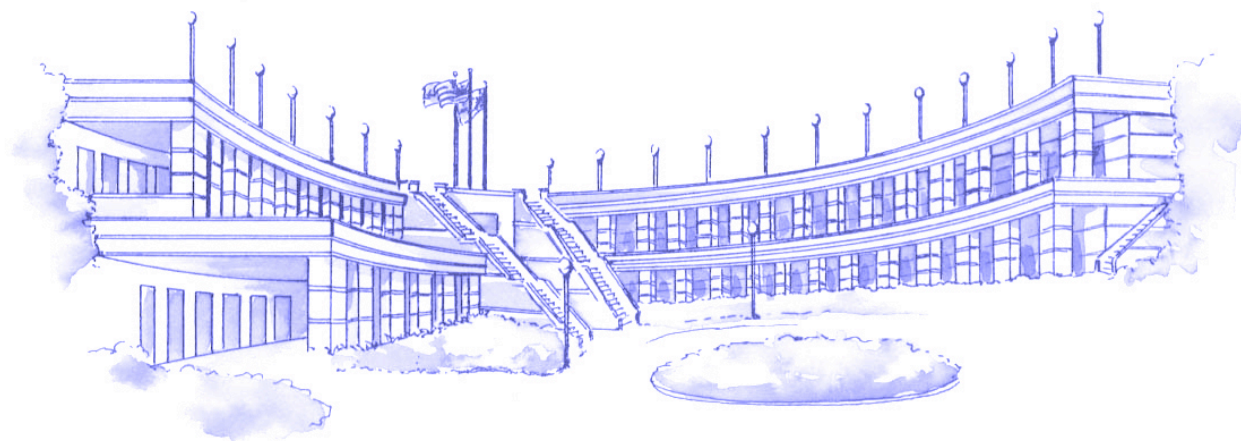


SOUTH CAROLINA'S STATE REVENUE SOURCES

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By

Holley H. Ulbrich
Ellen W. Saltzman

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Research Project

Evaluation of the South Carolina Revenue System

Project Report

Ensuring a Competitive Revenue System for South Carolina

Holley H. Ulbrich

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Holley H. Ulbrich and Ellen W. Saltzman

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Holley H. Ulbrich

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ABOUT THE AUTHORS

Holley H. Ulbrich, Ph.D., Alumni Professor of Economics Emerita at Clemson University, is a senior fellow of the Strom Thurmond Institute at Clemson University and the Center for Governance at the University of South Carolina. Ulbrich, the author of six books and well known as a consultant on taxation to government agencies and the General Assembly, has a national reputation. Since the seventies, she has developed recommendations and participated in studies of South Carolina's state and local revenue system that have shaped today's system. In 1997 and 1998 with other colleagues, she completed widely discussed fiscal sustainability research reports that analyzed projected state revenues and expenditures for South Carolina through 2010.

Ellen W. Saltzman, M.A., Economics, is a research associate with the Jim Self Center on the Future at Clemson University's Strom Thurmond Institute of Government and Public Affairs. Since 1994 Saltzman has conducted research with various colleagues in the areas of state fiscal sustainability, municipal and county government finances, education funding and performance, and transportation finance.

FINDINGS

SOURCES OF STATE REVENUE

- Although the state has many revenue sources, the main revenue for the South Carolina General Fund comes from just two sources, the individual income tax and the general sales tax.
- Thirty-seven of the fifty states and the District of Columbia share this general pattern of relying primarily on the individual income tax and the general retail sales tax to fund state government.
- In South Carolina, the individual income and retail sales tax together accounted for 83.4 percent of General Fund revenue in fiscal year 2005.
- Other state revenue sources include the corporate income tax; various excise (selective sales) taxes such as those on gasoline, tobacco and alcohol; fees and charges; and the state lottery. Some of these sources are earmarked for particular uses and are not part of the General Fund.

THE INDIVIDUAL INCOME TAX

- South Carolina's individual income tax is a significant source of revenue and revenue growth, generating an estimated \$2.7 billion in revenue in the 2005 fiscal year.
- Income tax revenue is vulnerable to downturns in the economy. From a 2001 high of \$2.5 billion, revenue dropped \$150 million in 2002 and another \$16 million in the next fiscal year before surpassing earlier levels in 2005.
- The state's individual income tax applies both to households and to income from unincorporated business. The rate structure is moderately progressive overall, except for income from unincorporated business, which will be taxed at a flat 5 percent rate after 2008.
- According to a 2003 study by the Board of Economic Advisors, income tax burdens in South Carolina are lower than a broad sample of other states up to a taxable income of \$40,000, but at higher incomes the tax burdens exceed those of some neighboring states.

- In 2002, effective individual income tax rates ranged from 0.2 percent of gross income for those earning less than \$13,000 to 5.1 percent of gross income at levels in excess of \$232,000.
- The close relationship between state and federal taxable income makes the state's income tax easy for taxpayers to comply with, but creates uncertainty in future revenue because of frequent changes in the federal code.
- There are a number of differences between the federal and state income tax, including treatment of pension benefits of various kinds, a tax credit on a second earned income for married couples, additional tax relief for families with children under age six, and the job development tax credit.
- The state's income tax is designed particularly to favor/attract/retain retirees, a policy that has been influenced by the absence of any broad-based income tax in two neighboring southern states, Florida and Tennessee. Among states with income taxes, South Carolina's treatment of the elderly relative to younger households is the most favorable in the nation.
- Income taxes have a variety of incentive effects on decisions by households and unincorporated businesses, including choice of location among states, work effort, home ownership, charitable contributions, retirement saving, and employer provision of health insurance.
- Major tax expenditures in the income tax, in addition to those that carry over from the federal code, include job development and retraining incentives, the two-earner credit, the child care credit, and the tuition tax credit.

TAXES ON BUSINESS INCOME

- South Carolina collects a variety of business income taxes, of which the largest is the corporation income tax. These taxes contributed \$399 million to the General Fund in 2005, just over half of it (\$215 million) from the corporate income tax.
- Banks, savings and loans and insurance companies are exempt from the corporation income tax, but banks pay 4.5 percent and savings and loans 6 percent on their net income, while insurance companies pay a 6 percent tax on premiums.
- Business income taxes are justified as a benefit tax, because business firms use public services and should contribute to their cost. However, critics of the corporate income tax argue that it constitutes a double tax on shareholders, be-

cause business income is taxed once when at the corporate level and again as personal income in the form of dividends (or capital gains when shares are sold).

- Revenue from the corporation income tax is low (only 3.6 percent of General Fund revenue in 2005) and extremely volatile. The 5 percent rate is lower than most other southeastern states. The modest and declining revenue is a result not only of the low rate but also 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.

THE RETAIL SALES TAX

- The general retail sales tax is the other workhorse of state revenues, generating \$2.9 billion in state revenue in 2005. Eighty percent (\$2.3 billion) goes into the General Fund and the other 20 percent (the “penny” increase from 1985) goes into the Education Improvement Act fund.
- Revenue from retail sales tax rises and falls with changes in state personal income but is not as volatile as income tax revenue.
- Revenue from the sales tax is constrained by a number of factors: a large number of exemptions, several tax caps (including cars), and limited coverage of services compared to some other states. Failure to collect sales tax on Internet and catalog sales and the annual sales tax holiday in August also reduces revenue from this source.
- South Carolina has a large number of sales tax exemptions as well as caps on the tax on cars, airplanes, boats and trailers. The state also exempts most services, so the base of the retail sales tax is a smaller percentage of state GSP or personal income than in some other states.
- A narrow tax base requires a higher rate to generate the same amount of revenue as could be raised with a lower rate and a broader base. A sales tax with a broad base and a low rate is more efficient (less likely to distort location and shopping decisions) and more equitable (less regressive) than one with a narrower base and a higher rate.
- South Carolina’s 5 percent state sales tax rate and maximum combined state and local rate of 7 percent is low by regional and national standards. Rates can be an important consideration in border shopping, tourism and Internet/catalog sales. Border shopping does not appear to be an issue in South Carolina because rates are similar to those in neighboring states. However, higher rates could result in some loss of the base of taxable retail sales.

- The distribution of the sales tax burden among households in South Carolina is regressive, ranging from 3.7 percent of income for the lowest income households to 0.6 percent of income for the highest income group, almost identical to national averages. The rate is low, which reduces the sales tax burden on low-income households; however, that effect is offset by the fact that food purchases are taxed in South Carolina, unlike many other states, while most services are exempt.

SELECTIVE SALES (EXCISE) TAXES

- Selective sales taxes are a significant overall source of revenue in South Carolina. Including the lottery, these taxes raised over \$1 billion in 2004. Much of the revenue from these taxes, including the \$292 million from the lottery in 2004, is earmarked for special funds or for local governments, with only about one-third (\$355 million) going into the General Fund.
- Most selective sales taxes are expressed in cents per physical unit—a pack of cigarettes or a gallon of gasoline. Revenues from such taxes are not sensitive to inflation. Selective sales (excise) taxes in South Carolina are seldom adjusted for inflation, so that revenue as a share of state General Fund revenue has declined over time.
- Taxes on admissions and amusements are at a flat percentage rate, similar to the sales tax. These taxes, together with accommodations taxes, local hospitality taxes, and the general sales tax, shift some of the tax burden to tourists and reduce the burden on state residents.
- South Carolina's selective sales tax rates are lower than many other states on gasoline and distilled spirits, higher on wine and much higher on beer. The state's seven cents a pack rate on cigarettes is the lowest in the nation. Many excise tax rates, particularly on cigarettes, have gone unchanged for very long periods.
- Excise taxes are a useful vehicle for assigning costs to those who use particular services (gasoline taxes for roads) or to discourage consumption of goods and services considered undesirable (alcohol, tobacco).
- Excise taxes contribute to the regressivity of the overall state tax system, because purchase of gasoline, tobacco products, alcoholic beverages, and lottery tickets are generally a larger share of income in lower income households.

OTHER STATE REVENUE

- State revenue from the estate tax has dropped sharply because of recent changes in the federal estate tax. The annual revenue loss is estimated at \$40.3

million for 2005. Seventeen states and the District of Columbia have enacted replacement taxes to avoid this revenue loss.

- Other revenue comes from federal aid, over which the state has little control; borrowing, which is constrained by constitutional and statutory limits on the amount that can be paid for debt service; and fees and service charges.
- State general obligation debt was over \$2.5 billion in 2005. The amount of general obligation borrowing is limited to what can be serviced with 5.5 percent of General Fund revenue from the last completed fiscal year. This limit on debt service has meant that the General Assembly has put great emphasis on retaining the state's AAA credit rating. A more favorable rating means lower interest costs and therefore the ability to incur more debt for a given amount of debt service funds.
- Fees and charges in South Carolina are a significant source of state revenue (\$5.0 billion in 2004-05). Only a small portion of this revenue flows through the General Fund. Most goes to programs that the state operates more like businesses, such as higher education institutions, unemployment compensation and other insurance programs, and housing and student loan financing programs.
- While there is value in using fees and charges for some kinds of services as a control on demand and on a user pays principle, fees and charges tend to make the overall revenue system more regressive. They are not always a satisfactory or appropriate substitute for general tax funding, especially for public goods or other kinds of widely shared consumption.

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SOUTH CAROLINA'S STATE REVENUE SOURCES

The state of South Carolina relies on a diverse group of own-source revenue instruments, including individual and corporate income taxes, a retail sales tax, excise taxes, and other taxes, fees, and service charges, to support current services. Federal aid supports specific programs and projects outside the state's General Fund. In addition, bond issues make possible the construction of large capital projects through long-term debt financing.

Revenue from a number of taxes and fees supplies South Carolina's General Fund, from which the General Assembly funds much of the state's discretionary spending as well as debt service on general obligation bonds. Revenue from certain taxes, most notably the motor fuel user fee and the fifth penny of the retail sales tax, is placed in separate funds that are earmarked for spending on specific programs such as transportation and education. Revenue from all sources to South Carolina's various governmental funds totaled \$15.6 billion in fiscal year 2004-05 (Figure 1; South Carolina Office of the Comptroller General 2005).¹

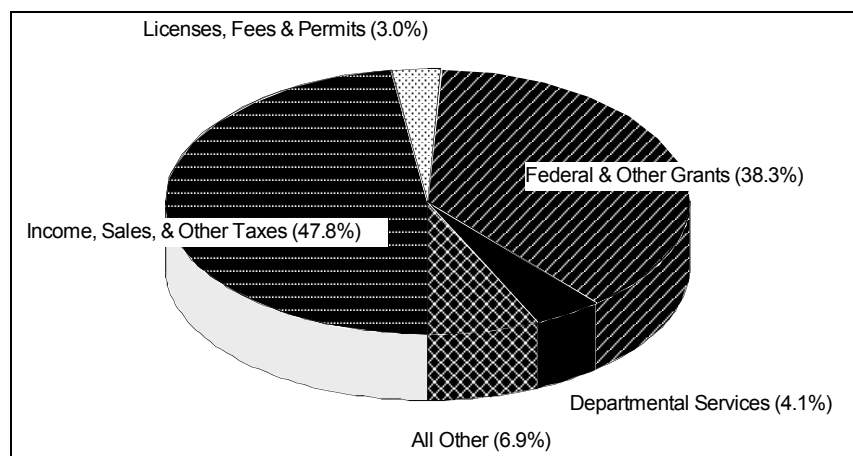


Figure 1. Revenue Sources for South Carolina Governmental Funds, 2004-05

Like 37 other states and the District of Columbia, South Carolina relies heavily on two statewide taxes for revenue from own sources—the individual income tax and the retail sales tax (Figure 2). These taxes accounted for 83.4 percent of revenue to the state's Gen-

¹ All years in this report are fiscal years unless otherwise indicated.

eral Fund in fiscal year 2005.² The individual income tax was adopted in 1927 and the sales tax in 1951. Forty-one states and the District of Columbia have broad-based income taxes and forty-five states and the District of Columbia have retail sales taxes. The majority of states have both, while only New Hampshire has neither. Like forty-nine other states, South Carolina also has a corporate income tax and like thirty-seven states a state lottery, as well as excise taxes on gasoline, tobacco products, alcoholic beverages, and other items.

