



SOUTHSCAROLINA



DEPARTMENT OF COMMERCE

SC Tax Policy & Economic Growth

*A Report to the
SC Tax Realignment Commission*

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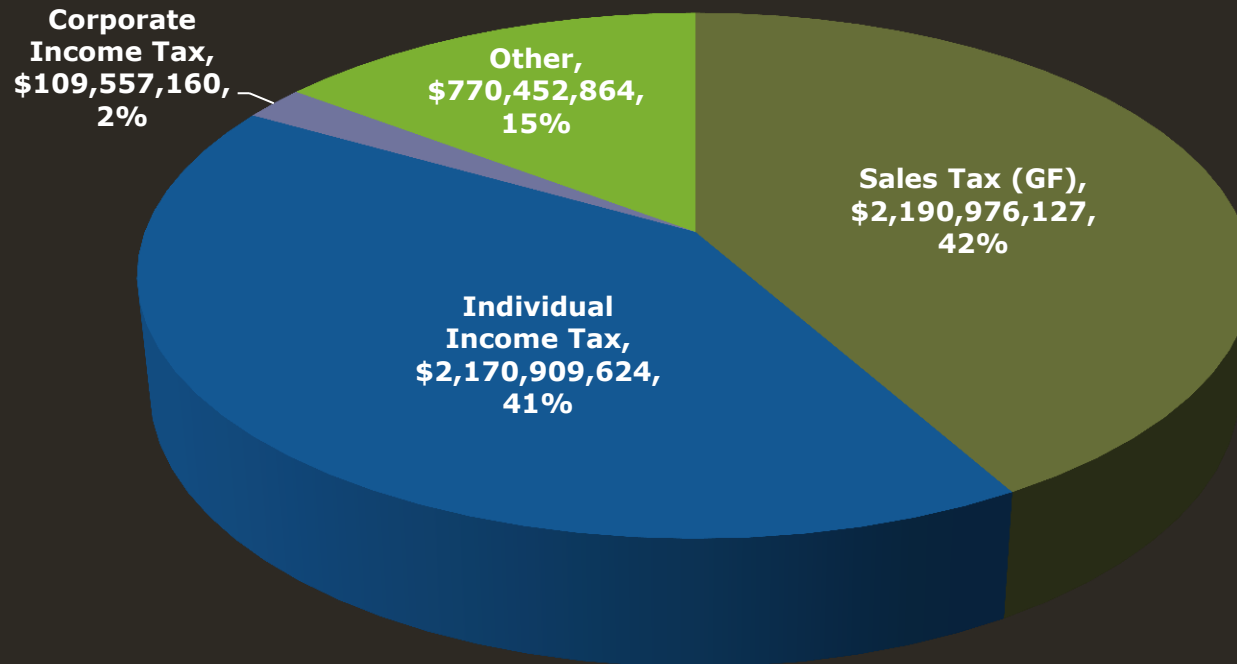


