General Revenue from All Sources, South Carolina, Fiscal Year 2002

The property tax, the general retail sales tax, and the individual income tax are the mainstays of state and local tax revenue in South Carolina as well as most other states (Figure 2). South Carolina is close to the U.S. average in the distribution of revenue from these three taxes. Property tax revenue tops the list (30.8 percent in the U.S. compared to 31.8 percent in S.C.), followed by revenue from the general retail sales tax (24.6 percent U.S. and 25.0 percent S.C.) and the individual income tax (22.4 percent U.S. and 24.1 percent S.C.). Selective sales (excise) taxes, other taxes, and the corporate income tax together bring in about 19 percent of combined state and local tax revenue in South Carolina and just over 22 percent in the nation.

¹ A regressive tax takes a larger share of income from a low-income person than from a higher-income person. For example, a tax that took \$1,000 from a household with a \$20,000 income and \$2,000 from a household with a \$60,000 income would be regressive, because the tax is 5 percent of income for the first household and only 3.3 percent of income for the second household. If the tax on the second household were \$4,000, the tax would be progressive because it would take a higher percentage ($\$4,000/\$60,000 = 6.67$ percent) of income from the higher income household than from the lower income household (5 percent).

² Fiscal year 2002 is the last year in which state and local revenue data is available for all states. Nongeneral revenue such as that associated with utilities and insurance trusts is excluded from this analysis.

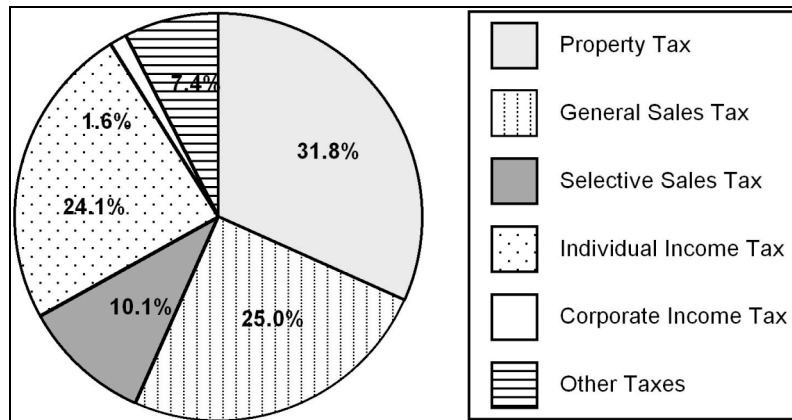


Figure 2. Combined State and Local Tax Revenue, South Carolina, Fiscal Year 2002

CONCLUSION

Tax policy decisions should result from considering proposed changes in taxes or fees in a context of state and local revenue as a single integrated system. Policy makers will make more informed choices if they think about revenue both as a holistic system and as the underpinning for the state's goals for economic development and quality of life.

WHAT MAKES A "GOOD" REVENUE SYSTEM? EFFICIENCY, EQUITY AND ADEQUACY

A competitive state and local revenue system will emphasize three criteria: adequacy, equity, and efficiency. Using these criteria, a "good" revenue system will provide (1) adequate and stable revenue to support essential public services, (2) equitable distribution of the burden across income levels and between businesses and households, and (3) efficiency in designing revenue tools that do not unduly distort private decisions or discourage private economic activity.

No single revenue tool can meet all three criteria of adequacy, equity, and efficiency. Revenue systems generally consist of a portfolio of revenue instruments with different strengths and weaknesses—the widely discussed *three-legged stool* of sales, property and income taxes supplemented by smaller, diverse revenue sources.

Adequacy means the tax system is generating enough revenue to support desired public services. Adequacy is both a cyclical concern and a long-term challenge. Some revenue sources are stable over the business cycle but unresponsive to growth, while others are sensitive to growth but volatile during recessions and expansions.

A revenue system that gets a good rating on adequacy will rely on a mix of revenue sources that provide a stable foundation that grows with the economy. Different taxes and fees in

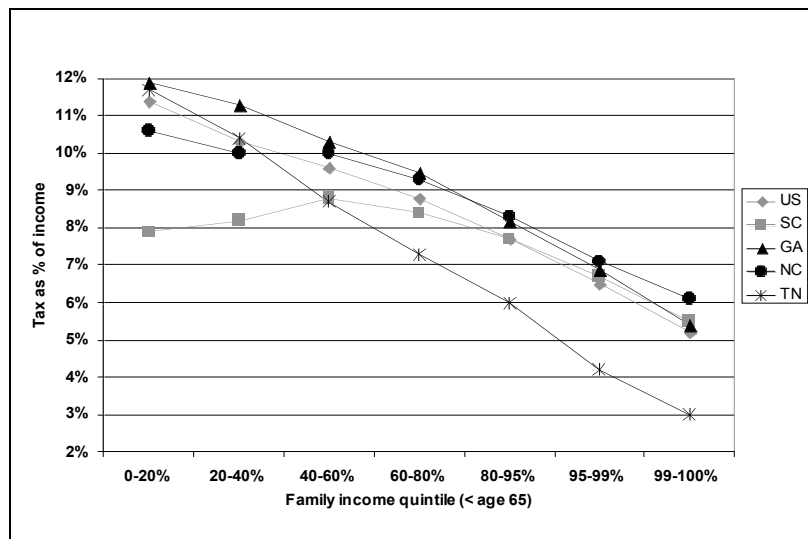
South Carolina's revenue system have different degrees of sensitivity to economic change. Revenue from both the individual income tax and the general sales tax is closely tied to overall economic activity, especially wage and salary growth. However, the individual income tax tends to grow faster than the economy overall, while the sales tax grows more slowly. Even over the boom decade of the 1990s state General Fund revenue grew only about 85 percent as fast as personal income.