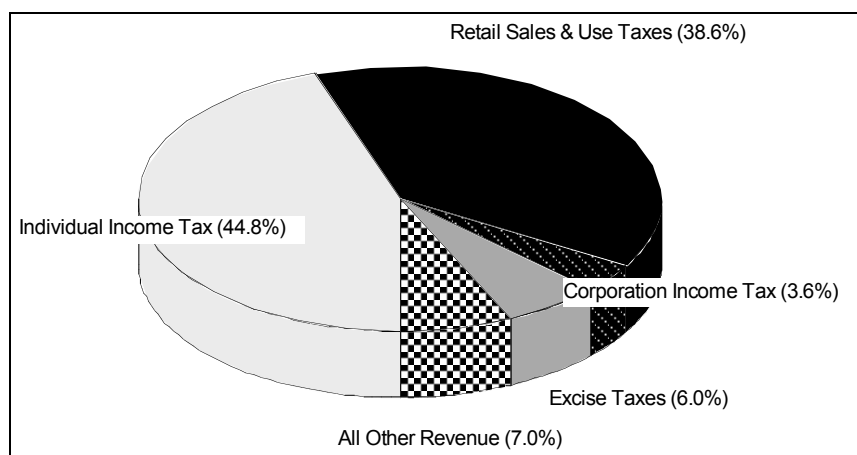


Figure 2. Revenue Sources for South Carolina General Fund, 2004-05

This working paper focuses primarily on state revenue sources for the South Carolina General Fund. It examines the structure of these revenue sources, revenue growth over time, and how incentives to households and businesses affect revenue collections. Financial data are drawn from the following South Carolina state agencies: Department of Revenue; Office of State Budget and Board of Economic Advisors, both part of the Budget and Control Board; Office of the Comptroller General; and Office of the State Treasurer. Comparative state tax rates are from the Federation of Tax Administrators (2006). Unless indicated otherwise, all revenues in this working paper are in nominal (current) dollars.

INDIVIDUAL INCOME TAX

The individual income tax, which covers unincorporated businesses as well as households, has been a productive revenue source for South Carolina. In 2005, the individual income tax generated nearly \$2.7 billion—\$636 per capita and 45 percent of General Fund revenue (BEA 2006). Much of the growth in state revenue has come from the individual income tax, but it is also a volatile source that is vulnerable to economic downturns. The individual income tax showed strong revenue growth in the 1990s, keeping pace with growth of personal income. This growth occurred despite legislation giving more favorable tax treatment to retirees and families with small children and some revenue-losing adjustments to the

² Excludes 1 percent of retail sales tax revenue earmarked for Education Improvement Act funding. Includes individual income tax and corporation income tax revenue later transferred to the Trust Fund for Property Tax Relief (BEA 2006, 32).

state's income tax code that reflect federal income tax changes. But income tax revenue fell from \$2.5 billion in 2001 each of the next two years through 2003, when it provided only \$2.3 billion.

TAX RATE STRUCTURE

South Carolina and thirty-three other states and the District of Columbia use an income tax with a progressive rate in tax year 2006, according to the Federation of Tax Administrators (2006). Six states employ flat rate taxes, one state computes income tax liability as a percentage of the federal tax, and two states limit their income tax to dividends and interest income. Seven states have no individual income tax. South Carolina's individual income tax uses a progressive rate structure from 2.5 percent to 7 percent of taxable income.

Twelve states and the District of Columbia have a higher top bracket rate than South Carolina. In South Carolina, the first \$2,570 of taxable income is taxed at 2.5 percent, while the top bracket begins at \$12,850. Taxable income above \$12,000 is taxed at 7 percent. Beginning in tax year 2006, the tax rate on income from unincorporated business activity in South Carolina will begin to decline. By tax year 2009 it will be taxed at the same flat 5 percent rate as the net income of corporations. This change in the tax law will cost the state an estimated \$13.3 million in revenue in 2006 and \$137 million in revenue in 2007.³

Most state individual income taxes are closely linked to the federal tax code. Only five states require taxpayers to make a completely separate calculation. Twenty-seven states start with federal adjusted gross income and set their own exemptions and deductions, while ten states use federal taxable income as a starting point. This method, adopted by South Carolina in 1985, is the easiest for taxpayers. The state legislature decides each year whether to continue to conform to changes in the federal code, which may increase or decrease state income tax revenue.

DIFFERENCES FROM THE FEDERAL INCOME TAX

When South Carolinians fill out state income tax forms they make some adjustments, most of which reduce tax liability—especially for retirees. Although most Social Security or railroad retirement pension benefits are taxable at the federal level for households with incomes above a certain level, South Carolina and some other states do not tax these benefits, nor does the state tax interest on federal government bonds and National Guard pay.

South Carolina offers a pension exclusion for any retiree receiving a pension (including a more generous pension exclusion for retirees age 65 or older), which cost an estimated \$48.6 billion in lost revenue in 2005. The state also offers an adjustment for each dependent under six years of age at an estimated \$42 million revenue loss. (BEA&ORS 2005). One of

³ Author's estimate is based on the Statement of Fiscal Impact attached to the January 19, 2005 report on H. 3007 by the South Carolina House's Committee on Ways and Means. This earlier version of the bill stepped down the income tax rate over ten years instead of four years, as was finally adopted in Act 41 of 2005.

the few additions to taxable income is deductions taken for state income taxes on the federal income tax.

Both the federal income tax and the state income tax are indexed annually for inflation. In the federal code, personal exemptions and the standard deduction are adjusted for inflation, an adjustment that carries over to taxable income on state income tax returns. However, federal and state governments index tax brackets separately.

Until 1985, South Carolina married couples had the option of calculating income taxes separately on a single form to avoid incurring a marriage penalty by adding a second income on top of the first in a higher bracket. Since 1985, the state has instead given a tax credit on the smaller of the two earned incomes.

The individual income tax is a particularly favorite method of creating tax expenditures, which sacrifice potential tax revenue to create incentives for certain desirable private expenditures.⁴ Charitable deductions, deduction of home mortgage interest and property taxes, and child care credits are popular tax expenditures. Some tax expenditures appear in both the federal and the South Carolina codes, while others are only part of the state tax code.

TAX CREDITS

Unlike exemptions, adjustments, and deductions, tax credits in South Carolina's individual income tax are completely separate from the federal tax code. Credits are subtracted from tax due after taxpayers calculate their state tax liability. Total credits claimed by households and unincorporated businesses in tax year 2003 amounted to \$190 million (DOR 2005).⁵ The child-dependent care credit, the two-wage earner credit, and the tuition tax credit are major credits claimed by households against the state's individual income tax. Together, these three credits cost the state \$66.7 million in revenue in tax year 2003.

New, expanding, and existing unincorporated business firms, like corporations, benefit from individual income tax credits. Employers who create at least ten new jobs can claim credits against the individual income tax by retaining part of their employees' income tax withholding, depending on wage rates and the company's location in the state. These job development credits cost the state \$53.8 million in individual income tax revenue in 2004. Qualifying employers may also claim \$500 per year in income tax withholding from production technology employees to use for retraining. These job retraining tax credits cost the state \$2.5 million in revenue from the individual income tax in 2004 (DOR 2005).

⁴ Tax expenditures are described in Ulbrich (2005) another working paper in this series.

⁵ Includes \$107.9 million in nonresident credits for taxes paid to other states.

DISTRIBUTION OF THE INCOME TAX BURDEN

The individual income tax is the only progressive component of state revenue in South Carolina, but it is not highly progressive. It is progressive because

1. For lower income households, a smaller share of income is subject to tax. Every taxpayer receives the same federal personal exemptions and standard deduction before calculating state taxes, but these exemptions and standard deduction represent a larger share of smaller incomes that is exempt from taxes.
2. Both federal and the state rate structure are progressive; that is, higher incomes are taxed at higher rates. The South Carolina income tax is much less progressive than the federal income tax, reaching the top bracket at a much lower taxable income and (like most states) with lower rates. But the South Carolina income tax is still progressive (Table 1).

Table 1. Distribution of South Carolina's Individual Income Tax Burden, 2002

| Annual Gross Income | Income Tax as % of Gross Income* |
|---------------------|----------------------------------|
| Less than \$13,000 | 0.2 |
| 13,000 to 22,000 | 1.3 |
| 22,000 to 35,000 | 2.4 |
| 35,000 to 59,000 | 3.2 |
| 59,000 to 110,000 | 4.1 |
| 110,000 to 232,000 | 4.6 |
| 232,000 or more | 5.1 |

Source: McIntyre et al. 2003.

*Based on 2002 tax law applied to 2000 income.

In evaluating equity, the average tax rate—the tax paid divided by household income—is more important to consider than comparison of tax burdens. The marginal tax rate—the rate on the last or next dollar of income taxed by a progressive income tax—is important for making decisions about tax incentives and efficiency of the tax system. The marginal rate reveals how much additional tax a person would owe when income increases.

The average rate is always lower than the marginal rate, because some part of each household's income is taxed at the lower rates in lower brackets. For example, an individual with a taxable income of \$40,000 (after personal exemptions, deductions and adjustments) would compute his or her tax at a rate of 7 percent on the last \$27,350 of taxable income, but at rates ranging from 2.5 percent to 6 percent on the first \$12,650 of income. So the average rate on taxable income would be 4.8 percent rather than 7 percent, the marginal rate. (The average rate on gross income would, of course, be much lower).

The individual income tax burden on South Carolina households increases with income, but the average rate (tax as a percent of gross income) only exceeds 5 percent for taxable in-

comes over \$232,000. A 2003 study by the Board of Economic Advisors indicates that income tax burdens in South Carolina are lower than a broad sample of other states up to a taxable income of \$40,000, beyond which they are higher than in some of our neighboring states (Gillespie et al. 2003).

Factors other than income levels affect distribution of the income tax burden. Particular groups may be favored by the state tax code, or they may be favored by the federal code in ways that carry over to the state. Both federal and state governments provide tax breaks for those over age 65.

Social Security benefits are not taxed federally until an individual or household reaches a certain income threshold, after which 15 percent of the benefits are exempt. Households over age 65 are entitled to a larger standard deduction. South Carolina's income tax code exempts all Social Security benefits, as do tax codes in twenty-six other states (Baer 2001). Retirees over age 65 can deduct up to \$10,000 in pension benefits from their taxable income, and those under 65 can deduct \$3,000. Individuals over 65 receive a maximum \$15,000 deduction, which includes the \$10,000 in pension benefits if the taxpayer receives a pension. The estimated cost of revenue lost to the retirement income deduction in 2005 was \$48.6 million, according to the Board of Economic Advisors (BEA&ORS 2005).

A recent study of tax expenditures for the elderly in states with income taxes compared average effective income tax rates for elderly and non-elderly residents. The differential ranged from 16 percent higher for elderly residents in North Carolina to 80 percent lower in South Carolina, which was the largest differential in the nation (Edwards and Wallace 2002). In effect, the average South Carolina elderly household is paying only 20 percent as much in income tax as younger taxpayers.

Many states, especially southern states, make an effort to attract or retain wealthy retirees through some kind of pension or retirement exclusion, with twenty-two states having a minimum age requirement (Edwards and Wallace 2002). The six states that place an income limit on their retirement tax breaks appear to be more concerned about reducing poverty among the elderly than encouraging retirees to relocate to or remain in their states.

The state income tax is deductible as an itemized deduction on federal income tax. This deduction saves more federal income tax for those at higher income levels, so adjusting for this effect means that the contribution of the state income tax to the progressivity of total tax burden is a little less than indicated in Table I.

INCENTIVE EFFECTS

Economists have found it difficult to determine how tax policy in general—and tax incentives in particular—affect taxpayer behavior (Triest 1998). The individual income tax is a complex bundle of incentives and disincentives. The very existence of an individual income tax is an incentive to locate in one of the nine states that have no such tax like Florida and

Tennessee. However, that incentive must be weighed against other considerations, such as sales tax rates (very high in Tennessee), property tax rates, and the types and quality of public services provided.

A recent study in Georgia indicated that wages were a significant determinant of interstate migration, but it could find no statistically significant effect of income taxes on migration, although it is possible that the tax is more significant for subgroups, particularly the elderly (Wallace 2002). Furthermore, the state income tax is deductible on the federal income tax, so the net effect is smaller.

Within the income tax, both federal and state income tax code offer many specific incentives. The income tax code encourages home ownership through the deduction of property taxes and mortgage interest. It encourages charitable contributions and the use of paid child care by working mothers. It encourages individuals to save for retirement and employers to provide part of compensation in the form of health insurance.

The income tax also influences decisions about work effort. Higher marginal tax rates discourage work because the net income is less, but higher tax rates also encourage work because one must work longer to gain the same net income. Some studies indicate that the principal negative effect of income taxes on work effort is on second earners in a household—primarily married women—because the higher marginal tax rate applies to the second income (McCaffery 1997). The effect of the Earned Income Tax Credit on work effort among women is more equivocal, with some studies showing significant increases in work effort among single women (Meyer and Rosenbaum 2000) and others finding a negative effect on employment among low income married women (Ellwood 2000).