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SC Tax Revenue Overview

SC Tax Revenue Overview

South Carolina General Fund Revenue, FY 2009-2010

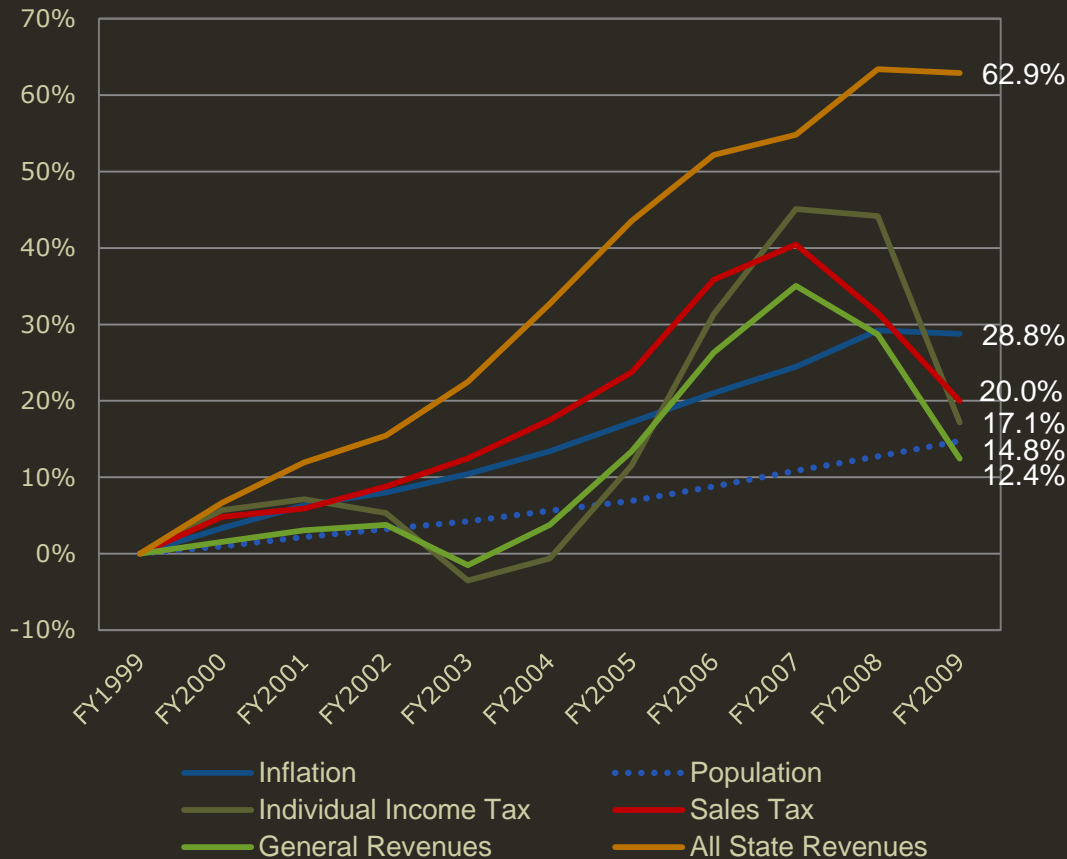


Source: South Carolina Comptroller General's End of Year Press Release



SC Tax Revenue Overview

State Revenue Growth



State Revenues

Volatile General Revenue growth

- Rapid Expansion after FY 2003
- Rapid decline after FY 2007

Total state revenues have grown much more rapidly. Includes...

- Federal (97.4% increase; \$6.8b)
- All Retail Sales & Use Tax, (55% increase; \$3.9b)
- Licenses, Fees, Fines, Contributions, Tobacco Legal Settlement, etc.

Goals of Study

Comprehensive look at revenue sources

- Impact on economic incentives
- Methods for measuring effect of policy changes
- Process for identifying an optimal tax system

Sources: SC Comptroller General's Consolidated Annual Financial Reports, FY1999-FY2009, US Census, US Bureau of Labor Statistics



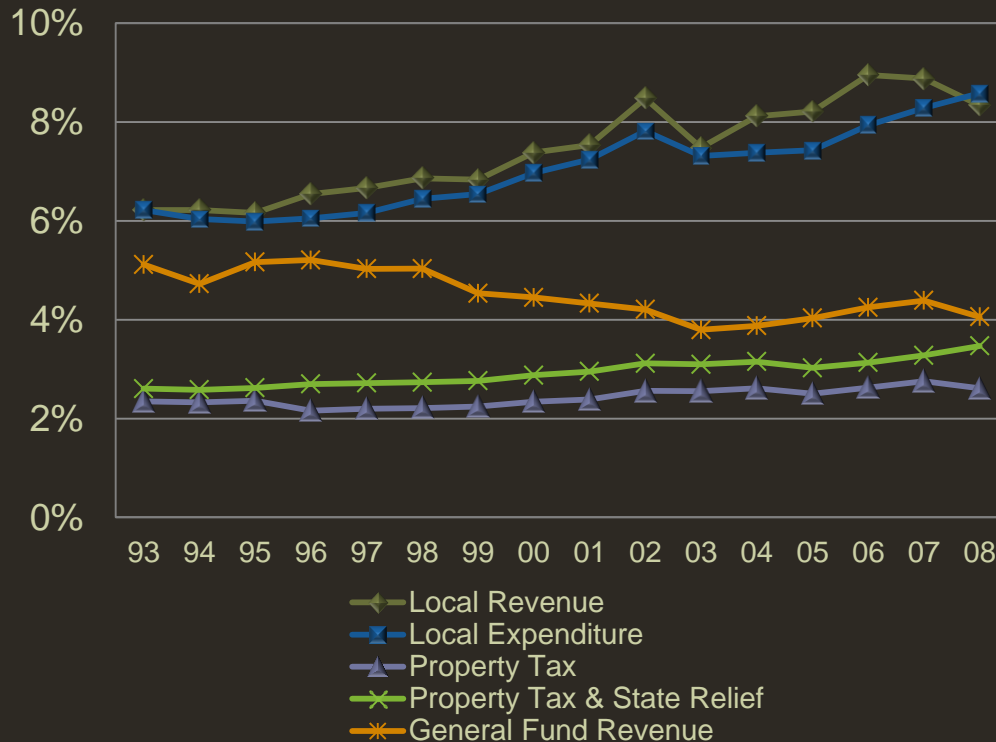
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Property Tax