Some revenue sources, including property taxes, fees, and service charges, are not strongly influenced by the ups and downs of the state economy. Revenue from these sources has grown faster than the economy in the last decade or so because of new and higher fees, changes in tax laws and rates, and increased average value of residential property. But in general, state revenue is more vulnerable to changes in economic conditions than local revenue. The biggest risk factor for local government is changes in state aid as state revenue rises and falls.

Equity is a measure of fairness of the distribution of the tax burden among households and business firms. The most widely used measure of equity is the distribution of the tax burden across income groups, measured as a share of personal income. Equity should be measured as a function of the overall revenue system, not of the individual tax or fee, although changes in one tax or fee may change the equity of the overall revenue system. Regressive taxes have a place in the revenue system as long as they are balanced by other taxes that are more progressive.

South Carolina's current combined state and local revenue system is moderately regressive. In 2002, sales, property, and income taxes combined took a higher percentage of personal income from households with incomes in the lowest 20 percent of the income distribution than from higher income households (Figure 3). Sales and excise taxes are regressive. If South Carolina expands its reliance on sales taxes, a larger share of the tax burden will shift toward lower income households.

The distribution of taxes between business firms and households is another important equity issue. While individual income tax burdens are often a major interstate competitive consideration for households, other taxes are more significant for business firms. Historically the main tools in competing for business location have been property taxes and corporate income taxes, but sales taxes are also a factor because of state-to-state differences in what business purchases are subject to sales tax. In fiscal year 2003, South Carolina was at the national average (43 percent) in the share of total state and local taxes paid by business firms, but the sales tax and sales tax exemptions are still a potential area for interstate competition.



Source: Calculated by author from data from Institute on Taxation and Economic Policy.
 Figure 3. Tax Burden by Family Income Group, State and Local Taxes Combined, South Carolina, 2002.

Efficiency refers to the effect of a tax or a tax change on household and business decisions, such as where to live, work and invest, how to spend and where to shop. In general, efficiency calls for a revenue system that is neutral, that is, one that does not create negative incentives for working harder, investing more, and creating economic growth and job opportunities. Increasingly, states define efficiency in terms of offering positive incentives to locate, work, and shop within the taxing jurisdiction.

South Carolina makes heavy use of tax expenditures to encourage desirable actions by citizens and firms. Tax expenditures are revenue foregone because of exemptions, exclusions, credits, or other kinds of tax relief given to certain groups of firms, households, or individuals. Some of these tax expenditures are very broad rather than targeted, sacrificing large amounts of revenue to attain rather limited goals.

An efficient tax expenditure would accomplish a significant increase in private sector economic activity in exchange for a relatively modest loss of tax revenue. For example, if the General Assembly wanted to use the tax system to encourage more planting of trees, it would be most effective or efficient to give a tax break for purchases of trees, not for all plant materials or all gardening supplies. In 2005, the General Assembly considered a blanket reduction in income tax rates, but instead chose to target relief to unincorporated business by giving them the same 5-percent flat rate as corporations. This narrower targeting resulted in a much smaller loss of revenue. In general, there is little advance matching in South Carolina of the size of the tax expenditure to the desired amount of the outcome or action, and little after the fact review of such tax expenditures in order to evaluate whether they are successful in achieving the desired objective and at what cost.

The benefits from incentives designed to influence household and business decisions must always be weighed in light of any undesired effects the incentives have on equity (changes in the distribution of the tax burden) and adequacy (raising enough funds for public purposes). But efficiency issues in revenue systems are especially important in business taxation.

At present the state's tax-based economic development incentives favor new or expanding businesses over established ones. No similar tax incentive for job retention or diversification in order to continue to earn a return on existing facilities exists, even though older, established firms are also important sources of jobs and income. If the state's economic development objectives include building on existing strengths while trying to develop new complexes or sectors, the tax system needs to be even handed in addressing the needs of both older industries and newer firms.

Of all state taxes, the individual income tax is best suited to creating efficiency-oriented targeted incentives for households and unincorporated businesses, but targeting makes the tax more complex. Some incentives in the state's individual income tax to contribute to charity, save for retirement, and own one's home are carried over from the federal income tax.