Of all the taxes in the system, the income tax is a particularly flexible and useful tool for targeted incentives. Incentives are part of the reason that the federal and most state tax codes are so complex. Incentives also make it difficult to evaluate the impact of a policy change on different taxpayers.

REVENUE TRENDS

Over time, the South Carolina individual income tax has been the fastest growing major revenue source for the state (BEA 2005). During the economic boom years in the mid- to later-1990s revenue from this source increased between 5 percent and 10 percent each year (Table 2). Revenue from the individual income tax reached a high of \$2.5 billion in 2001, but the national economic downturn quickly caused this trend to reverse and revenue declined close to 1 percent a year in each of the next two years. As the state and national economy improved, revenue from the individual income tax reached a new high of nearly \$2.7 billion in 2005 (Figure 3).

Conditions in the larger economy are clearly reflected by periods of faster and slower revenue growth, as individual income tax revenue illustrates (Table 3). Because the state's population is growing, per capita revenue growth always lags total revenue growth.

Table 2. Individual Income Tax Revenue Growth

| | Average Yearly Revenue Increase |
|--------------------|---------------------------------|
| 1985-86 to 2004-05 | 5.9 percent per year |
| 1992-93 to 2000-01 | 7.0 percent per year |
| 2000-01 to 2004-05 | 1.9 percent per year |

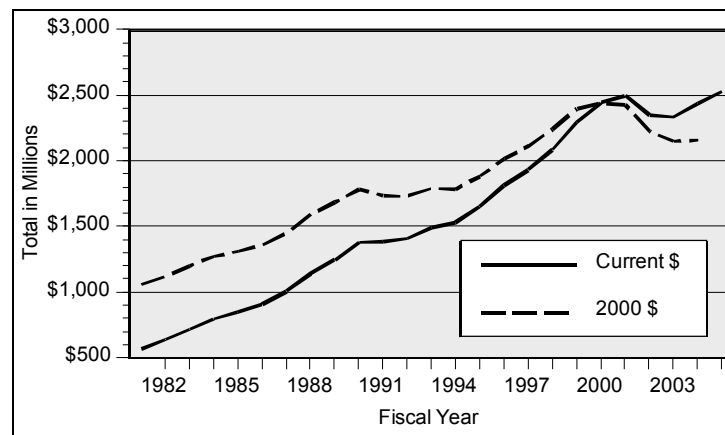


Figure 3. Individual Income Tax Revenue, 1985-86 to 2004-05

ISSUES AND EVALUATION

The income tax has come under attack nationally and in South Carolina in the last decade with efforts to either abolish it or to scale down the higher bracket rates. Various legislative proposals for replacing the federal income tax with a national retail sales tax get regular discussion in Congress (Esenwein and Gravelle 2004; Fox and Murray 2005). In South Carolina, the current governor originally strove to eliminate the income tax, then compromised on an effort to reduce the top bracket rate to 4.75 percent. That proposal was defeated in 2005 because of concern about its impact on the state's bond rating, and instead a more modest change affecting only income of unincorporated businesses was approved.

The changes in 1985 linking the state tax to the federal taxable income have made filing much easier for South Carolinians. Each year the legislature must decide whether to conform to changes in the federal code, and each year that means weighing the revenue effects of conforming, usually a loss, against the increase in complexity if federal changes are not adopted. If the federal government ever enacts some version of the flat tax, South Carolina would have to reevaluate its relationship to the federal tax code.

The income tax is also somewhat more vulnerable to economic fluctuations than other taxes. However, it has shown steady growth. A tax that at least keeps pace with personal income is a reliable vehicle for ensuring adequate funds for public services as population and price levels continue to increase.

Table 3. Individual Income Tax Revenue, 1985-86 to 2004-05

| Fiscal Year | Revenue (in millions) | Annual Growth (%) | Revenue Per Capita | Annual PC Growth (%) |
|-------------|--------------------------|----------------------|-----------------------|-------------------------|
| 1985-86 | \$ 907 | 6.6 | \$ 272 | 5.4 |
| 1986-87 | 1,009 | 11.2 | 299 | 10.0 |
| 1987-88 | 1,142 | 13.2 | 336 | 12.2 |
| 1988-89 | 1,248 | 9.3 | 362 | 7.9 |
| 1989-90 | 1,380 | 10.6 | 394 | 8.8 |
| 1990-91 | 1,387 | 0.5 | 388 | -1.5 |
| 1991-92 | 1,411 | 1.7 | 390 | 0.3 |
| 1992-93 | 1,495 | 5.9 | 408 | 4.7 |
| 1993-94 | 1,531 | 2.4 | 413 | 1.3 |
| 1994-95 | 1,656 | 8.2 | 442 | 6.9 |
| 1995-96 | 1,813 | 9.5 | 478 | 8.1 |
| 1996-97 | 1,933 | 6.6 | 501 | 4.8 |
| 1997-98 | 2,087 | 8.0 | 533 | 6.4 |
| 1998-99 | 2,298 | 10.1 | 578 | 8.6 |
| 1999-00 | 2,446 | 6.4 | 608 | 5.1 |
| 2000-01 | 2,499 | 2.2 | 616 | 1.3 |
| 2001-02 | 2,349 | -6.0 | 572 | -7.0 |
| 2002-03 | 2,334 | -0.6 | 563 | -1.7 |
| 2003-04 | 2,439 | 4.5 | 582 | 3.5 |
| 2004-05 | 2,691 | 10.4 | 636 | 9.3 |

Source: BEA 2005, 2006.

Any review of the individual income tax needs to focus on the actual versus desired distribution of the tax burden, especially across income groups, age groups, work patterns, and family composition. The issue of how much to favor the elderly in the tax system recurs from time to time, especially since the partial pension exclusion is not indexed for inflation. The benefits of any proposed tax incentives or tax expenditures must be also weighed against revenue losses and increased complexity of filing.

CORPORATION INCOME TAX AND OTHER BUSINESS INCOME TAXES

The corporate income tax of 5 percent of net income generates the most revenue of all taxes on incorporated business in South Carolina (Table 4). Business firms that distribute or sell tobacco products also pay a license tax to the state in addition to any local business license.⁶ Others, such as banks, savings and loans, and insurance companies are exempt from the corporate income tax and are taxed separately. Banks are taxed at 4.5 percent of net income and savings and loans at 6 percent of net income. Insurance companies pay a 6 per-

⁶ The business license tax on tobacco can also be considered an excise tax on tobacco. This tax is discussed more in the section on excise taxes. Businesses that distribute or retail alcoholic beverages also pay license fees, but revenue from these business taxes is discussed in the section on excise taxes because it is not separated from the excise tax revenue.

cent tax on premiums. Since 2005, unincorporated businesses (partnerships and proprietorships), which file returns as individuals, pay tax on net income at a declining rate that will be the same as for corporations (5 percent) after 2008.

Revenue from the corporate income tax is particularly volatile, and the share of state revenue from business taxes has declined over the past decade and more. The decline in bank tax revenue reflects bank mergers that have reduced the number of banking headquarters in South Carolina.

According to the Council on State Taxation (Cline et al. 2005), state and local taxes on business have risen at a faster rate than total state and local taxes in recent years. Business property taxes, which are levied by local governments, accounted for 37 percent of business taxes and sales taxes on business inputs and capital equipment were another 23 percent, while corporate income taxes represented only 4 percent of the total. South Carolina derived \$4.6 billion in state and local taxes on business firms, including unincorporated businesses, in 2004, 42.6 percent of all taxes and 4.3 percent of private sector gross state product.

THE RATIONALE FOR BUSINESS TAXATION

Whether and how business firms should be taxed is the subject of an ongoing debate. The debate is based on the incidence of business taxes, so it is primarily an argument about the distribution of the tax burden. But there are also efficiency arguments for and against taxing business firms.

From an efficiency perspective, businesses, like households, use public services—public safety and fire protection, roads and streetlights, and solid waste collection. They rely on the public schools and the technical college system to provide trained and competent workers. These services are a cost of doing business, and property taxes pay for some of these local services.

The argument against business taxation from an efficiency perspective usually centers on the taxation of the profit of corporate business firms. Profit or net income accrues to business owners or shareholders either directly as dividends or indirectly through reinvesting and increasing the value of the stock. In theory, the incidence of the corporate income tax⁷ could fall in any combination on customers through higher prices, suppliers through lower prices received, employees through lower wages, or shareholders through lower net income. However, economic theory strongly suggests that the burden of this tax falls primarily on shareholders (Neil 1998). Because shareholders tend to be more affluent than average, the corporate income tax can be considered a progressive element in the overall tax system (Gravelle 1995).

⁷ See Ulbrich (2005).

Table 4. General Fund Revenue from Business Income Taxes

| | 1985-86 | 1995-96 | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 |
|--------------------------------------|---------|---------|---------|---------|---------|---------|---------|
| <i>Total Revenue (in millions)</i> | 257.20 | 348.09 | 359.73 | 283.33 | 313.59 | 336.65 | 399.4 |
| Bank Tax | \$4.17 | \$13.24 | \$9.36 | \$12.64 | \$21.32 | \$18.16 | \$ 28.8 |
| Business License Tax | 29.99 | 26.10 | 24.50 | 29.15 | 29.19 | 29.74 | 29.6 |
| Corporation License Tax | 24.19 | 43.27 | 64.43 | 59.17 | 64.38 | 72.30 | 74.5 |
| Corporation Income Tax | 185.01 | 233.83 | 212.85 | 142.94 | 149.14 | 174.72 | 215.3 |
| Electric Power Tax | 12.65 | 19.89 | 24.49 | 23.03 | 24.01 | 25.15 | 25.5 |
| Insurance License Tax | n.a. | 5.18 | 15.77 | 8.07 | 18.60 | 9.35 | 19.5 |
| Private Car Lines Tax | 1.10 | 1.76 | 3.19 | 3.19 | 2.61 | 2.69 | 2.4 |
| Retailers License Tax | 0.92 | 1.03 | 0.87 | 0.87 | 0.91 | 0.92 | 0.9 |
| Savings & Loan Tax | -0.83 | 3.79 | 4.27 | 4.27 | 3.43 | 3.62 | 2.8 |
| <i>Total Share of GF Revenue (%)</i> | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Bank Tax | 1.6 | 3.8 | 2.6 | 4.5 | 6.8 | 5.4 | 7.2 |
| Business License Tax | 11.7 | 7.5 | 6.8 | 10.3 | 9.3 | 8.8 | 7.4 |
| Corporation License Tax | 9.4 | 12.4 | 17.9 | 20.9 | 20.5 | 21.5 | 18.7 |
| Corporation Income Tax | 71.9 | 67.2 | 59.2 | 50.5 | 47.6 | 51.9 | 53.9 |
| Electric Power Tax | 4.9 | 5.7 | 6.8 | 8.1 | 7.7 | 7.5 | 6.4 |
| Insurance License Tax | n.a. | 1.5 | 4.4 | 2.8 | 5.9 | 2.8 | 4.9 |
| Private Car Lines Tax | 0.4 | 0.5 | 0.9 | 1.1 | 0.8 | 0.8 | 0.6 |
| Retailers License Tax | 0.4 | 0.3 | 0.2 | 0.3 | 0.3 | 0.3 | 0.2 |
| Savings & Loan Tax | -0.3 | 1.1 | 1.2 | 1.5 | 1.1 | 1.1 | 0.7 |

Source: BEA 2005, 2006.

Notes: All totals exclude revenue from business license taxes on distributors and retailers of alcoholic beverages due to lack of available detail. Data are instead reported as excise tax revenues.
n.a. = not available.

Capital gains are subject to income tax again to the individual shareholder, as are dividends. On the other hand, the federal income tax and the state income tax through linkage to the federal tax give very favorable treatment to capital gains income. The controversy might be more significant if the actual amount of tax collected was larger.

CORPORATE INCOME TAX RATES

Most states tax corporate income (FTA 2006). Thirteen states use graduated rates. Thirty-two states, including South Carolina, have flat rates ranging from 1 percent of net income (Alaska and Arkansas) to 9.99 (Pennsylvania). South Carolina's 5 percent rate is the lowest among the eight southeastern states with single flat rates, and below the maximum rate in all of the other four southeastern states except Mississippi (Table 5). Michigan and Texas each tax business, but not specifically corporate income. Four states have no corporate income taxes (Nevada, South Dakota, Washington and Wyoming).

In 1921, South Carolina began collecting corporate income taxes at a rate of 6 percent, which was reduced to 5 percent in 1989. The reduction in South Carolina's corporate income tax rate from 6 percent to 5 percent in 1989 is currently costing the state about \$36 million a year in revenue (BEA&ORS 2005).

The corporate income tax was brought into conformity with federal practice in 1985, when the state adopted about two-thirds of the federal code. In addition to the corporate income

tax, both corporations and unincorporated business firms pay a state license tax of 0.001 percent of capitalization plus \$15. Capitalization is defined as a firm's capital stock and paid-in surplus.

Table 5. Corporate Income Tax Rates, Southeastern States, 2006

| State | Tax Rate* (%) | Tax Brackets | | |
|----------------|------------------|--------------|---------|-----------|
| | | Number | Low | High |
| Alabama | 6.5 | 1 | Flat | Flat |
| Arkansas | 1.0 - 6.5 | 6 | \$3,000 | \$100,000 |
| Florida | 5.5 | 1 | Flat | Flat |
| Georgia | 6.0 | 1 | Flat | Flat |
| Kentucky | 4.0 - 7.0 | 3 | 50,000 | 100,000 |
| Louisiana | 4.0 - 8.0 | 5 | 25,000 | 200,000 |
| Mississippi | 3.0 - 5.0 | 3 | 5,000 | 10,000 |
| North Carolina | 6.9 | 1 | Flat | Flat |
| South Carolina | 5.0 | 1 | Flat | Flat |
| Tennessee | 6.0 | 1 | Flat | Flat |
| Virginia | 6.0 | 1 | Flat | Flat |
| West Virginia | 9.0 | 1 | Flat | Flat |

Source: FTA 2006.