Property Tax

Local Government Finances as % of State GDP



Sources: Office of Research and Statistics, South Carolina Budget and Control Board, Local Government Reports; US Bureau of Economic Analysis

LOCAL EXPENDITURES

Local government spending increased...

- from 6.2% to 8.6% of GSP (93-08).
- from \$1,649 in 1993 to \$2,762 in 2008 (real, per-capita), 67.5% total or 3.5% compounded annually.

PROPERTY TAX RELIEF

SC laws to provide tax relief...

- Homestead Exemption (1972)
- Residential Exemption (1994, 2006)
- 15% Reassessment Cap (2006)

Regardless, property taxes have grown

- from 2.2% to 2.8% of GSP (93-08).

State relief for exemptions has grown

- from \$18m to \$964.5m (93-08).
- from \$6.30 to \$198.50 (real, per-capita), 3,036% total or 25.8% compounded annually.



Property Tax

1

Constraints on Local Expenditure Growth

Millage Rate Increases

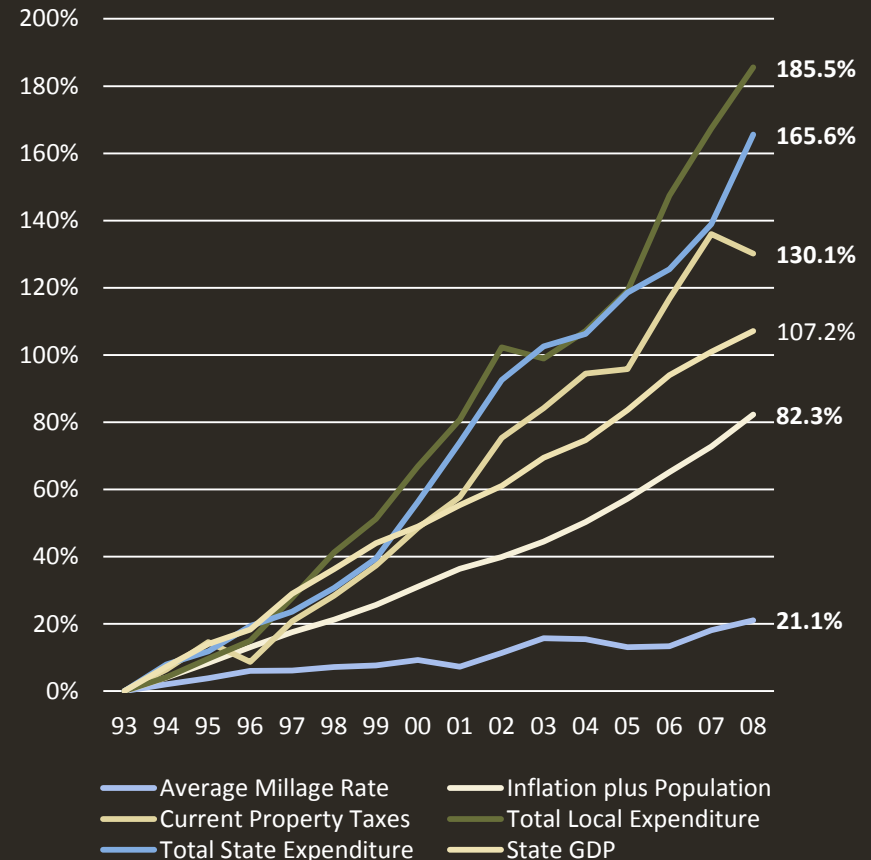
Counties may increase millage rates year-over-year to reflect increases up to the CPI plus their resident population.