CONCLUSION

Adequacy, equity, and efficiency are the most widely used criteria for evaluation of revenue systems and proposed changes in taxes or fees. Sometimes these criteria are supplemented by other factors such as stability, growth potential, or costs of compliance and collection. Some taxes or specific tax provisions will rate high on one criterion and low on another. The sales tax scores high on adequacy because it is a productive and dependable source of state revenue, but it is regressive, so expanding reliance on this tax by raising the rate would make the overall revenue system less equitable. On the other hand, collecting more sales tax revenue by broadening the base—covering more services and eliminating some of the existing exemptions—might increase both adequacy and equity at the same time.

REVENUE AND THE STATE BUDGET

South Carolina's total state general revenue in fiscal year 2004 was \$14.4 billion, of which just over \$5 billion flowed through the General Fund for the General Assembly to appropriate. The remainder was unavailable for appropriations, either because it was reserved for specific projects (federal aid and other grants) or was earmarked for special, off-budget funds. Unlike some other states, the General Assembly does not pass a regular capital budget, although particular capital projects are identified in bond bills and supplemental appropriations bills.

Over the years, more and more general revenue has been moved off budget, such as the half billion dollars that goes directly into the Trust Fund for Property Tax Relief. Earmarking of general revenue to off-budget funds limits the General Assembly's flexibility to provide revenue for essential state programs during economic downturns. In addition, when revenue is earmarked it also is no longer part of the General Fund base that determines how much money goes to the Local Government Fund for distribution to cities and counties or to replenish the General Reserve Fund and the Capital Reserve Fund.

The General Assembly has made a common practice of annualization or appropriation of nonrecurring revenue to fund recurring operating expenditures. These one-time funds come yearly from the Capital Reserve Fund (if it is not needed to cover a revenue shortfall) and in many years from surplus revenue. State law restricts the use of Capital Reserve Fund appropriations to capital facilities and other nonrecurring programs; different restrictions are placed on appropriations of surplus revenue for fiscal years 2004-05 through 2008-09. High dollar levels of annualizations in the later 1990s placed added strain on the General Fund when state revenue growth slowed and actually fell during and after the 2000 recession. The General Assembly has made efforts to reduce annualizations, but they remain a concern.

Forecasts of General Fund revenue made by the South Carolina Board of Economic Advisors are intentionally conservative. The upside of this policy is greater fiscal stability, because agencies are less likely to face midyear budget cuts. The downside is more surplus revenue for supplementary appropriations in good times and more pressure to spend those funds for annually recurring purposes.

The majority of the state's borrowing has been for construction and renovation of capital facilities. Issuing bonds allows the state government to build facilities now and spread the repayment over the many years they will be in service. The state constitution controls borrowing by limiting the amount that can be spent on debt service (interest and principal payments) to 5.5 percent of General Fund revenues collected in the previous year.³ The debt limit is a reflection of the state's conservative policy and a critical element in maintaining the state's credit rating, because a higher credit rating means lower interest costs and therefore more debt that can be supported.

CONCLUSION

Meeting the state's needs for public infrastructure and services calls for not only adequate revenue but also budgetary practices that ensure that funding for basic operations will be both stable and flexible. Some of the state's budgetary practices, such as earmarking general revenue for off-budget funds and allocating nonrecurring revenue for recurring needs, con-

³ Tax and bond anticipation notes are excluded from this limitation because they are short-term borrowing that does not obligate the state for more than one year.

tribute to both instability and inflexibility. The existing debt service limitation, if combined with an explicit capital budget, could ensure more careful and conscious attention to the state's facilities needs over a longer time horizon.

HISTORICAL DEVELOPMENT OF SOUTH CAROLINA'S REVENUE SYSTEM

The development of South Carolina's state and local revenue structure has followed an evolutionary path of fits and starts over the past 200 years. The history of the revenue system includes both well-considered and ad hoc responses to structural changes and emerging revenue needs. Some of the most successful changes emerged from a series of commissions and studies at critical junctures in the state's history.

The four most significant changes made in the South Carolina state and local revenue system in the twentieth century were the individual income tax, adopted in 1921; the retail sales tax, adopted in the 1950s; administrative reform of the property tax assessment system and creation of the classified assessment system in the 1970s; and the expansion of local revenue sources between the mid-1970s and the mid-1990s. The individual income tax was adopted so that the state could relinquish the property tax exclusively to local governments. The retail sales tax funded improvements in public education.

Administrative reform of the property tax assessment system dealt with inequities tolerated in the tax system for more than half a century. The classified property tax system, determining a distribution of the property tax burden according to classes of property, has been a source of continual controversy in the succeeding 30 years as various groups sought relief at the expense of the others.

The one-man, one-vote decisions that ended the county delegation system in South Carolina in the 1970s forced the General Assembly to cede more home rule to counties, and with home rule came demands for more diversified revenue sources. After a Clemson study of alternate local revenue sources in the 1970s, the General Assembly authorized a statewide accommodations tax in 1984 and a local option sales tax in 1990, followed by local hospitality and accommodations taxes.

South Carolina has paralleled national trends in state and local finance with a revenue structure that relies primarily on individual income taxes and retail sales taxes at the state level and property taxes at the local level. But that simple revenue structure has been under attack from multiple directions in the last thirty years, including local governments seeking a more diversified revenue base, property tax protestors demanding relief, increased revenue instability, and pressure for tax incentives to accelerate economic development.