*As of January 1.

TAXING MULTISTATE CORPORATIONS

States usually apply a formula to determine what share of a multistate corporation's income is taxable. Apportioning corporate profits or net income among states is more complicated than allocating personal income or the income of unincorporated firms. Like many other states, South Carolina bases its formula on the share of the firm's tangible assets (property), sales, and payroll located in South Carolina. Since 1996, South Carolina's four-factor apportionment formula is based 50 percent on sales, 25 percent on payroll, and 25 percent on property.⁸ Some states use a gross receipts ratio test as an alternative to a formula.

The ability to collect business activity taxes, including corporate income taxes, from a corporation doing business in a state is subject to a nexus or physical presence test, similar to the test used in retail sales taxes that allows a state to require vendors to collect and remit the tax. Congress has already created some *safe harbors* to insulate some businesses from state taxation and is considering expansion of those safe harbors with more restrictive nexus tests. Such legislation would further erode corporate income tax revenue as well as other taxes on business activity (Mazerov 2005).

⁸ The four-factor apportionment method is used for manufacturing firms and other businesses dealing with tangible personal property. Construction contractors and service companies including those in real estate rentals use a gross receipts apportionment method. Special apportionment factors are used for railroads, airlines, shippers, and telephone and pipeline companies (DOR 2006).

TRENDS IN CORPORATE INCOME TAX REVENUES

The corporate income tax is a volatile revenue source that is affected by changes in general economic conditions as well as a variety of business tax incentives. It is not as steady a source of revenue as the individual income tax, and revenue growth is slower (Table 6). Corporate income tax revenues were low during the recession in the early 1990s and rose quickly as the economy improved throughout the decade (BEA 2005). Revenues dropped precipitously after fiscal year 2001 with the recent recession and now appear to be on their way back up along with the improving economy of the past two years (Figure 4).

Table 6. Corporate Income Tax Revenue Growth

| Time Period | Average Annual Revenue Increase |
|--------------------|---------------------------------|
| 1985-86 to 2004-05 | 0.8 percent per year |
| 1992-93 to 2000-01 | 3.8 percent per year |
| 2000-01 to 2004-05 | 0.3 percent per year |

Source: BEA 2005, 2006.

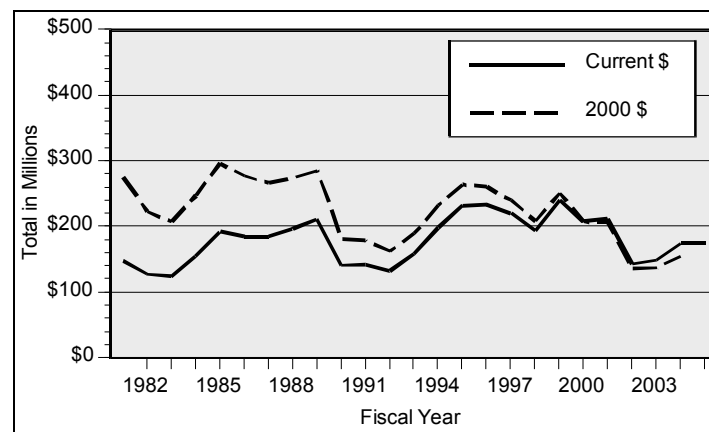


Figure 4. Corporate Income Tax Revenue, 1985-86 to 2004-05

Changes in the tax rate and its structure have also had a major influence on revenues from the corporate income tax. Conformity with federal tax law may have precipitated the increase in tax revenue from \$154 million in 1984 to \$192 million in 1985. Revenue remained at this level until 1990, dropping to \$141 million after the state's tax rate was lowered in 1989. The Board of Economic Advisors estimates that the reduction of the corporate income tax rate from 6 percent to 5 percent cost the state \$36.2 million in revenue in 2005 (BEA&ORS 2005). Revenue from the South Carolina corporate income tax and corporate license tax was close to three-quarters of state revenue from business taxation in 2005. This share is down from over 81 percent in 1986 (Table 7).

In 2004, federal legislation created a new deduction for qualified production activities income (QPAI), which will cost the federal government an estimated \$10.7 billion in corporate income tax revenue and a simultaneous loss of \$1.3 billion to states whose corporate

income tax is coupled to the federal code. For South Carolina, the potential revenue loss is \$8 million a year. The law is quite complex, but basically creates new deductions that will reduce taxable corporate income by 9 percent by 2010 (Duncan 2005, McNichol and Johnson 2005). Because South Carolina's income tax on corporations uses federal taxable income as a starting point, this new federal deduction will reduce the state's revenue from this tax unless the state chooses to decouple its tax code from the deduction.

Table 7. Corporate Income Tax Revenue, 1985-86 to 2004-05

| Fiscal Year | Revenue (in millions) | Annual Growth (%) | Revenue Per Capita | Annual PC Growth (%) |
|-------------|--------------------------|----------------------|-----------------------|-------------------------|
| 1985-86 | \$185.0 | -3.7 | \$ 56 | -4.8 |
| 1986-87 | 184.9 | -0.1 | 55 | -1.2 |
| 1987-88 | 196.2 | 6.1 | 58 | 5.1 |
| 1988-89 | 211.2 | 7.7 | 61 | 6.3 |
| 1989-90 | 140.9 | -33.3 | 40 | -34.3 |
| 1990-91 | 142.7 | 1.3 | 40 | -0.4 |
| 1991-92 | 132.4 | -7.2 | 37 | -8.3 |
| 1992-93 | 158.2 | 19.5 | 43 | 18.4 |
| 1993-94 | 198.8 | 25.6 | 54 | 23.2 |
| 1994-95 | 232.3 | 16.8 | 62 | 15.5 |
| 1995-96 | 233.8 | 0.7 | 62 | -0.6 |
| 1996-97 | 220.2 | -5.8 | 57 | -7.4 |
| 1997-98 | 193.8 | -12.0 | 49 | -13.3 |
| 1998-99 | 240.9 | 24.3 | 61 | 22.6 |
| 1999-00 | 208.0 | -13.7 | 52 | -14.7 |
| 2000-01 | 212.9 | 2.4 | 52 | 1.4 |
| 2001-02 | 142.9 | -32.8 | 35 | -33.6 |
| 2002-03 | 149.1 | 4.3 | 36 | 3.2 |
| 2003-04 | 174.7 | 17.2 | 42 | 16.0 |
| 2004-05 | 215.3 | 23.2 | 51 | -0.7 |

Source: BEA 2005, 2006.

INCENTIVE EFFECTS

With low rates and generous exemptions, the corporate income tax and related business income taxes do not appear to be a serious deterrent to business location and expansion in South Carolina. The corporate income tax has been a useful vehicle for targeted incentives for business location and expansion, as it has in other states. The drawback of having low rates, generous exemptions, and targeted incentives and tax credits is that revenue from this source has been declining not just in inflation-adjusted dollars but in actual dollars over the last decade (Figure 4).

ISSUES AND EVALUATION

Providing 6.6 percent of General Fund revenue in 2005, the corporate income tax and other business income taxes are a relatively small source of revenue to the state of South Carolina. Revenue projections from business taxes are somewhat uncertain because accumulated unused credits from business location incentives make it unlikely that this revenue source will grow much in the next decades.

The change in the treatment of unincorporated business income to parallel corporate net income was a significant improvement in equity for a sector that is important in new job creation, and the expected revenue loss is relatively modest. However, despite their limited role, corporate income taxes, and now more favorable income tax treatment on unincorporated business firms as well, provide a useful business location incentive while ensuring that business firms make some contribution to the cost of public services on which they rely. In a highly competitive economic development climate, it is unlikely that business income will be taxed more heavily in the near future, although some fine-tuning of incentives for effectiveness and accountability is always under consideration.

GENERAL SALES TAXES

The general retail sales and use tax is a mainstay of state revenue not only in South Carolina but also in most of the rest of the nation. Local sales taxes are also important revenue sources for local governments throughout the country. Forty-five states and the District of Columbia levy broad-based retail sales taxes at combined maximum state and local rates ranging from 4 percent in Virginia to 11 percent in Alabama (Table 8).

Table 8. Sales Tax Rates, Southeastern States, 2006

| State | State Rate* (%) | Maximum Local Rate* (%) | Maximum Combined Rate* (%) |
|----------------|-----------------|-------------------------|----------------------------|
| Alabama | 4.000 | 7.000 | 11.000 |
| Arkansas | 6.000 | 5.500 | 11.500 |
| Florida | 6.000 | 1.500 | 7.500 |
| Georgia | 4.000 | 3.000 | 7.000 |
| Kentucky | 6.000 | None | 6.000 |
| Louisiana | 4.000 | 6.250 | 10.250 |
| Mississippi | 7.000 | 0.250 | 7.250 |
| North Carolina | 4.500 | 3.000 | 7.500 |
| South Carolina | 5.000 | 2.000 | 7.000 |
| Tennessee | 7.000 | 2.750 | 9.750 |
| Virginia | 4.000 | 1.000 | 5.000 |
| West Virginia | 6.000 | None | 6.000 |

Source: FTA 2006.

*As of January 1.

THE RATIONALE FOR GENERAL SALES TAXATION

Almost every country uses some form of sales tax. Consumption or spending is a measure, albeit imperfect, of a household's ability to pay. Point of sale is also a convenient and easily tracked *tax handle*—a transaction involving money where the government can step in to claim a share. In other countries, the most common sales tax is a value-added tax or VAT, usually at the national level. Collection of a value-added tax involves extensive recordkeeping because all buyers and sellers—not just retailers—pay tax on what they sell and receive a credit for taxes paid on what they buy. In the United States, the sales tax is almost always rated least unfavorable among the major taxes, partly because it is paid in small amounts

instead of all at once. Taxpayers often observe that they feel that they have more choice in paying sales tax than other kinds of taxes.

A few states tax most services as well as goods—legal services, travel services, medical services, rental services, personal services, communication services, and a variety of others. Hawaii, South Dakota, and New Mexico have the broadest coverage of services as well as the tangible goods that are the base of the retail sales taxes in most other states (Due and Mikesell 1994). Florida attempted to expand its sales tax base to include most services in the late 1980s and retreated after six months because of an intense lobbying campaign fueled by protests from advertising and legal services industries. In other states, the tax base is gradually expanding to include more services. Services now commonly taxed are repairs and cleaning, landscaping, beauticians' and barbers' services, parking, pest control, and car washes (NCSL 2004). The law in South Carolina describes the retail sales and use taxes as a levy on the retail sale of tangible goods, although in practice a few services are included.

Economists argue that a broader base of purchases is more efficient (less distortion of choices) and more equitable (makes the tax less regressive). For several decades spending on services has been growing faster than sales of tangible goods, so broadening the tax base to include services would link sales tax revenue more closely to personal income. The chief drawback of taxing services is the large number of small service firms that would be brought into the network, increasing the cost of collection and compliance.

TAX STRUCTURE

Sales and use tax. The retail sales tax is both a sales tax and a use tax. It covers purchases in South Carolina as well as purchases made in other states and brought into South Carolina to use. The buyer pays the sales and use tax, but most of the tax is collected by the seller and remitted to the state. States can compel collection of the tax by in-state sellers including sellers that have some nexus or physical connection with the state, such as an office, a warehouse, or a retail outlet, but the state has no such power over vendors outside the state. Every state with a retail sales tax also has a companion use tax intended to cover this potential loophole for out-of-state purchases, including catalog and Internet purchases.

South Carolina's sales and use tax is levied on sales of goods, including food except for food bought with food stamps. Food is exempt in many other states. Some goods, such as Bibles, textbooks, newsprint, and prescription drugs are exempt. Some services, such as dry cleaning, transient accommodations, communications such as cable television and wireless charges, laundry, electricity, some kinds of warranties, maintenance contracts and late fees, and accommodations in motels, hotels, and vacation rentals are taxed. Admissions and amusements are exempt from the sales tax but are subject to a separate tax.

Special tax rules apply to automobiles, aircraft, boats, and trailers, setting a maximum tax of \$300 on the sale or long-term lease of these vehicles. At 5 percent, the maximum state sales tax would apply to the first \$6,000 on the purchase of a used car, a \$50,000 car, a

\$500,000 luxury yacht, or even a company or personal airplane. When a buyer of an automobile trades in a car on a new purchase, the tax is levied on the net price after subtracting the trade-in allowance.

The taxation of mobile homes or manufactured homes is complicated. If the buyer plans to live in the home, the maximum tax is \$300. If the buyer is using the home for other purposes, the tax is 5 percent of 65 percent of the net sale price after any trade-in if 65 percent of the selling price is less than or equal to \$6,000, resulting in the same maximum of \$300 as on cars, boats and aircraft. If the selling price is more than \$6,000, the tax is \$300 plus 2 percent of the amount in excess of the net selling price over \$6,000 (DOR 2006).

The general retail sales and use taxes were adopted together in 1951 at the rate of 3 cents. A fourth penny was added in 1969, remaining at this level until 1984, when it was raised to 5 percent. The fifth penny funds the programs of the Educational Improvement Act (EIA). All other revenues from the sales and use taxes are also earmarked for K-12 education, although they are not excluded from the General Fund as is revenue earmarked for EIA programs.