Property Valuation Increases

Counties perform general reassessments every 5 years, but reappraisals can occur at other times too. Home values do not always follow the CPI.

Large Summed Increases

Property taxes are able to increase at levels greater than either housing price index or CPI plus population.



$$\text{PROPERTY TAX} = (\text{PROPERTY VALUATION}) \times (\text{ASSESSMENT RATE}) \times (\text{MILLAGE RATE})$$



Property Tax

2 Variance in Assessment Rates

| | AL | FL | GA | LA ¹ | MS | NC | SC | TN | VA |
|----------------------------|-----|------|-----|-----------------|-----|------|-------|-----|------|
| Owner-Occupied Residential | 10% | 100% | 40% | 10% | 10% | 100% | 4% | 25% | 100% |
| Other Real | 20% | | | 15% | | | 6% | 40% | |
| Agricultural (Private) | 10% | | 30% | 10% | 15% | | 4% | 25% | |
| Agricultural (Corp) | | | | | | | 6% | | |
| Motor Vehicles | 15% | | 40% | 15% | 30% | | 6% | 30% | |
| Personal | 20% | | | | 15% | | 10.5% | 40% | |
| Manufacturing | | | | | 30% | | 10.5% | 55% | |
| Utility | 30% | | | | | | 9.5% | 40% | |
| Motor Carriers | 20% | | | | 15% | | 10.5% | | |
| Business Personal | | | | | | | | | |
| Other Public Service | | | 25% | | | | | | |

¹ All land in Louisiana, both residential and commercial, is assessed at a rate of 10% of fair market value. Residential buildings are assessed at a rate of 10%, and commercial buildings are assessed at a rate of 15%.

ASSESSMENT RATES

17 states have classified assessment systems...

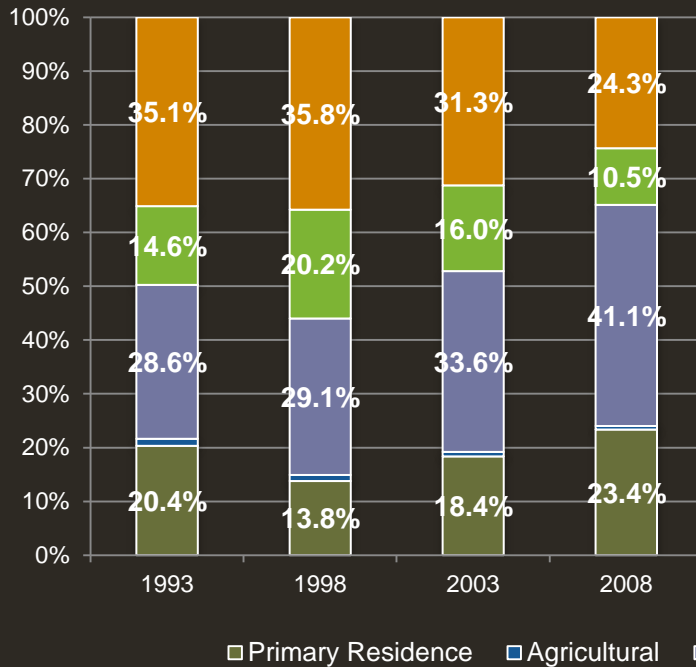
- South Carolina has the most categories at 10 and the most rates at 4. (AL & TN also have 4 rates.)
- One of 4 SE states (LA, MS, SC, TN) with different assessment rates for primary residential and other real property.
- FL, NC, and VA have uniform assessments of 100%.
- Industrial real and business personal assessed at 2.625 times the rate of primary residential, more than all other SE states.