The General Assembly has responded to these demands with more local tax choices, multiple tax incentives for new and expanding firms, income tax relief primarily for the elderly,

expanded sales tax exemptions, and property tax relief. Business location incentives and property tax relief for homeowners and cars both have significantly altered the distribution of the property tax burden as approved by the voters in 1976. Unlike changes in earlier periods, when commissions and studies laid the groundwork for major changes in the revenue system, most changes in the last three decades have been reactive rather than proactive and piecemeal rather than systemic.

In order for commissions and study groups to evaluate the revenue system, their members and staffs need access to accurate data in a timely manner. State data is generally available, although scattered among several agencies and not always conveniently accessible to the general public. Access to local government data is more problematic. Many smaller local governments are not trained and staffed to provide the raw data in a timely manner, and the responsibility for the collection and publication of descriptive data about state and local revenue in South Carolina is scattered among a number of agencies. As a result, local government tax and spending data are only available long after the end of the fiscal year, sometimes by several years.

CONCLUSION

Historically, significant and lasting improvements in the revenue system have come in response to fiscal crises. But some of the most lasting improvements to the revenue system were based on the recommendations of external agencies that were created by the General Assembly. Such outside agencies can take an independent, research-based approach to evaluation of the revenue system. Many of these earlier groups engaged South Carolina's major interest groups (consumers, business groups, public agencies, nonprofit groups) in the process and drew technical expertise from the state's universities to conduct independent reviews of the state and local revenue structure, review proposed changes, and develop recommendations. Evaluating the performance of the revenue system needs to be based on clear and reasonably recent data, which is often not available in a consistent format and in a timely manner.

CHANGES IN THE ECONOMY AFFECT STATE AND LOCAL REVENUES

In the past, changes in the state and national economy have forced South Carolina and other states to change the way they raise revenue. Some of the ongoing changes in the present period that influence the ability to raise revenue include:

- a shift from manufactured goods to services in both production and consumption
- increased national and global competition
- increased mobility of firms, workers, and residents
- changes in the composition of personal income
- a change in the age distribution of the population

The whole country, not just South Carolina, has experienced a dramatic economic shift in both consumption and employment away from tangible goods and towards services. As a result, the sales tax base represents a declining share of gross state product (GSP—the measure of total production in the state). A sales tax primarily on tangible goods will not provide a stream of revenue that grows as fast as personal income⁴ unless the tax rate is increased. In South Carolina, general sales tax revenue appears to be fairly stable in relation to income, but much of that apparent revenue stability is actually due to a one-cent tax rate increase in the 1980s and the addition of local option sales taxes beginning in the early 1990s.

However, if the one-cent increase in the sales tax in 1984 and the local sales taxes are excluded from the analysis, the state sales tax was 2.25 percent of personal income in 1981 but fell to 2 percent of personal income during fiscal 2000. By fiscal year 2004, the 4 percent sales tax had fallen to just 1.96 percent of state personal income. Under these circumstances, the decline in sales taxes relative to economic growth is more immediately noticeable. This portion of the sales tax revenue supports the General Fund.

Another important economic shift that influences revenue is the increased mobility of firms and workers. Regions, states, counties, and cities offer portfolios of characteristics that are evaluated by firms, workers, and residents when they make location decisions. Increasingly, state and local governments are competing not only with each other, but with foreign locations. Workers and firms, in turn, find themselves competing in a global market that creates much greater pressure for efficiency and productivity. As firms and workers move around in a global market, taxes and fees as well as the quality of public infrastructure and public services are among the characteristics that they consider in deciding when and where to move. State and local governments find themselves in an increasingly competitive situation in attracting and retaining commercial, industrial, and residential occupants.

Because state personal income is such a broad measure of state economic activity, it is often used as a proxy for the state's tax base. Nationally and in South Carolina, the composition of personal income has changed dramatically over recent decades. Today a smaller share of personal income is direct wages and salaries, while dividends and interest payments, transfer receipts (such as Social Security benefits and pensions), and employer-provided benefits (primarily health insurance) account for a growing share. This shift particularly affects the individual income tax, because many of these growing forms of income are excluded from the income tax base or given favorable tax treatment. So it is, also, likely revenue from the individual income tax will be growing more slowly in the future.

⁴ Personal income is income received by households, which includes not only wages and salaries (but not fringe benefits), but also interest and dividends, pensions and Social Security benefits and other transfer payments.

The composition of workers' earnings has also changed. Take home pay is a smaller share of total compensation because of the rising cost of fringe benefits. If workers take home a smaller share of their earnings, it will shrink the base of both the income tax and the sales tax. Statistically, growth in individual income tax revenue is strongly linked to growth in wage and salary income, but not to changes in other components of personal income. Retail sales tax revenue is also statistically tied more closely to income from wages and salaries than other components of personal income.