[At the end of the 2006 legislative session the South Carolina General Assembly passed Act 388, which raises the state sales tax rate to 6 percent starting June 1, 2007. This one-cent increase will be used to fund property tax relief from school taxes for owner-occupied residential property. Unlike the earlier rate increases, this one will not increase total funding for schools. These funds will be segregated from the General Fund. Act 388 also reduces the sales tax rate on unprepared food to 3 percent on October 1, 2006, among other things.]

Casual sales excise tax. South Carolina also has a casual excise tax that is applied when individuals transfer ownership of motor vehicles, motorcycles, boats, motors, and airplanes. The casual excise tax was enacted in 1982 and is imposed at the general sales tax rate of 5 percent. The tax brought in \$21.0 million in revenue to the state in 2005. Revenues from the general sales tax and the casual excise tax are combined in this report because both taxes are levied at the same tax rate and revenues from each are distributed using the same formula. The Board of Economic Advisors and the Department of Revenue also treat the casual excise tax as a sales tax in their revenue projections and reports.

SALES AND USE TAX EXEMPTIONS AND CAPS

South Carolina's tax code has numerous tax exemptions for both households and businesses. The original 1951 legislation contained exemptions, many of which eliminated the tax on inputs to agricultural and manufacturing activities. In 1984 and 1985, starting at the time the sales tax rate was increased to 5 percent, the sales tax caps were adopted for motor vehicles, aircraft, motorcycles, boats, and mobile homes. Between 1956 and 1987, separate legislative acts added thirty-three new tax exemptions and seven new tax caps to the tax code (South Carolina Tax Commission 1987). This trend has continued to the present.

Treatment of business purchases is uneven in South Carolina. The general rule is that purchases of goods or services that are inputs into the production of other taxable goods or services should be exempt in order to avoid double taxation. Exemptions for manufacturing include machines for manufacturing, processing, and mining as well as parts, attachments and replacements for those machines. Pollution control equipment and recycling equipment as well as purchases of electricity and fuel used in manufacturing are also exempt. Agricultural exemptions include sales of livestock and farm products and purchases of feed, fuel for farm machinery, electricity for irrigation, and building materials for housing livestock. Supplies used by laundries and radio and television businesses are exempt, but purchases of construction materials for residential, commercial or industrial construction are subject to the sales and use tax.

Very few buyers are wholly exempt from sales taxes. Sales to the federal government are exempt, but not sales to state agencies or charitable organizations. Since 2001, South Carolina has had a sales tax holiday every August that exempts a large number of items from sales tax for three days as a back-to-school event. In 2005, the estimated revenue loss from this tax holiday was \$5.2 million (BEA&ORS 2005).

Congress imposed a significant and growing sales tax exemption in the 1990s when it declared a moratorium on requiring Internet vendors to collect and remit retail sales taxes to the states. South Carolina could attempt to collect the use tax on Internet sales, but the state would have to collect from the buyer, not the seller, which is much more expensive and difficult to do. Other sellers, including catalog retailers, are required to comply with the collection requirement only if they pass a test of nexus or physical presence in the taxing state.

Efforts to tax Internet and catalog vendors have been very frustrating for state tax officials. In-state merchants are disadvantaged in competing with out-of-state sellers who do not have to collect sales tax, and the revenue loss is substantial (NCSL 2004). One of Congress' concerns about permitting general taxation of such vendors was the high cost of compliance and collection from multiple states, especially for smaller firms. States have responded to that objection with the creation of a streamlined sales tax project to form an agreement to simplify state taxes and make their bases more similar in order to reduce compliance cost. According to the Streamlined Sales Tax Governing Board, 19 states have brought their retail sales tax bases into compliance with the simplified code or will be in compliance by 2008. South Carolina is not one of these 19 states, but the Fee in Lieu of Tax Simplification Act complies with the streamlined sales and use tax agreement.⁹

⁹ See information at the Streamlined Sales Tax Governing Board Website: <http://www.streamlinedsalestax.org>

DISTRIBUTION OF THE SALES TAX BURDEN

The sales tax is generally believed to be regressive because lower income households spend a larger share of their income on taxable goods. As household incomes rise, a larger share of income is saved and invested or spent on services, which are not taxed.

Measuring the distribution of the sales tax burden is complicated by the fact that many business purchases, including building materials, are subject to sales tax. Nationally, sales taxes on business inputs account for about 25 percent of all taxes on business firms. It is difficult to allocate that part of the sales tax among owners, workers, suppliers, and consumers in order to measure tax incidence. However, it is likely that sales taxes on business purchases burden small business more than large businesses, because small businesses are more likely to purchase taxable goods and services from outside suppliers that might be produced within the firm for larger businesses.

The ease of shifting the sales tax burden to nonresidents complicates determining how the sales tax burden affects a state's citizens and businesses. The sales tax is more easily shifted to nonresidents than many other taxes. South Carolina's strong tourism and manufacturing sectors suggest that the average sales tax burden on state residents is lower because tourists and businesses pay sales tax.

The limited coverage of services and the taxation of food purchases make the South Carolina retail sales and use tax somewhat more regressive than in the average state. However, with an average state and local sales tax rate in South Carolina of about 5.5 percent compared to a national average of almost 8 percent, the retail sales taxes burden on low-income households is just about at the national average. According to the Institute on Taxation and Economic Policy, general sales taxes took 3.7 percent of income of households with annual household income under \$13,000 in South Carolina in 2003, while taking 0.6 percent from the income of households with annual income of \$232,000 or more. Nationally, the comparable figures were 3.6 percent and 0.6 percent, respectively (McIntyre et al. 2003).

INCENTIVE EFFECTS

The important incentive effects of a sales tax are on location decisions for firms and shopping choices for both consumers and businesses. The important consideration is how a state's tax rate compares to that levied on out-of state sellers, whether they are retailers in adjacent states (cross-border shopping) or untaxed vendors on the Internet or via catalog.

South Carolina's retail sales tax rate is aligned closely enough with its neighbors' rates that cross-border shopping for tax reasons does not appear to be of major consequence for retailers in the 20 counties along the Georgia and North Carolina borders. According to a study at Georgia State University, the typical effect of a 1 percent higher sales tax rate is a decline in per capita sales along state borders of 1 percent to 6 percent. For border sales, it

is not the absolute tax rate but the rate differential that is important (Pandey and Sjoquist 2005).

However, for Internet and catalog purchases, the rate differential is much larger, because the alternative rate is zero. The existence of any state sales tax at all is an incentive to shop on the Internet or by catalog, although some catalog sales are subject to sales tax. The higher the rate, the greater the incentive to take action to avoid it. Estimates of the revenue loss to South Carolina from the inability to collect use tax on Internet and catalog purchases range from \$93 million to \$276 million for 2003 (USGAO 2000, USCBO 2003).

REVENUE TRENDS

Like the individual income tax, the sales tax (including the casual sales excise tax) is a major revenue producer for South Carolina (Table 9). In 2005, it produced \$2.3 billion in revenues. Revenue has grown at rates comparable to those of the income tax. Revenues from the sales tax reflect economic conditions with revenue growth accelerating during a strong economy and slowing or declining during downturns and recessions (Table 10, Figure 5). Revenue growth slowed but did not decline in the most recent recession. Spending levels in the state remained relatively high during the economic decline of the past four years, compared to those in the recession of the early 1990s.

Table 9. Retail Sales and Use Tax and Casual Sales Excise Tax Revenue, 1985-86 to 2004-05

| Fiscal Year | Revenue (in millions) | Annual Growth (%) | Revenue Per Capita | Annual PC Growth (%) |
|-------------|--------------------------|----------------------|-----------------------|-------------------------|
| 1985-86 | \$ 893.3 | 7.9 | \$ 268 | 6.6 |
| 1986-87 | 946.9 | 6.0 | 281 | 4.8 |
| 1987-88 | 1,006.2 | 6.3 | 296 | 5.3 |
| 1988-89 | 1,085.6 | 7.9 | 315 | 6.5 |
| 1989-90 | 1,155.8 | 6.5 | 330 | 4.8 |
| 1990-91 | 1,155.4 | 0.0 | 324 | -2.0 |
| 1991-92 | 1,166.0 | 0.9 | 322 | -0.5 |
| 1992-93 | 1,250.6 | 7.3 | 341 | 6.0 |
| 1993-94 | 1,346.9 | 7.7 | 363 | 6.5 |
| 1994-95 | 1,442.5 | 7.1 | 385 | 5.9 |
| 1995-96 | 1,544.7 | 7.1 | 407 | 5.7 |
| 1996-97 | 1,634.6 | 5.8 | 424 | 4.1 |
| 1997-98 | 1,741.8 | 6.6 | 444 | 4.9 |
| 1998-99 | 1,889.6 | 8.5 | 475 | 7.0 |
| 1999-00 | 1,980.8 | 4.8 | 492 | 3.6 |
| 2000-01 | 2,000.2 | 1.0 | 493 | 0.1 |
| 2001-02 | 2,026.5 | 1.3 | 494 | 0.2 |
| 2002-03 | 2,071.1 | 2.2 | 499 | 1.1 |
| 2003-04 | 2,201.7 | 6.3 | 526 | 5.3 |
| 2004-05 | 2,318.5 | 5.3 | 548 | 4.3 |

Source: BEA 2005, 2006.

Note: One cent funding the Education Improvement Act excluded.

Table 10. Sales and Use Tax Revenue Growth

| Time Period | Average Annual Revenue Increase |
|--------------------|---------------------------------|
| 1985-86 to 2004-05 | 5.2 percent per year |
| 1992-93 to 2000-01 | 6.1 percent per year |
| 2000-01 to 2004-05 | 3.8 percent per year |

Note: Includes casual sales excise tax.

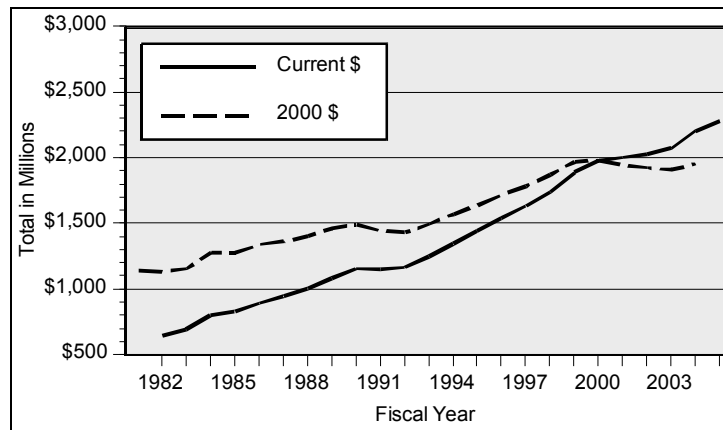


Figure 5. Sales and Use Tax Revenue, 1985-86 to 2004-05

ISSUES AND EVALUATION

The retail sales and use tax is one of the solid underpinnings of the state revenue system and an increasingly important local revenue source as well. But the revenue from the retail sales tax also is vulnerable. It will be vulnerable to increased competition when the rate is increased, because a higher rate will encourage more cross-border, catalog and Internet shopping. The base of the retail sales tax has also remained relatively constant while the economy has shifted beneath it, explaining the interest in expanding coverage to more services. Exemptions also continue to be a contentious issue, especially the \$300 sales tax cap on cars, boats, and airplanes.

SELECTIVE SALES (EXCISE) TAXES

Along with the general retail sales tax, a variety of specific excise taxes are significant revenue sources for South Carolina and most states. Excise taxes are levied on a particular good or service. An excise tax is separate from and sometimes in addition to the general sales tax. All states levy at least some excise taxes, most commonly on alcohol, tobacco, gasoline, and transient accommodations (Table 11).

South Carolina levies excise taxes on the *big three*—motor fuels, tobacco, and alcohol. The state also levies excise taxes on admissions to entertainment and sporting events, bingo games and coin-operated devices, and electric power. The excise tax on admissions is in lieu of a sales tax. The tax on accommodations in hotels and motels is collected by the state but returned to local governments where the revenue originated. Economists regard revenue

from the lottery, begun in 2001, to be a form of excise tax (Hansen 2005). Local governments in South Carolina also levy excise taxes—local accommodations taxes, hospitality taxes on restaurant meals, and taxes on public utilities.

Table 11. Gasoline, Alcohol and Cigarette Tax Rates, Southeastern States, 2006

| State | Gasoline Tax ^b (Cents/Gallon) | Alcohol Taxes (Dollars per Gallon) | | | Cigarette Tax (Cents/Pack) |
|-----------------------------|---|------------------------------------|--------|---------|-------------------------------|
| | | Distilled Spirits ^a | Wine | Beer | |
| Alabama ^a | 18.00 cents | n.a. | \$1.70 | \$0.530 | 42.5 cents |
| Arkansas | 21.50 | 2.50 | 0.75 | 0.230 | 59.0 |
| Florida | 14.90 | 6.50 | 2.25 | 0.480 | 33.9 |
| Georgia | 15.30 | 3.79 | 1.51 | 0.480 | 37.0 |
| Kentucky | 18.50 | 1.92 | 0.50 | 0.080 | 30.0 |
| Louisiana | 20.00 | 2.50 | 0.11 | 0.320 | 36.0 |
| Mississippi ^a | 18.40 | n.a. | 0.35 | 0.430 | 18.0 |
| North Carolina ^a | 30.15 | n.a. | 0.79 | 0.530 | 30.0 |
| South Carolina | 16.00 | 2.72 | 0.90 | 0.770 | 7.0 |
| Tennessee | 21.40 | 4.40 | 1.21 | 0.140 | 20.0 |
| Virginia ^a | 17.50 | n.a. | 1.51 | 0.260 | 30.0 |
| West Virginia ^a | 27.00 | n.a. | 1.00 | 0.180 | 55.0 |
| Southeast Median | 18.45 | — | 0.95 | 0.375 | 32.0 |
| U.S. Median | 18.40 | 3.75 | 0.69 | 0.188 | 80.0 |

Source: FTA 2006.