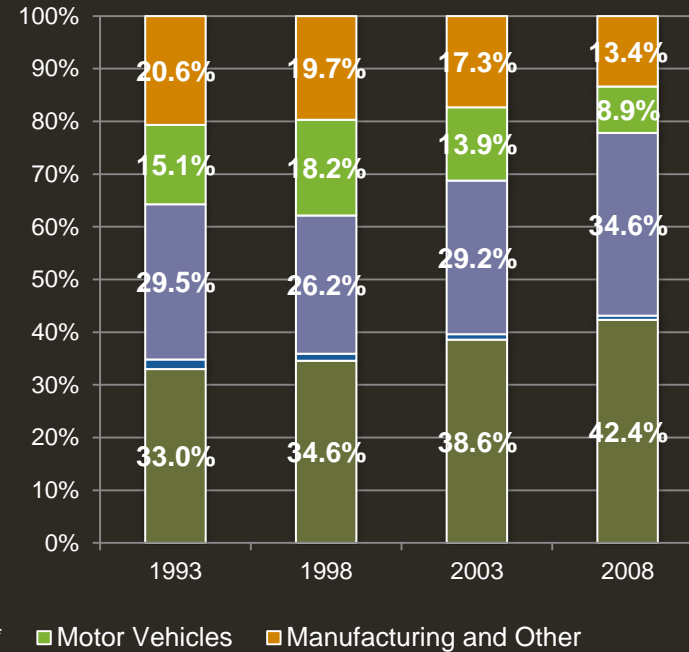
Property Tax

2 Variance in Assessment Rates

Distribution of Property Tax Revenues by Category



Distribution of Property Values by Category



Source: Office of Research and Statistics, South Carolina Budget and Control Board.
 Notes: *Other Real includes rental, commercial, and second residences.



Property Tax

3 Disparate Valuation Methods

“MARKET” & “TAXABLE” VALUES OFTEN DIFFER FROM TRUE MARKET PRICE

Sales price, market value, and taxable value vary considerably

- The State Newspaper article “S.C.’s Unhappy Homeowners” –October 24, 2010
- Changes in the market occur more rapidly than changes in appraisals

EXEMPTION STATUS CAN VARY ACROSS COUNTIES AND ASSESSOR OFFICES

Exemptions...

- Foster inequity across municipalities
- Have the potential to be subjective and unevenly applied even within the same jurisdiction
- Shrink the tax base
- Shift the tax burden
- Complicate the tax structure



Property Tax

4 Exemptions

South Carolina has 47 total exemptions for property tax (see S.C. Code § 12-37-220), some of which have not been reexamined for a number of years.

Exemptions for Residential Homeowners, Homestead, and Manufacturer's Depreciation that were reimbursed by the state totaled \$964.5 million in 2008 and \$1,059.7 million in 2009.

1. Homestead Exemption began in 1972 with an exemption of \$20,000 for those 65+.
 - Expanded to \$50,000 in 2001.
 - Credit increased from \$45.9 million to \$156.2 million (2000 to 2008).
 - Number of claimants is anticipated to increase rapidly with the retirement of the baby boomers.
 - Percentage of elderly population in poverty is declining, statewide and nationwide (13.9% in 2000 vs. 12.1% in 2008).
2. FILOT began in 1987. It allows manufacturing properties a rate of 6% for 30 years with a \$2.5 million investment or 4% for 40 years with \$100 million and 125 jobs. Allows fixed millage rate.
 - Establishes competitive, stable rates for businesses.
 - Favors new, large capital investments over existing, smaller capital.