The impact of an aging population on state and local government revenue and budgets is harder to predict. An aging population can place a strain on government budgets, reducing revenue while increasing service demands. In South Carolina, the aging population tends toward the two extremes: poor, mostly native-born residents and a relatively affluent group of mostly in-migrants. The low-income elderly are concentrated in rural areas and older cities, while the wealthy retirees gravitate toward the mountains and the coast.

An aging population living on pensions, interest, dividends, and Social Security contributes less than working age residents to the income tax base. An aging population will also probably spend a larger share of income on health care and other untaxed services, reducing growth of sales tax revenue. In addition, South Carolina provides partial pension exclusion and full exemption of Social Security income on the income tax, and a \$50,000 homestead exemption from property taxes for homeowners over age 65. As the population ages, a larger share of the population will qualify for these tax breaks.

CONCLUSION

Economic trends and demographic trends, taken together, will tend to slow the growth of state tax revenue. The share of Gross State Product covered by the sales tax and the share of personal income in the individual income tax base will continue to decline as tangible goods become a smaller share of output and wages and salaries furnish a diminishing share of personal income. In a highly competitive environment with mobile workers and firms, states need to fine-tune their tax structures to capture enough revenue from the growing but shifting flow of income and output while remaining competitive in the market for business and residential location.

As the population ages, more income will fall into tax-favored categories such as interest, dividends, pensions, and Social Security. In addition, less disposable income will be spent on tangible goods subject to sales tax and more will be spent on non-taxed services. Even without some of the special tax advantages granted to senior citizens, this demographic shift would result in slower growth of income and sales tax revenue. Thus, the structure of age-related tax relief particularly needs to be reviewed for its effects on the equity, efficiency and adequacy of the revenue system as a whole.

COMPARATIVE MEASURES OF TAX ADEQUACY, TAX BURDEN AND TAX EFFORT

A revenue system is considered efficient if it encourages desirable activities, such as work effort and business expansion, and discourages undesirable ones, such as consumption of alcohol or water pollution. Adequacy and equity, however, are more subjective. How much revenue is enough? How much of the responsibility for paying for public services should fall on the rich rather than the poor, the old rather than the young, and business firms rather than households?

Policymakers look to their peers for benchmarks of adequacy and equity, comparing their states to others on the basis of how much revenue the state collects relative to population, to income, or to potentially taxable economic activity. These figures offer various measures of tax adequacy, tax burden, and tax effort. *Tax adequacy* is a subjective measure because populations in different states have a variety of public service needs and wants. States also face different challenges, such as colder than average climates, high incidence of poverty, or greater distances between population centers. *Tax burden* attempts to measure sacrifice—how much private consumption citizens must forego in order to pay for public goods and services. *Tax effort* measures how hard a state tries to raise revenue relative to its potential taxable resources of production, income, consumption, and wealth.

Comparing tax adequacy, tax burden, or tax effort tax-by-tax is misleading. States raise revenue from a variety of tax structures and tax rates. A state may have a high relative burden on the property tax but a low burden on the sales or individual income tax. These comparative measures should incorporate all the related elements of the revenue system—all taxes or all revenue from own sources.

Tax (or own source revenue) per capita is the most widely used measure to compare states on the basis of adequacy. It measures adequacy because demand for public services is closely tied to population. However, it is not necessarily a good measure of how burdensome taxes are, because low per capita taxes or revenues may be simply a result of low per capita income.

South Carolina's combined state and local tax collections were well below the national average in fiscal year 2002. Overall, the state ranked 47 in the nation with \$2,375 in taxes per capita compared to the U.S. average of \$3,143. Even in total revenue collected from own-sources, the state ranked only 44 in the nation with \$3,874 per capita in revenue collections compared to \$4,599 nationwide.

South Carolina has a low tax burden for combined state and local revenue from taxes. The state ranked near or within the bottom fifth of states in the three measures of tax burden examined in this report: tax revenue as a share of state personal income (42), as a share of

GSP (37), and as a share of total taxable resources (40). The state ranked particularly low in the tax burden for selective sales taxes and the corporate income tax.

South Carolina has a moderate tax burden for combined state and local revenue from own sources. Both state and local governments in South Carolina rely heavily on fees and services charges for revenue, which raised the state's rank in tax burden for own-source revenue to close to that of the median state: own-source revenue as a share of state personal income (24), as a share of GSP (29), and as a share of total taxable resources (26). South Carolina's rank in non-tax revenue (fees, charges, misc.) from own sources alone was 13 in the U.S. in fiscal year 2002.

South Carolina is relatively low in tax effort for state and local revenue combined. The state ranked 38 in the Representative Tax System's (RTS) tax effort measure in both fiscal years 1994 and 1997. The RTS index takes into account 21 individual state and local taxes in order to come up with a single measure of tax effort. By this measure, over two-thirds of the states worked harder to raise revenue from their state and local tax bases than South Carolina during the mid-1990s.

CONCLUSION

Per capita taxes (or revenues) offer a useful comparative measure of adequacy, and taxes (or revenues) as a percent of personal income, GSP, or total taxable resources provide a benchmark against other states for tax burden. By any measure, the overall burden from combined state and local taxes in South Carolina is low compared to other states. Because the state and local governments rely relatively heavily on non-tax (rather than tax) revenue, South Carolina's overall revenue burden is moderate.