^aOne of 18 states, in which the government directly controls the sales of distilled spirits. Revenue from distilled spirits in states designated *n.a.* (not applicable) is generated from various taxes, fees and net liquor profits rather than taxation alone.

^bMay include additional state or local taxes or fees. In SC these are \$0.75.

In South Carolina, excise taxes provide revenue for the General Fund as well as special funds and departmental accounts. Excise taxes raised over \$1.1 billion for the state in 2004, when lottery revenue is included (Table 12). The lottery and the motor fuel tax, both directed to special funds, are the two largest sources of state revenue from excise taxes. Portions of other excise taxes are directed to special funds and state agencies. Excise taxes accounted for \$361.8 million of the state's General Fund revenue in 2005, 6.0 percent of the total.

RATIONALE FOR EXCISE TAXES

Some excise taxes are levied primarily for revenue. Often the revenue is earmarked for a related use. The best examples are state and federal taxes on motor fuels, used to build and maintain highways. In this and similar cases, excise taxes act as user fees, where the tax is paid by the user who directly benefits from the service provided.

Sometimes a good or service is subject to an excise tax because demand is price-inelastic, and the tax will not affect sales very much. Taxes on telephone service and automobile tires have been levied on this basis. Still other excise taxes are used to discourage certain types of consumption, such as drinking alcohol and using tobacco products. Some excise taxes are also used to mitigate the regressive nature of the sales tax by levying additional taxes on

items consumed more heavily by higher income households, such as restaurant meals, admissions to recreational events, and hotel rooms.

Table 12. Revenue from Excise Taxes, 2003-04

| | Revenue (in millions) | Revenue Per Capita | Share of General Fund ^a (%) |
|--------------------------------|--------------------------|-----------------------|---|
| Excise Taxes: | | | |
| Motor fuel | \$ 489.3 | \$117 | 0 |
| Alcoholic liquor | 58.0 | 14 | 90 |
| Beer and wine | 94.3 | 23 | 100 |
| Tobacco (business license) | 29.7 | 7 | 100 |
| Admissions tax and bingo | 37.8 | 9 | 85 |
| Aircraft | 7.3 | 2 | 100 |
| Coin-operated devices | 1.8 | < 1 | 100 |
| Electric power | 25.2 | 6 | 100 |
| Insurance premium | 119.8 | 29 | 100 |
| Total (excluding lottery) | 863.2 | 206 | 41.1 |
| Education Lottery ^b | 292.0 | 70 | 0 |
| Total (including lottery) | 1,155.1 | 276 | n.a. |

Source: DOR 2005, OSB 2005b.

^aCalculated by authors for current year.

TAX STRUCTURE

Many excise taxes are expressed in cents or dollars per physical unit—per gallon of gasoline, per pack of cigarettes, or per gallon of alcohol. While this method makes the tax easy to understand and apply, revenue is solely linked to unit of consumption and does not rise with inflation. In fact, during inflation the value or purchasing power of a tax per physical unit actually declines. For example, it would require a tax of about 31 cents per pack of cigarettes today to have the same value as South Carolina's 7 cents per pack tax when enacted in 1972. Other excise taxes, such as the admissions tax and the accommodations tax, are computed as a percentage of the price, like the retail sales tax.

Motor Fuel User Fee. The federal government, all states, and the District of Columbia tax motor fuels, including gasoline, diesel fuel, gasohol, and liquefied petroleum gas. Local governments in some states also levy motor fuel taxes. Governments rely on the revenue from motor fuel taxes to help fund the maintenance and construction of transportation infrastructure. Although the primary purpose of motor fuel taxes is to fund roads, bridges, and highways, they are also intended to encourage fuel economy and use of public transportation.

In South Carolina the state motor fuel excise tax—called the motor fuel user fee—is 16 cents per gallon (cpg) for gasoline, diesel, and gasohol.¹⁰ Additional earmarked fees totaling 75 cpg are added to the motor fuel user fee and are included in revenues discussed in this

¹⁰ In many states the tax varies with the fuel. The additional federal motor fuel excise tax is 18.4 cpg for gasoline, 24.4 cpg for diesel, and 13.1 cpg for gasohol.

working paper.¹¹ Liquefied petroleum gas is not currently taxed. Only five states have a lower combined motor fuel tax rate (excise tax *plus* other per-gallon-motor-fuel fees *plus* sales taxes) on gasoline than South Carolina (London and Saltzman et al. 2002). Gasoline is not subject to the retail sales tax in South Carolina as it is in a few other states, including neighboring Georgia. Legislative proposals to increase the motor fuel tax have been discussed in recent years but not adopted.

Revenue from South Carolina's motor fuel user fee goes into the Department of Transportation's special revenue fund. The fee generated \$467.4 million for state-maintained roads, bridges, and highways in 2004 (DOR 2005). The legal definition of the tax on motor fuels as a user fee allows this revenue to fund certain transportation expenditures that state law does not allow to be funded with revenue from taxes.

Revenue from the motor fuel user fee has not followed the pattern of other excise tax revenues. Consumption of motor fuel is influenced by the fuel economy of the vehicle, annual vehicle miles traveled (VMT), and the price of fuel. Between 1980 and 2000, VMT in the United States has risen faster than the number of registered vehicles and population. In addition, the most dramatic increase in VMT has occurred in the light truck category, which includes vans, pickups, and sport utility vehicles. Light trucks, which made up about one-third of VMT in the nation in 2000, are subject to lower federal fuel economy requirements than are passenger cars (London and Saltzman et al. 2002). These trends have combined to increase the rate of fuel consumption, resulting in strong long-term growth in revenues from motor fuel excise taxes in South Carolina and nationwide. Over the short run, however, the recent recession and rising fuel prices caused fuel consumption and thus revenues to decrease.

Taxes on Alcoholic Beverages. The state of South Carolina has separate excise taxes on liquor, beer and wine. The taxes generated \$152.3 million in revenue in 2004, of which \$146.7 million went into the General Fund (DOR 2005). The remainder was distributed to local governments for local option permits for alcoholic liquor and for seven-day permits for beer and wine. In 2005 the General Fund received \$149.4 million in revenue from these two taxes and related business license fees (BEA 2006).¹²

South Carolina's tax rate on beer at 76.8 cents per gallon is well above the national and regional median rates. The state's tax rate per gallon on wine is close to the median rate in the Southeast, but well above the national median. Distilled spirits are taxed more lightly in South Carolina than in some southeastern states (FTA 2006). The state's tax rate on liquor also is well below the U.S. median. For small quantities of liquor, the tax was 17 cents per eight ounces or 25 cents per minibottle, but this tax changed in 2005 following the passage

¹¹ Of the additional 75 cpg fee on the state gasoline tax, 50 cents goes to the South Carolina Department of Health and Environmental Control for environmental cleanup, and 25 cents is earmarked for petroleum inspection fees.

¹² Revenue from business license fees for manufacturers, wholesale distributors, retailers, breweries, and wineries is not separated from revenue from the excise taxes.

of a 2004 referendum to eliminate the sale of mixed drinks using the minibottle and permit mixed drinks from bar stock. Now an excise tax of 5 percent of the gross proceeds of alcoholic liquor by the drink is imposed for on-premises consumption. This change was determined to have no fiscal impact on the General Fund by the South Carolina Office of State Budget (2005a).

Eighteen states including Alabama, Mississippi, North Carolina, Virginia, and West Virginia sell distilled spirits and wine with higher alcoholic content directly through state-owned and operated liquor stores. In South Carolina and most other states, sales taxes in addition to the excise tax are imposed on purchases of alcohol, as well as federal taxes of 50 cents per gallon for distilled spirits, \$1.07 per gallon of wine, and 50 cents for beer.¹³

In addition to the excise tax per unit sold, the state derives revenue from license fees for manufacturers, wholesalers, and retailers. This revenue is included in the excise tax totals because available data sources do not separate the revenue. Local government revenue comes from local option Sunday permits of \$200 per Sunday or \$3,050 per year and seven-day beer and wine permits, \$2,200 biannually for most retailers (DOR 2005).

Taxes on Tobacco. Like other tobacco-producing states, South Carolina levies taxes on cigarettes and other tobacco products at rates well below the national median (Table 11). Because South Carolina is a tobacco-growing state, cigarettes are still taxed at the rate of seven cents a pack, which was set in 1972. Adjusted for inflation, the tax would have to be about 34 cents a pack just to have the same purchasing power in 2006. The federal tax is 24 cents per pack.

Taxes on Tourism. Tourism taxes on accommodations, admissions and amusements, hospitality, rental cars, airport parking, and cruise ship departures serve several functions. Besides exporting the tax burden, tourism taxes help pay for the public services used by tourists and business travelers. Finally, they make the overall sales and excise tax structure less regressive, because higher income groups generally use the services more heavily. Because tourism is a highly competitive industry, tax rates must be set with consideration of rates in other tourism destinations.

South Carolina's admissions tax on places raised \$27 million for the state in 2004 (DOR 2005). Fishing piers, tourism areas, and the General Fund share admissions tax revenue. Revenue from the statewide 2 percent accommodations tax in addition to the sales tax is returned to cities and counties based on revenue generated. Cities and counties may also levy an optional local accommodations tax of an additional one percent; and an optional local hospitality tax on restaurant meals.

¹³ \$13.50 per barrel for distilled spirits, and \$18 per barrel for beer. Like most states, federal taxes are higher on wine with more than 14 percent alcoholic content.

The Lottery. The legislature annually appropriates receipts from the operation of the South Carolina Education Lottery. The largest appropriation goes to higher education scholarships. Deposits of lottery revenue into the Education Lottery Account were \$80.7 million in 2002, the first year of operation, and \$284.5 million in 2005, down slightly from the previous year (OSB 2005b). Lottery revenue growth will probably stabilize as the lottery loses its novelty, and the economy emerges from the recent recession. The recent adoption of a new state lottery in North Carolina will also depress lottery sales in South Carolina.

The South Carolina Education Lottery allocates 45 percent of its gross revenue for prizes, 8 percent for management expenses, and 7 percent for vendor commissions. The net revenue of 40 percent for educational purposes¹⁴ is equivalent to a 40 percent excise tax on lottery gambling. Allocations of lottery receipts vary from state to state with some states offering higher payout ratios for prizes, but South Carolina's allocation is fairly typical.

The state also collected revenue of \$10.8 million in 2004 from nonprofit organizations that conduct authorized bingo operations (DOR 2005). The charity sponsor keeps 26 percent of bingo tax revenue; two agencies on aging, the Department of Parks, Recreation and Tourism, and the state General Fund share the remainder.

DISTRIBUTION OF THE EXCISE TAX BURDEN

The excise taxes on alcohol, tobacco, motor fuel are regressive, that is, they take a higher percentage of the income of lower income households than more affluent households. As family incomes increase, households do not significantly increase their consumption of alcohol, tobacco products, or gasoline. Other excise taxes tend to be either proportional or progressive, especially taxes on tourism like accommodations, hospitality, and admissions. Most studies show that the impact of the lottery is regressive because lower income households tend to play the lottery more than middle or upper income households, although that conclusion does not always hold as jackpot sizes increase (Oster 2004).

REVENUE TRENDS

Excise taxes, like the retail sales tax, are consumption taxes, but their overall pattern of revenue growth lags that of the retail sales tax (Table 13). Because the retail sales tax is a

Table 13. Growth in Excise Tax Revenue to the General Fund

| Time Period | Average Annual Revenue Increase |
|--------------------|---------------------------------|
| 1985-86 to 2004-05 | 1.6 percent per year |
| 1992-93 to 2000-01 | -0.4 percent per year |
| 2000-01 to 2004-05 | 2.8 percent per year |

¹⁴ Detailed information about the operation of the S.C. Education lottery can be found at the lottery's Web site, www.sceducationlottery.com

percentage of the purchase price, it grows with changes in prices. Thus revenue from the retail sales tax and other ad valorem taxes rises as prices rise, even if sales volumes remain fairly constant.

Excise taxes levied on a unit of consumption, however, only generate additional revenue when unit sales or the tax rate increases. Unless the tax rate is periodically adjusted upward to account for changes in prices, inflation erodes the value of revenue from excise taxes over time as well as its share of total revenue (Figure 6). The contribution of excise taxes to the South Carolina General Fund has slowly declined from 12 percent of total revenue in the 1981 to 6 percent today (Table 14).

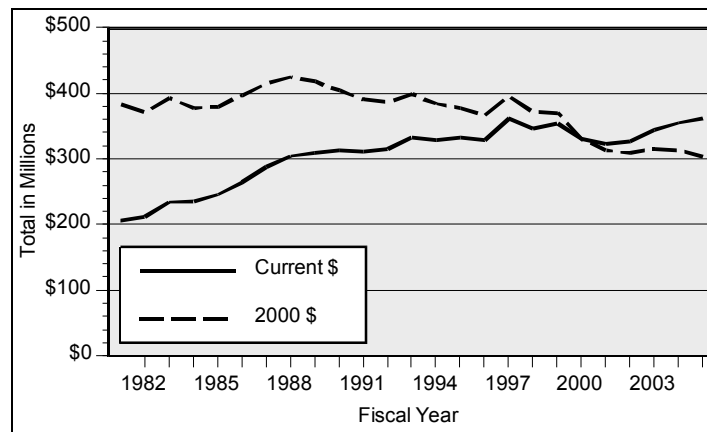


Figure 6. Excise Tax Revenue to the General Fund, 1980-81 to 2004-05

ISSUES AND EVALUATION

Excise taxes play several important roles in the South Carolina revenue system. They discourage the consumption of alcohol and tobacco and ensure that motorists pay their fair share of the cost of highways through the gasoline tax. Some excise taxes—especially tourism taxes—reduce the regressivity of the system because they are levied on items upper income groups or nonresidents consume. Tourism taxes also help to pay the higher cost of servicing a transient or seasonal population in the state’s popular tourism destinations, especially the coast.