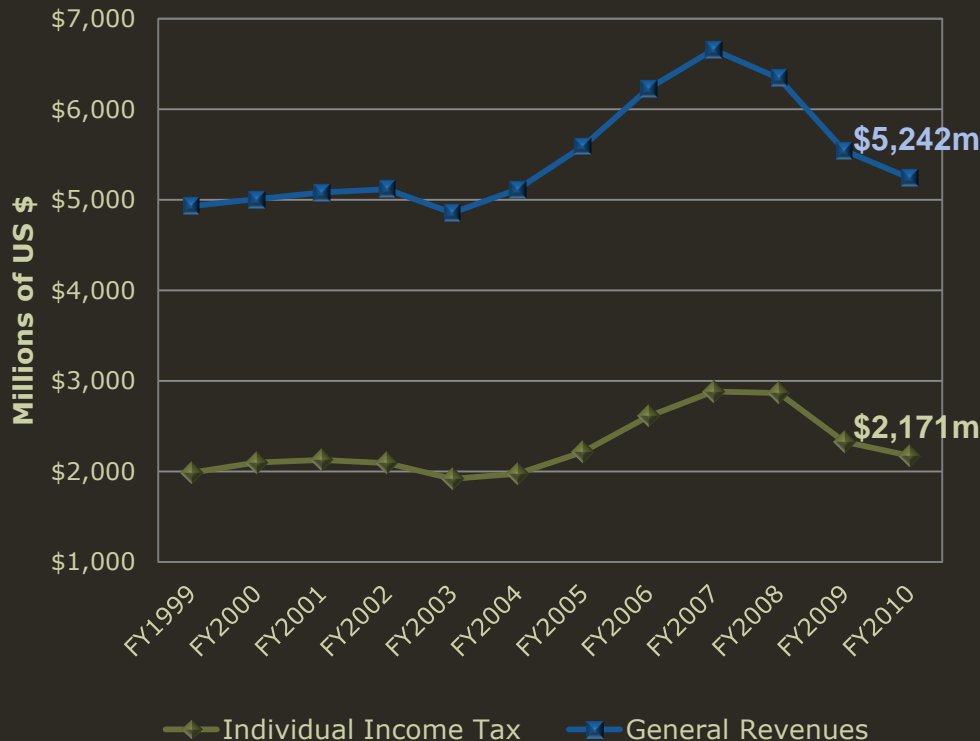


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Personal Income Tax

Personal Income Tax

State Personal Income Tax Revenues



KEY POLICY CHANGES

Changes affecting individual income tax revenues include:

- Federal Tax Relief (2004) increased the width of the tax bracket for married couples.
- Reduced tax rates for pass through entities (2006) incrementally from 7% to 5%.
- Elimination of lowest (2.5%) tax bracket (2007)

Source: S.C. Comptroller General's Consolidated Annual Financial Reports



Personal Income Tax

1 High Marginal Tax Rates on Low Taxable Income

Over time, tax bracket changes have not kept pace with inflation, moving taxpayers into higher tax brackets.

| Tax Rate | Starting Income (1959) | Starting Income (2010) | Starting Income (CPI-Adjusted from 1959) |
|----------|------------------------|------------------------|--|
| 2.5% | \$0 | - | \$0 |
| 3% | \$2,000 | \$2,670 | \$14,700 |
| 4% | \$4,000 | \$5,340 | \$29,400 |
| 5% | \$6,000 | \$8,010 | \$44,100 |
| 6% | \$8,000 | \$10,680 | \$58,900 |
| 7% | \$10,000 | \$13,350 | \$73,600 |

Higher tax on labor income discourages human capital investment and entrepreneurial activities.

- **"I Can Afford Higher Taxes. But They'll Make Me Work Less."** –N. Gregory Mankiw, *N.Y. Times Op Ed*, 10/4/2010

Higher tax rates on higher tax brackets results in greater inefficiencies.

- **Deadweight Loss:** The value of work that would have taken place but doesn't because of tax incidence.



Personal Income Tax

1 High Marginal Tax Rates on Low Taxable Income

South Carolina has the highest marginal tax rate on the lowest level of taxable income in the SE.

But, the state allows larger standard deductions and exemptions than most southeastern states.