FEES AND CHARGES

Interstate comparisons highlight the important role of fees and charges in funding public services in South Carolina compared to other states. While South Carolina taxes are low by all comparative measures, the state is well above the regional and national average in fees and charges as a share of state (and local) revenue. However, relatively little of the revenue from fees and charges finds its way into the state's General Fund.

Fees and charges supplied about 3 percent of General Fund revenue in fiscal year 2004. Other fees and charges were collected by quasi-business activities, such as hospitals, ports, parks, solid waste management operations, and educational institutions. In many cases, fees were raised to replace reductions in state funding during the difficult budget years 2000 to 2004. Fees and charges are a much larger share of general fund revenue for counties and municipalities. At the state level, most revenue from fees and charges is not available to fund general public services.

Fees and charges get a low score on equity but a high score on efficiency, and a neutral score on adequacy. When fees and charges are included in comparisons, the South Carolina revenue system is more regressive than when only taxes are compared. Fees and charges for a particular service are the same regardless of income, so they take a larger share of income from lower-income households. Also, lower income households tend to rely more heavily on public services. Fees and charges do get good marks for efficiency because they are based on the user-pays principle that assigns at least part of the cost of public services to those who demand them. Users of public recreation, parking, parks, libraries and other services benefit more than non-users and should bear more of the cost.

CONCLUSION

Fees and charges play an important role in funding certain kinds of public services in South Carolina where it is possible to distinguish users from non-users. It is important to include them as part of the revenue system in any overall evaluation of adequacy to which they make a positive contribution, equity where they make the revenue system more regressive, and efficiency which is enhanced by a system where the user pays. However, most fees and charges in South Carolina do not provide general revenue with which to fund basic state services such as education, corrections, and public safety.

STATE TAX REVENUE

The *individual income tax* is a significant source of revenue and revenue growth for South Carolina. In recent years it has supplied close to 40 percent of the revenue in the General Fund. The individual income tax is moderately progressive overall and fairly easy to comply with because of its relationship to federal taxable income. Thus, it rates high on adequacy and equity.

The linkage to the federal income tax is, however, a source of uncertainty to the state. Each year the South Carolina legislature must decide whether to conform the state's individual income tax to changes in the federal income tax code. Each year that means weighing the revenue effects (usually a loss) of conforming to the federal code against the increased effort for taxpayers to file when the state does not adapt to federal changes.

South Carolina carries over most tax expenditures from the federal code and adds several of its own including business job tax credits, the two-earner credit, the child care credit, and the tuition tax credit. The state's individual income tax is designed particularly to favor, attract, and retain retirees, a policy that has been influenced by the absence of any broad-based income tax in two southeastern states, Florida and Tennessee. South Carolina's

treatment of the elderly relative to the non-elderly is the most generous in the nation, with an 80 percent differential in the average effective income tax.⁵

South Carolina collects a variety of *business income taxes*, of which the largest is the corporate income tax. Others include bank taxes, franchise fees, etc. These taxes contributed \$337 million to the South Carolina General Fund in fiscal year 2004 with just over half from the corporate income tax. Revenue from business income taxes is low, only 6.6 percent of General Fund revenue in fiscal year 2004, and extremely volatile. The modest and declining revenue from the corporate income tax results from low rates, an apportionment formula that favors sales, and the availability of numerous credits against the tax as business incentives to locate and to expand in the state. Recent and proposed changes in federal taxation of corporate income involving qualified production activities deductions and a more stringent definition of nexus would lead to further erosion of corporate income tax revenue.

South Carolina is one of 45 states with a *general retail sales tax*, which brought the state \$1.9 billion in revenue in fiscal year 2004. Twenty-nine counties collect local sales taxes at a one percent rate, as well as a limited number of special-purpose, time-limited local sales taxes for capital projects. A 5 percent tax rate on the state retail sales tax and maximum combined state and local tax rate of 7 percent is low by regional and national standards. Unlike the majority of states, South Carolina does not exempt food.

The sales tax gets reasonably good ratings for adequacy but raises some problems with equity and efficiency. In terms of adequacy, revenue growth from the general sales tax is constrained by limited coverage of services as well as numerous and growing exemptions and the cap on sales tax on automobiles, boats and airplanes. As far as equity is concerned, the tax is regressive. The sales tax burden among households in South Carolina ranges from 3.7 percent of income for the lowest income group to 0.6 percent of income for the highest income group.

The sales tax rate is an important efficiency issue, because rate differentials encourage cross-border shopping and internet and catalog purchases. If the rate is raised, the incentive to shop elsewhere will be increased. There is a concerted national effort to create a uniform state sales tax base in order to persuade Congress to lift the ban on vendor collection of sales taxes on internet and catalog sales. That change would increase adequacy as well as efficiency, because it would discourage shopping on the internet for tax reasons and thus reduce the disadvantage presently faced by in-state retailers who have to collect the tax. Eighteen states have made these changes in their sales tax base, but South Carolina has not.