Excise taxes account for about 6 percent of General Fund revenue today, a share that continues to decline. Excise taxes based on quantity or volume are most frequently criticized for revenue not keeping pace with inflation, as revenue from sales or income taxes does. Attempts in recent years to increase the tax rate on both tobacco and gasoline have not succeeded.

Table 14. General Fund Revenue from Excise Taxes, 1985-86 to 2004-05

| Fiscal Year | Revenue (in millions) | Annual Growth (%) | Revenue Per Capita | Annual PC Growth (%) | Share of General Fund ^a (%) |
|----------------------|--------------------------|----------------------|-----------------------|-------------------------|---|
| 1985-86 | \$265.4 | 7.9% | \$80 | 6.6% | 12.1% |
| 1986-87 | 288.4 | 8.7% | 86 | 7.5% | 11.8% |
| 1987-88 | 304.6 | 5.6% | 90 | 4.6% | 11.9% |
| 1988-89 | 309.9 | 1.7% | 90 | 0.4% | 10.6% |
| 1989-90 | 313.4 | 1.1% | 90 | -0.5% | 10.3% |
| 1990-91 | 311.8 | -0.5% | 87 | -2.5% | 10.6% |
| 1991-92 | 315.4 | 1.2% | 87 | -0.2% | 10.7% |
| 1992-93 | 332.8 | 5.5% | 91 | 4.3% | 10.4% |
| 1993-94 | 328.9 | -1.2% | 89 | -2.3% | 9.9% |
| 1994-95 ^b | 332.3 | 1.0% | 89 | -0.1% | 9.5% |
| 1995-96 | 329.2 | -1.0% | 87 | -2.2% | 9.4% |
| 1996-97 | 362.1 | 10.0% | 94 | 8.2% | 9.4% |
| 1997-98 | 346.6 | -4.3% | 88 | -5.7% | 9.1% |
| 1998-99 | 354.6 | 2.3% | 89 | 0.9% | 8.2% |
| 1999-00 | 331.1 | -6.6% | 82 | -7.8% | 7.9% |
| 2000-01 | 323.7 | -2.2% | 80 | -3.1% | 7.6% |
| 2001-02 | 326.5 | 0.9% | 80 | -0.2% | 7.9% |
| 2002-03 | 345.0 | 5.7% | 83 | 4.6% | 7.2% |
| 2003-04 | 355.2 | 2.9% | 85 | 1.9% | 6.7% |
| 2004-05 | 361.8 | 1.9% | 86 | 0.9% | 6.1% |

Source: BEA 2005, 2006.

^aIncludes individual income and corporate income tax revenue later transferred to the Trust Fund for Tax Relief.

^bTotal prior to 1994-95 contains insurance premium tax, insurance license tax, and other insurance taxes and fees; only one sum was available for all these sources. Starting in 1994-95, the excise tax total contains only the insurance premium tax.

ESTATE TAX

Taxes on estates or on inheritances have been used by governments around the world as a revenue source for several reasons. First, the transfer of assets provides a convenient, visible, and measurable basis on which to impose a tax. Second, taxing estates or inheritances makes at least some gesture toward equalization or reduced regressivity of tax systems. The tax is progressive with an initial large exemption, so it falls mainly on the wealthiest families. The large and increasing exemptions in the federal estate tax and the scheduled elimination of that tax by 2010 suggest that these rationales are no longer widely accepted. However, the revenue loss to the federal government and to state governments is substantial.

South Carolina is one of thirty-eight states that employed a pick-up estate tax, that is, a state estate tax that is equal to the maximum state death tax credit allowed under the federal Internal Revenue Code. Such a tax does not increase the total tax burden on the estate or the heirs but merely shifts revenue from the federal government to the state. However, recent changes in the federal estate tax law have eliminated that option. In the federal Economic Growth and Tax Reconciliation Act of 2001, the state death tax credit that could be taken against federal estate taxes fell by 25 percent in 2002, 50 percent in 2003, and 75 percent in 2004 in preparation for elimination in 2005 (Duncan 2002). The Board of Economic Advisors estimated that South Carolina lost \$15.5 million in revenue the first year and \$40.3 million in 2005 (BEA&ORS 2005).

Seventeen states and the District of Columbia have chosen to enact a replacement estate tax similar to the amount collected under the federal credit. States with the replacement tax, which exempts all estates left to a spouse, have exemptions ranging from \$675,000 to \$1.5 million. Since 83 percent of estates were less than \$2.5 million in 2001, very few heirs pay the highest rates. A \$2.5 million estate typically pays 2.9 percent or about \$75,000. Rates reach 16 percent in the highest bracket (McNichol 2004).

In 2003, 757 estate tax returns filed in South Carolina were for gross estates of \$1 million or more (Urban Institute and Brookings Institution 2004). For a state with a large and growing elderly population, the estate tax can be a productive revenue source. However, states that are attempting to attract retirees, such as South Carolina, may find that an estate tax is a drawback.

FEDERAL AID

Federal aid does not flow through the South Carolina General Fund. But federal aid nonetheless influences the state's revenue needs because many kinds of federal aid require a match in expenditures by state and local governments.

Some federal aid is distributed directly to individuals or passed through state agencies to individuals, such as food stamps. Other aid to individuals, such as Medicaid payments, requires the state to serve as agent for distribution and to provide a match. Some aid is distributed based on formulas, such as aid to schools with a high percentage of children from poverty-level families. Finally, some kinds of aid come as direct grants to state or local governments, either automatically by formula or competitively through grant applications or by direct congressional action. Over 63 percent of federal aid to South Carolina in 2004 funded health and human service programs, such as Medicaid (Table 15).

Table 15. Federal Aid to South Carolina State and Local Governments, 2004

| Federal Agency or Program | Federal Aid (\$1,000s) | % Share | Federal Aid Per Capita |
|--|---------------------------|---------|---------------------------|
| Total Federal Aid | \$5,543,917 | 100.0 | \$1,321 |
| Agriculture | 324,157 | 5.8 | 77 |
| Education | 104,373 | 1.9 | 25 |
| Health and Human Services | 3,506,776 | 63.3 | 835 |
| Centers for Medicare and Medicaid Services | 2,968,721 | 53.5 | 707 |
| Housing and Urban Development | 380,247 | 6.9 | 91 |
| Labor | 109,103 | 2.0 | 26 |
| Transportation | 736,906 | 13.3 | 176 |
| All Other | 382,355 | 6.9 | 91 |

Source: Census Bureau 2006.

South Carolina ranks low among southeastern states in federal aid per capita, especially when the state's relatively low personal income per capita is taken into account (Table 16). States with low personal income per capita tend to receive more federal funds than other

states because eligibility for many federal programs is tied to individual, household, or neighborhood income levels near or below the federal poverty limits.

Table 16. Federal Aid to Southeastern State and Local Governments, 2004

| State | Federal Aid (\$1,000s) | Federal Aid Per Capita | Federal Aid Rank in Southeast | Per Capita Personal Income | PCPI Rank in Southeast |
|----------------|---------------------------|---------------------------|-------------------------------------|----------------------------------|------------------------------|
| Alabama | \$6,057,110 | \$1,337 | 7 | \$27,695 | 6 |
| Arkansas | 4,123,682 | 1,498 | 6 | 25,814 | 10 |
| Florida | 18,174,467 | 1,045 | 11 | 31,469 | 2 |
| Georgia | 9,539,616 | 1,080 | 10 | 29,782 | 4 |
| Kentucky | 6,307,498 | 1,521 | 5 | 27,265 | 8 |
| Louisiana | 7,035,351 | 1,558 | 3 | 27,297 | 7 |
| Mississippi | 5,297,355 | 1,825 | 2 | 24,518 | 12 |
| North Carolina | 11,353,969 | 1,329 | 8 | 29,322 | 5 |
| South Carolina | 5,543,917 | 1,321 | 9 | 27,185 | 9 |
| Tennessee | 9,128,666 | 1,547 | 4 | 29,844 | 3 |
| Virginia | 6,598,051 | 884 | 12 | 36,160 | 1 |
| West Virginia | 3,384,459 | 1,864 | 1 | 25,792 | 11 |

Source: USBEA 2006, Census Bureau 2006.

The future of federal aid to state and local governments is uncertain. Since the big changes during the Reagan presidency, which ended general revenue sharing and reduced overall aid to states while putting more of it into block grants, federal aid programs have been relatively stable. However, the war in Iraq, recent tax cuts, and a sluggish economy have caused escalation of federal deficits and put pressure on Congress to cut back discretionary spending, such as Community Development Block Grants.

The president's proposed budget for 2007 could reduce federal revenue to states in coming years. The Center for Budget and Policy Priorities estimates that if enacted, the Bush administration's budget proposal could cost South Carolina \$172 million in federal revenue between 2007 and 2011 (Lav 2006).

BORROWING AS A REVENUE SOURCE

Like most state governments, South Carolina, is required by law to balance its General Fund budget. However, the state as well as its local governments frequently borrows for various reasons. The state may borrow to finance capital improvements, for emergencies, or occasionally to meet cash flow problems. The state issues bonds, which pay lower than average interest rates because interest income from government bonds is exempt from both federal and state income taxes. The majority of the state's bonded indebtedness finances the construction and renovation of facilities. Bonds allow the state government to advance the construction of major capital projects by spreading the repayment obligation over the many years the facility will be in service.

General obligation bonds are of the greatest interest to legislators, state budget officials, and policy analysts because the payment of bonds is guaranteed by the general taxing power of the state. Principal and interest on general obligation bonds is paid directly from appropriated general funds or by earmarked revenues but guaranteed by general funds. Interest rates on bonds are lower if the state has a good credit rating that reflects both fiscal health and budget history.

As of June 30, 2005, the state was obligated to pay \$2.3 billion of the over \$2.5 billion in outstanding general obligation state debt in bonds and notes from state General Fund revenue. Higher education institutions were responsible for payment of \$230 million. Low interest rates combined with growth in the General Fund enabled the state to increase bond issues in recent years. Throughout the 1990s, net general obligation debt outstanding in South Carolina was below \$300 per capita, but by 2001 it had risen to over \$500 per capita and has remained at that higher level since that time (Table 17).

Table 17. South Carolina General Obligation Debt, 2005

| Fiscal Year | Total G.O. Debt Outstanding (in millions)* | Debt Payable by Higher Ed Fund (in millions)* | Net G.O. Debt Outstanding (in millions)* | Net G.O. Debt Outstanding Per Capital* |
|-------------|--|---|--|--|
| 1990-91 | \$828.6 | \$28.6 | \$800.1 | \$225 |
| 1991-92 | 876.3 | 44.6 | 831.7 | 231 |
| 1992-93 | 884.0 | 43.2 | 840.8 | 230 |
| 1993-94 | 929.6 | 40.4 | 889.2 | 240 |
| 1994-95 | 898.0 | 44.3 | 853.7 | 228 |
| 1995-96 | 1,007.4 | 41.9 | 965.5 | 254 |
| 1996-97 | 1,052.2 | 85.4 | 966.8 | 250 |
| 1997-98 | 1,036.6 | 84.5 | 952.2 | 243 |
| 1998-99 | 1,218.9 | 78.3 | 1,140.6 | 287 |
| 1999-00 | 1,493.6 | 99.9 | 1,393.6 | 346 |
| 2000-01 | 2,151.8 | 96.3 | 2,055.5 | 506 |
| 2001-02 | 2,348.6 | 142.6 | 2,206.0 | 538 |
| 2002-03 | 2,448.1 | 209.0 | 2,239.2 | 540 |
| 2003-04 | 2,509.0 | 242.7 | 2,266.3 | 543 |
| 2004-05 | 2,528.7 | 230.4 | 2,298.3 | 545 |

Source: South Carolina Comptroller General 2005.

*As of June 30.

Revenue bonds, in contrast, are used for projects that generate fees or other income that can be earmarked for bond payments, such as dormitories, parking garages, and recreational facilities. Revenue bonds are of little immediate policy interest because state general revenue are not used for debt service and cannot be appropriated for this purpose if payments go into default. However, if the state wanted to make greater use of revenue bonds, it would pay higher interest than on general obligation debt because state backing in case of default would be lacking.

The South Carolina constitution and state law limits the annual debt service or principal and interest that the General Assembly can obligate itself to pay to 5.5 percent of General Fund

revenue collected the year previous to a legislative session.¹⁵ This limit protects the General Fund from excessive spending demands for repayment of principal and interest on bonded indebtedness. State public school facilities bonds and capital improvement bonds are the primary types of bonds that fall under this debt service limitation. 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.

State higher education institution bonds and state highway bonds are general obligation bonds; however, debt service on these bonds is mostly paid using revenues that are not part of the state's General Fund. These bonds also have separate debt service limitations, which are linked to the revenues used for repayment. Debt service on state institutional bonds is paid by the Higher Education Fund, an enterprise fund containing revenues for the operation of the state's ten four-year colleges and universities and sixteen technical colleges. The debt service limitation on higher education bonds is 90 percent of tuition received by an institution in the previous fiscal year.