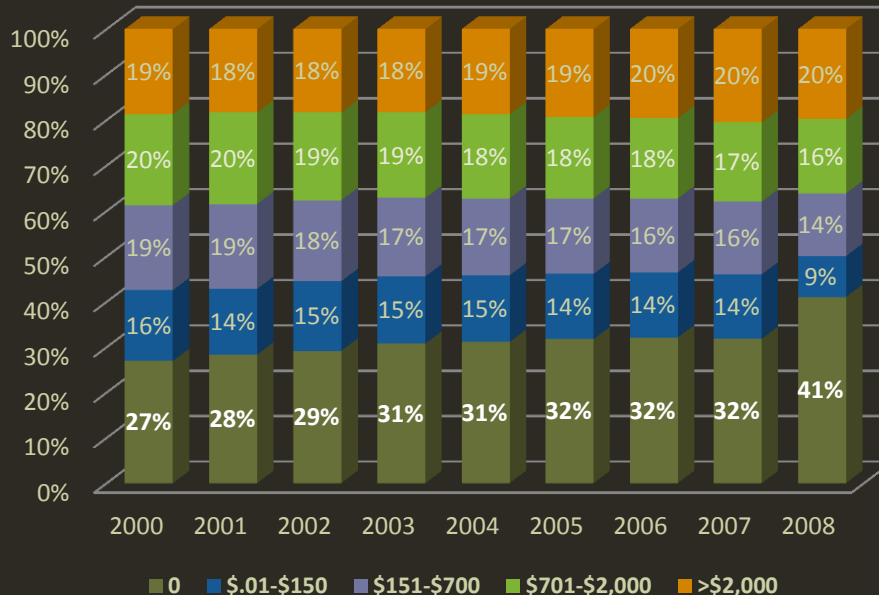
| State | Highest Marginal Tax Rate | Top Tax Rate Income Threshold | Standard Deduction (Single) | Standard Deduction (Joint) | Personal Exemption (Single) | Personal Exemption (Dependent) |
|----------------|---------------------------|-------------------------------|-----------------------------|----------------------------|-----------------------------|--------------------------------|
| Alabama | 5% | \$3,000 | \$2,000 | \$4,000 | \$1,500 | \$300 |
| Georgia | 6% | \$7,000 | \$2,300 | \$4,300 | \$2,700 | \$3,000 |
| Louisiana | 6% | \$50,000 | NA | NA | \$4,500 | \$1,000 |
| Mississippi | 5% | \$10,000 | \$2,300 | \$4,600 | \$6,000 | \$1,500 |
| North Carolina | 7.75% | \$60,000 | \$3,000 | \$6,000 | \$2,000 | \$100 credit |
| South Carolina | 7% | \$13,350 | \$5,700 | \$11,400 | \$3,650 | \$3,650 |
| Virginia | 5.75% | \$13,000 | \$3,000 | \$6,000 | \$930 | \$930 |



Personal Income Tax

2 Rapidly Increasing Number of Taxpayers with \$0 Liability

Returns Filed by Tax Liability



Source: SC Department of Revenue

TAXABLE INCOME

In 2008, 41.0% of individual filers paid no state income tax.

- Up from 27.0% in 2000
- Up from 31.8% in 2007

CAUSALITY

Explanations for declining tax liability...

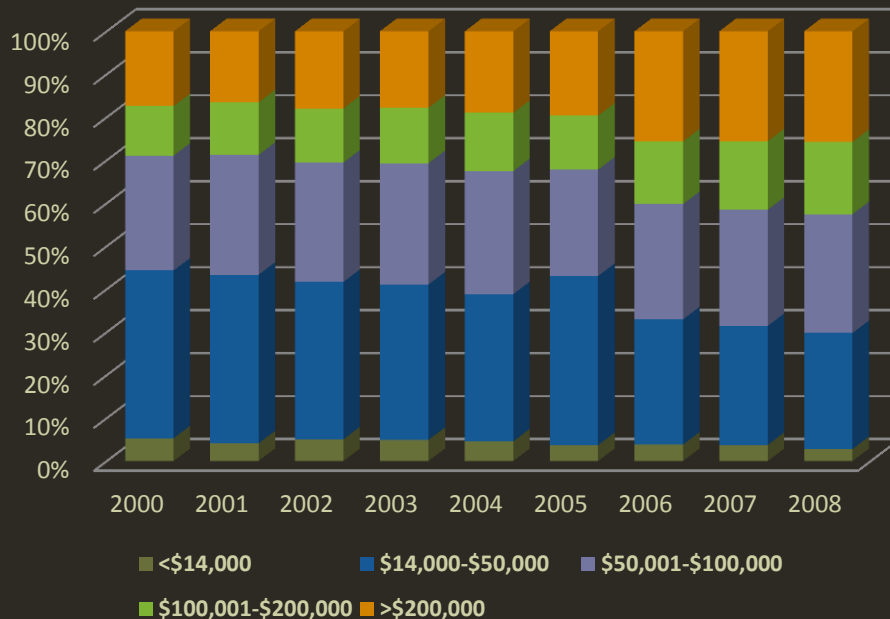
- Using federal taxable income rather than AGI as the starting point for calculating state taxable income
- High level of state standard deductions and personal exemptions
- Increasing tax credits and targeted deductions
- Elimination of the 2.5% tax bracket



Personal Income Tax

2 Rapidly Increasing Number of Taxpayers with \$0 Liability

Tax Liability by Taxable Income



Source: SC Department of Revenue

TAX LIABILITY

In 2008, individuals in the 7% tax bracket (taxable income greater than \$13,150)...