⁵ Barbara Edwards and Sally Wallace, *How Much Preference: Effective Personal Income Tax Rates for the Elderly*, FRP Report 70 (Atlanta, Ga.: Andrew Young School of Policy Studies, Georgia State University, 2002). <http://frp.aysps.gsu.edu/frp/frpreports/Report70/wallacetext.pdf>

Selective sales (excise) taxes are a modest source of revenue in South Carolina. Including the South Carolina Education Lottery,⁶ these taxes raised over \$1 billion in revenue for the state in fiscal year 2004. Revenue from some of these excise taxes is earmarked for special funds. Selective sales taxes have provided a useful efficiency tool for assigning costs to those who use particular services (gasoline taxes for highways, tourism-related taxes) or for discouraging consumption of goods and services considered undesirable (alcohol, tobacco). However, selective sales taxes contribute to the regressivity of the tax system.

Selective sales taxes in South Carolina are seldom adjusted for inflation, so that revenue in relationship to personal income and revenue as a share of state revenue have declined over time. Revenue from selective sales taxes is not responsive to growth in personal income. Many of the rates, particularly on cigarettes and gasoline, have gone unchanged for very long periods. Rates on gasoline, distilled spirits, and tobacco are well below regional and national averages, while rates on wine and beer are among the highest in the region and the nation.

South Carolina is one of 38 states that employed a pick-up **estate tax**; that is, a state estate tax equal to the maximum state death tax credit allowed under federal law since 1926. Changes in the federal estate tax law have eliminated that option and reduced state revenue by an estimated \$48 million a year. Some states have chosen to enact a replacement estate or inheritance tax similar to the amount collected under the federal credit.

CONCLUSION

The basic structure of South Carolina taxes is fairly typical of most states—a broad-based income tax, a broad-based retail sales tax, a more modest group of taxes on business income and another group of selective sales taxes, combined with heavy reliance on property taxes at the local level. South Carolina differs from other states in favoring of retirees in the income tax, a great variety of exemptions in the sales tax, and more limited use of the corporate income tax. South Carolina has also been slow to respond to some national trends in state taxation such as expanded sales tax coverage of services, adjusting for changes in the federal estate tax, and exempting food from the sales tax.

There are opportunities in the current tax structure to raise more revenue without raising tax rates by such simple mechanisms as indexing excise taxes for inflation, revising the current \$300 sales tax cap on cars, reducing other sales tax exemptions, providing a pickup estate tax, or broadening the sales tax base. Many of these changes have the potential to increase revenue adequacy while also distributing the tax burden more equitably.

⁶ Because the tax is a fixed share of the price of a lottery ticket and goes to the government, economists consider the state revenue from lottery sales to be equivalent to an excise tax.

THE PROPERTY TAX

The property tax raises over \$3 billion a year in South Carolina. It remains the primary local government revenue source, especially for school districts. It has been a dependable revenue source, with fairly good marks for adequacy. The state sets assessment rates, oversees local assessment, assesses some property, and creates (and sometimes funds) various kinds of property tax relief. South Carolina is one of seventeen states with a classified assessment system with different assessment ratios for different classes of property. South Carolina's system favors homeowners and agricultural property. South Carolina also gives targeted relief to homeowners, homeowners over 65 years of age, owners of farm and forest property, and firms that are being recruited for relocation or expansion. The state does not provide any property tax relief based on need or income.

Property tax relief was extended to owners of personal vehicles by reducing the assessment rate over a six-year period from 10.5 percent to 6 percent. Personal vehicles made up about 20 percent of the property tax base in 2000, so the lower assessment rates was equivalent to an 8.3 percent reduction in the property tax base. Other expansions of property tax relief in the last decade included an increased homestead exemption for seniors who are homeowners and authorized counties to impose a cap on the increase in property value during reassessment. The combination of differential assessment and targeted property tax relief not related to income results in poor marks for equity. Among other states, 75 percent of those states that provide state-funded property tax relief base that relief on need or income.

The state has also tried to reduce the pressure on the property tax by providing other revenue options for cities and counties, including a statewide accommodations tax, a local option accommodations tax, a local option (one percent) sales tax and some special purpose local sales taxes, and a local hospitality tax on restaurant meals. In fiscal year 2002, South Carolina ranked 27 in property taxes as a percent of personal income and 36 in per capita property taxes among the 50 states and the District of Columbia.

Property tax revenue growth comes from new construction, increases in the value of existing property, and changes in the property tax rate. In the 1990s, the average property tax rate grew more slowly than revenue, so increases in the tax base were the major source of revenue growth. The fastest-growing components of the property tax base were owner-occupied housing and personal vehicles, which led to successful demands for relief from both groups, shifting the tax burden to other classes of property.

Property taxes, together with the quality of local services (especially education) affect location decisions for households and business firms. Firms also consider such factors as infrastructure, educational quality, labor force quality, and access to transportation and markets. Fee-in-lieu-of tax agreements contain no provision for repayment of tax breaks if a

firm fails to fulfill its commitments in terms of capital investment, job creation, or wage levels. The appropriate level of incentives and the recovery of tax abatements if firms do not fulfill commitments are important efficiency issues.