Debt service on state highway bonds is paid by the Department of Transportation's special revenue fund, the repository for state motor fuel tax revenues and other earmarked transportation fees. The debt service limitation for state highway bonds is 15 percent of revenues collected in the previous year. Appropriations from the General Fund for debt service on state institutional bonds and state highway bonds are not included when calculating the general obligation debt service ceiling of 5.5 percent of the General Fund (South Carolina Comptroller General 2005, 204-205).

When bonds are issued, the face value of the bond, the interest rate, and the term of repayment all work together to determine the amount of annual debt service that the issuer pays (Table 18). The state of South Carolina maintained the highest rating on its bond issues for a number of years. This vote of confidence from the independent bond rating agencies allowed the state to issue bonds at the lowest prevailing interest rates, which maximized the amount of money the state could raise using this financing tool. In July 2005, Standard & Poors downgraded the state's general obligation bonds slightly, pointing to slow economic growth and high unemployment following the recession that started in 2000 (South Carolina Comptroller General 2005, 32).

¹⁵The 5.5 percent limitation on debt service is calculated on the previous year's General Fund minus any General Fund revenues pledged to pay state institution or highway bonds.

Table 18. South Carolina General Obligation Debt Service, 1990-91 to 2004-05

| Fiscal Year | General Fund Spending on Debt Service (in millions) | Debt Service as % of Prior Year's General Fund |
|-------------|---|--|
| 1990-91 | \$ 118.1 | -- |
| 1991-92 | 118.9 | 3.6 |
| 1992-93 | 159.5 | 4.8 |
| 1993-94 | 136.6 | 3.7 |
| 1994-95 | 141.2 | 3.5 |
| 1995-96 | 136.5 | 3.2 |
| 1996-97 | 156.8 | 3.6 |
| 1997-98 | 150.6 | 3.3 |
| 1998-99 | 147.3 | 3.0 |
| 1999-00 | 129.0 | 2.6 |
| 2000-01 | 170.3 | 3.4 |
| 2001-02 | 179.1 | 3.6 |
| 2002-03 | 212.1 | 4.4 |
| 2003-04 | 209.5 | 4.3 |
| 2004-05 | 229.3 | 3.8 |

Source: OSB 2005b.

FEES AND SERVICE CHARGES

South Carolina and other states rely on fees, service charges, licenses, permits and other miscellaneous revenue to rebalance the revenue portfolio around collections from major sources such as sales and income taxes. States also use these mostly non-tax revenue sources to clearly link, in some cases, payments made and services received by the individual citizen.

Both state and local governments in South Carolina rely more heavily on fees and charges than do most other states.¹⁶ At the state level, automobile license plates and drivers' licenses, fees for state parks, and tuition at public universities and technical colleges fall into this category, just to name a few. Much of this revenue does not flow through the General Fund but rather goes directly to the service-providing agency to supplement its state appropriations used to cover the cost of operations.

THE RATIONALE FOR FEES AND CHARGES

Greater reliance on fees and charges represents a shift from a philosophy of shared consumption of public services toward a *user pays* and *government as a business* way of thinking. Some government services, such as police protection and provision of roads, benefit most citizens. However, other services a few citizens used heavily. If users are not poor, elderly, children, disabled, or otherwise deserving of special consideration, it seems appropriate that at least part of the cost should be paid by the user rather than shifting the entire cost to other taxpayers. Building inspection, recreation, and parking services fall into the category of private benefits.

¹⁶ See Porča, Saltzman, and Ulbrich (2005) for interstate comparisons.

Most government services benefit some more than others. Roads and solid waste collection benefit everyone, but some people use them more than others. For such goods, often a mix of tax financing and some fees based on usage are the answer to the mix of public and private benefits. Fees and charges also effectively extract some revenue from tax-exempt entities including schools, churches, colleges and state agencies that use public services. Finally, fees and charges are a relatively flexible tax tool. A modest adjustment in a fee or service may be all that is needed to balance a budget, whereas an increase in the income, sales, or property tax rate will raise more revenue than required.

DISTRIBUTION OF THE TAX BURDEN FROM FEES AND CHARGES

The burden of fees and charges falls on those who use the service. Citizens find fees and charges like hunting licenses, parking fees, and admission to parks appealing, because they offer a degree of choice or control. However, everyone pays uniform flat fees for services like recreation or solid waste collection regardless of the level of use. Flat fees are regressive because they are the same for everyone regardless of either usage or income. Poor people are more likely to use public facilities rather than private facilities, such as a public swimming pool instead of a private one in the back yard or at the country club, so they may also pay more for that reason.

Not all fees are regressive. Impact fees on new development help place the burden of providing local public capital improvements from current residents to newer ones, who are often more affluent and benefit from the new infrastructure. Some fees have two components, one a flat fee that pays for availability, the other based on usage or volume. Such fees may be less regressive than a simple flat fee. But overall, the shift toward fees and charges appears to be making the revenue system more regressive.

TRENDS IN REVENUE FROM FEES AND CHARGES

The state of South Carolina collected nearly \$5.0 billion in revenue from charges for service in primary government activities in 2005, according to the South Carolina Comptroller General's Office (2005). Most of these revenues were directly collected by state agencies or were earmarked for special funds. Sixty-four percent was collected by state programs that operate more like businesses, such as higher education institutions, unemployment compensation and other insurance programs, and housing and student loan financing programs. Only a small share of total charges for service went into the South Carolina General Fund in 2005. Above and beyond the \$5.0 billion in revenue from charges for service collected for primary government activities, the state's separate component units collected an additional \$2.3 billion.¹⁷

¹⁷ The state's component units, which are legally separate from state government although the state's elected officials are financially accountable for them, include Santee-Cooper Public Service Authority, the State Ports Authority, the Connector 2000 Association, and the Lottery Commission.

Long-term trends in charges for services over all primary governmental activities in South Carolina were difficult to track until recent changes to the format of the state's *Comprehensive Annual Financial Report* (Table 19). The significant growth in revenue from fees and charges in the state's business-type activities was largely due to increases in revenue from higher education. These revenues, which are mostly tuition and fees, grew from \$1.75 billion in 2002 to over \$2.7 billion in 2005 as state General Fund appropriations for higher education did not keep up with the growing cost of services.

Table 19. Revenue from Charges for Service for Primary Government Activities and Component Units, 2001-02 to 2004-05

| Fiscal Year | Governmental Activities | | Business-Type Activities | | Component Units | |
|-------------|--------------------------|-----------------------|--------------------------|-----------------------|--------------------------|-----------------------|
| | Revenue (in billions) | Revenue Per Capita | Revenue (in billions) | Revenue Per Capita | Revenue (in billions) | Revenue Per Capita |
| 2001-02 | \$1.7 | \$425 | \$2.2 | \$526 | \$1.4 | \$345 |
| 2002-03 | 1.5 | 362 | 2.8 | 678 | 1.9 | 459 |
| 2003-04 | 1.6 | 382 | 3.0 | 719 | 2.2 | 515 |
| 2004-05 | 1.8 | 429 | 3.2 | 750 | 2.3 | 544 |

Source: South Carolina Comptroller General 2005.

Sources of fee and service charge revenue to the South Carolina General Fund include departmental revenue, motor transport fees and motor vehicle licenses, workers compensation insurance, circuit and family court fines, mental health fees and parole and probation fees. (Other miscellaneous revenue in this total comes from interest on investments, the documentary stamp tax, estate and gift taxes, and indirect cost recoveries.)

Revenue from fees and charges increased in 1994 when revenue from motor vehicle license fees was directed to the General Fund. Since 1999, however, some revenue from motor vehicle license fees and motor transport fees has been directed to the South Carolina Transportation Infrastructure Bank and the Department of Transportation Special Revenue Fund. Such legislative actions, along with fluctuations in revenue from other fee sources due to economic conditions or for other reasons, have slowed growth in this revenue source (Table 20).

ISSUES AND EVALUATION

Fees and charges have a role to play in any public revenue system. Fees and charges help to assign the cost of public services to those who use them most. They are a flexible revenue tool that can help bridge smaller gaps between revenue and expenditures to balance state or local budgets. Although generally regressive, fees can be designed to spread the tax burden more equitably by basing them on the degree of use rather than just access. However, they should not be the primary revenue source for any government but rather one of a collection of revenue tools with different qualities or characteristics to create an overall revenue system that is adequate, efficient, equitable, responsive and transparent.

Taxes are still the means of choice for support of general government functions that benefit everyone, while fees and charges are more suited to those public goods and services that benefit particular citizens, especially when those citizens are able to pay a part of the cost. South Carolina relies more heavily on fees and charges than many other states, in part because of resistance to tax increases including no-new-tax pledges by many legislators.

Table 20. General Fund Revenue from Fees, Service Charges, and Miscellaneous Sources, 1985-86 to 2004-05

| Fiscal Year | Revenue (in millions) | Annual Increase (%) | Revenue Per Capita | Annual Increase (%) |
|----------------------|--------------------------|------------------------|-----------------------|------------------------|
| 1985-86 | \$186.0 | 14.3% | \$56 | 13.0% |
| 1986-87 | 182.4 | -1.9% | 54 | -3.0% |
| 1987-88 | 199.9 | 9.6% | 59 | 8.6% |
| 1988-89 | 195.7 | -2.1% | 57 | -3.4% |
| 1989-90 | 212.0 | 8.4% | 61 | 6.7% |
| 1990-91 | 205.4 | -3.1% | 58 | -5.0% |
| 1991-92 | 205.7 | 0.1% | 57 | -1.3% |
| 1992-93 | 198.7 | -3.4% | 54 | -4.6% |
| 1993-94 | 276.6 | 39.2% | 75 | 37.7% |
| 1994-95 ^a | 310.9 | 12.4% | 83 | 11.1% |
| 1995-96 | 307.3 | -1.1% | 81 | -2.4% |
| 1996-97 | 304.0 | -1.1% | 79 | -2.7% |
| 1997-98 | 343.8 | 13.1% | 88 | 11.4% |
| 1998-99 | 363.1 | 5.6% | 91 | 4.1% |
| 1999-00 | 289.3 | -20.3% | 72 | -21.3% |
| 2000-01 | 299.8 | 3.6% | 74 | 2.7% |
| 2001-02 | 315.1 | 5.1% | 77 | 4.0% |
| 2002-03 | 241.3 | -23.4% | 58 | -24.2% |
| 2003-04 | 238.5 | -1.2% | 57 | -2.1% |
| 2004-05 | 234.9 | -1.5% | 56 | -2.5% |

Source: BCB 2005, 2006.

CONCLUSION

Since the adoption of the sales tax in the 1950s, South Carolina has enjoyed a balanced state revenue system that deserves reasonably good marks for adequacy, equity and efficiency.

Like the majority of states (36), South Carolina relies on the two major broad-based taxes for the bulk of state revenue; the individual income tax and the retail sales tax. These two taxes are supplemented by a modest level of business income taxation, the usual array of excise taxes, and a variety of fees and charges. In general, states that use both individual income and retail sales taxes as revenue sources are able to maintain more moderate tax rates overall than states that have either no broad-based income tax or no broad-based sales tax.

South Carolina's rates for the major state taxes are generally within national norms; the sales tax is somewhat low and some of the excise taxes (particularly on tobacco and gaso-

line) are also well below national levels. The greatest divergence from national patterns is the heavy reliance on fees and charges in South Carolina at both the state and local level.

Three clouds hang over the state revenue picture. One is a threat to adequacy—whether a revenue system that relies mainly on sales taxes on tangible goods and an individual income tax that is constantly seeing added adjustments, exclusions, and deductions can continue to produce enough revenue to meet state needs in the long term. Sales taxes are particularly vulnerable to nontaxed competition in a global economy with Internet, catalog, and cross-border shopping. The failure to adjust excise taxes upward at least to compensate for inflation, especially taxes on gasoline and alcohol, is another divergence from national trends that slows the growth of revenue.

The second cloud is instability—the fluctuations in revenue that parallel the fluctuations in the state and national economy. Both the individual income tax and the sales tax are sensitive to changing economic conditions, making it difficult to budget responsibly in good times and to meet the basic needs of the state when worsening economic conditions produce less revenue.

The third cloud is equity—changes in the distribution of the tax burden that favor some groups at the expense of others, not just rich over poor but also old over young, homeowners over other property taxpayers, and new business over old business. Like most states, South Carolina's tax system is mildly regressive, and the revenue system (which includes fees and charges) is even more regressive because fees tend to fall more heavily on lower income families. Tax changes in the income and property tax that favor wealthy retirees and homeowners over younger families and renters, failure to expand the sales tax to include more services, and increasing reliance on fees all shift the tax burden increasingly to those least able to pay.

Any threat is also an opportunity. The changes in the economy, the changes in national patterns of state taxation and expenditure, have stimulated dialogue inside and outside the state about how to structure our tax system so as to encourage investment and economic growth while ensuring adequate public revenue and distributing the burden in such a way that everyone pays a fair price for public goods and services. South Carolina has conducted such dialogues in the past, particularly in the 1920s, the 1950s, and the 1970s.

In the 1990s and into the new century, however, the approach to the revenue system has been much more piecemeal and less systemic than at critical earlier times in the state's history. Faced with multiple challenges, and looking at the experiences of other states in adjusting to similar circumstances, the conversation about state revenue sources needs to be continued and expanded, looking systemically at the state's revenue sources and how they might need to be adjusted to changing goals and a changing economy.

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