CONCLUSION

The property tax is under great pressure for reform or relief of some kind, primarily on grounds of equity. While the average or per capita property tax burden is not high, the distribution of the burden has altered dramatically because of rapid growth in residential property values in many areas and the shift of the tax burden away from personal vehicles because of the change in the assessment rate. There has been state-funded relief to homeowners over sixty-five years of age and relief in 29 counties through the local option sales tax. However, there is still pressure to provide additional relief, particularly for homeowners and particularly for school taxes as part of the larger debate on how and at what level to fund K-12 education.

STATE AID TO LOCAL GOVERNMENTS

Direct state aid to cities and counties helps to equalize resources between richer and poorer localities, even if it is redistributed on a simple per capita basis. A per capita distribution helps to ensure that citizens can count on some basic level of local public services wherever they live in the state. In fiscal year 2002, South Carolina's per capita state aid of \$911 to local governments—cities, counties, school districts, and special districts combined—was well below the national average of \$1,235.

In South Carolina, the major forms of state aid to cities and counties are state-shared revenues including the Local Government Fund, state grants, and state reimbursements for property tax relief. Counties receive close to 80 percent of combined aid to counties and municipalities. The Local Government Fund, the largest single source of state aid to cities and counties, annually distributes an amount equivalent to 4.5 percent of the state's previously completed fiscal year's General Fund revenues. The General Assembly has moved certain monies off budget, primarily the Trust Fund for Tax Relief, which is expected to disburse approximately \$505 million in fiscal year 2005. This action has shrunk the revenue base on which the Local Government Fund is computed, resulting in less state aid to cities and counties in recent years.

Public education funding is the largest single category of state and local spending in South Carolina and an important driver of revenue needs. Spending on all levels of education accounted for nearly 30 percent of all state and local general spending in South Carolina in fiscal year 2002. State aid in fiscal year 2002 provided 39.4 percent of total revenue to school districts—34 percent if property tax relief is not counted in the total. State funds for K-12 education alone accounted for about 37 percent of expenditures from the Gen-

eral Fund in fiscal year 2004. General fund expenditures on higher education were another 15 percent.

School districts rely primarily on the property tax at the local level and do not have access to alternative local revenue sources and, in many cases, do not have much leeway in raising property tax rates in order to cover revenue needs. School property taxes are about 60 percent of all local property taxes. School districts are heavily dependent on state aid, which has been cut in recent years. The state's funding efforts for education have been challenged in a long-running court case as neither adequate nor equitable. The fiscal year 2006 budget has restored the Education Finance Act (EFA) funding to the full amount required by the formula.

The primary vehicles for state aid to education are the EFA and the Education Improvement Act (EIA). The EFA formula, which is the primary tool for equalization among school districts, distributes funds (per weighted pupil units) to cover the base student cost of a defined minimum program with an average of 70 percent coming from the state and 30 percent from local effort—mostly property taxes. Districts receive more or less than 70 percent of the EFA-required base student cost depending on their index of taxpaying ability, which in turn is based on each district's ability to raise revenue using the property tax.

However, a growing gap between actual cost per student and the base student cost used in the EFA formula is developing. The base student cost was set in 1977 to cover the minimum operating cost per student. Since that time, cost per student has risen as a result of higher demands and expectations of schools, teachers, and students, and changes in the technology of education (especially computers). But the base student cost used in the EFA formula has at most been adjusted for inflation. For example, in fiscal year 2003, the base student cost in the EFA formula represented only 27.3 percent of actual operating expenditures per pupil.

EIA funds, which come from a dedicated one cent of the state's five-cent general retail sales tax, are distributed on a per pupil basis and are earmarked for particular programs and services that may change over time. Reimbursement for state-funded property tax relief for homeowners, seniors, and businesses accounted for another \$339 million in state transfers to school districts in fiscal year 2004.

CONCLUSION

In the difficult budget years from fiscal year 2001 to fiscal year 2004, state aid to cities, counties and school districts was impacted by declining or slowly growing state revenue. State aid to cities and counties also declined because of the shift of some state revenues to earmarked, off-budget funds. EIA aid to schools is vulnerable to instability because it depends on the performance of the sales tax. Because the state failed to fully fund the EFA

formula for several years before getting back on track, the burden of fully funding education has been shifting back to the local property tax, which has created further pressure for property tax relief.

High quality, adequately funded local public infrastructure and public services are an important aspect of an environment that is competitive with other states and that permits citizens and productivity to flourish, create wealth, and generate more public revenues to fund that public infrastructure and public services. State and local governments are partners in providing that public infrastructure and public services to the state's citizens. Citizens, business enterprises, local governments, and state governments are all part of an integrated and interdependent system of public and private economic activity, not competing with but complementing each other in order to create prosperity and quality of life for all the state's citizens. A smooth-functioning, stable, adequate, efficient, equitable revenue system is an important underpinning of that shared enterprise.