- Made up 42% of returns filed.
- Bore 96% of the tax liability.

IMPLICATIONS

Progressivity exists only in a very narrow range of taxable income.

- SC's income tax structure effectively becoming a high flat tax with a large range of exempt income (a 2-tiered bracket).
- Trend: A greater percentage of those filing returns will pay no income taxes, while the entire burden will fall on fewer and fewer individuals.



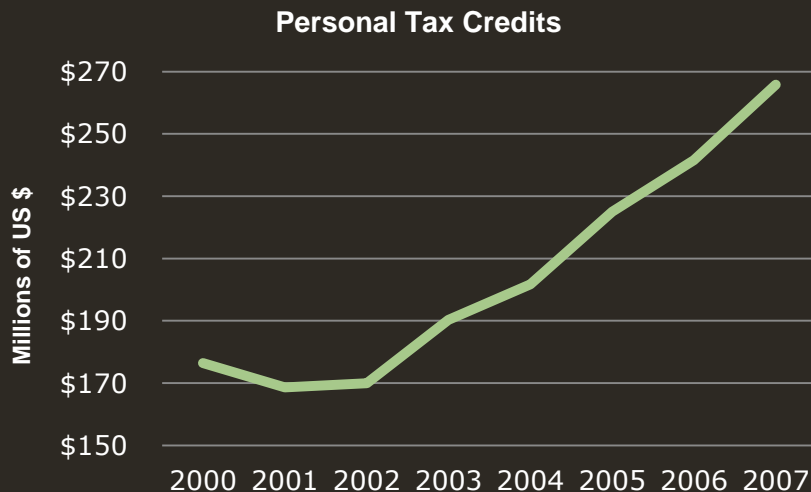
Personal Income Tax

3 Credits and Deductions

South Carolina allows 36 personal income tax credits.

The most substantial include...

- Non-resident credit (61%)
- Two-wage earner credit (22%)
- Child care credit (9%)



Source: SC Department of Revenue

TARGETED DEDUCTIONS & ADVANTAGES

Standard Deductions & Exemptions

- Single: \$5,700
- Head of Household: \$8,350
- Married Filing Jointly: \$11,400
- Additional Deduction for 65+: \$1,100
- Per Taxpayer and Per Dependent: \$3,650

Social Security Income: Exempt

Qualifying Retirement Income

- Until age 65: \$3,000
- Age 65+ (both spouses): \$10,000

65+ Income Deduction (both spouses): \$15,000

Income From Pass-Through Entity (Schedule C):

- 5% instead of 7%



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Corporate Income Tax



Corporate Income Tax

State Corporate Tax Revenues



Source: Comptroller General's Office

CORPORATE TAX

Collections highly variable year-over-year

- Totaled \$109.6 million (2.1% of state general revenues) in FY 2010.
- Sparse data on firms paying corporate tax:
 - 80,866 filers in 2008.
 - An estimated 89% have \$0 liability.
 - An estimated 68% of revenues comes from foreign firms.
- SC also imposes a corporation franchise fee, collecting \$73.4 million in FY2010.

OTHER STATES

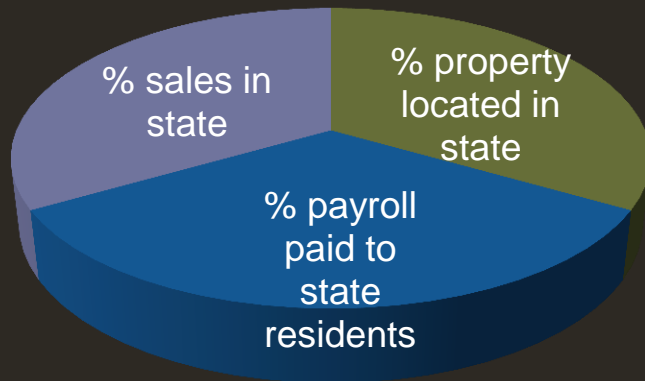
SC has one of the lowest corporate income tax rates.

- Other states impose gross receipts tax (GRT), franchise tax, or additional tax on property, payroll, capital, etc.

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Single Sales Factor

In 1957, the Uniform Division of Income for Tax Purposes Act prescribed 3 factors to be used in determining the percentage of a corporation's income to be taxed by each state:



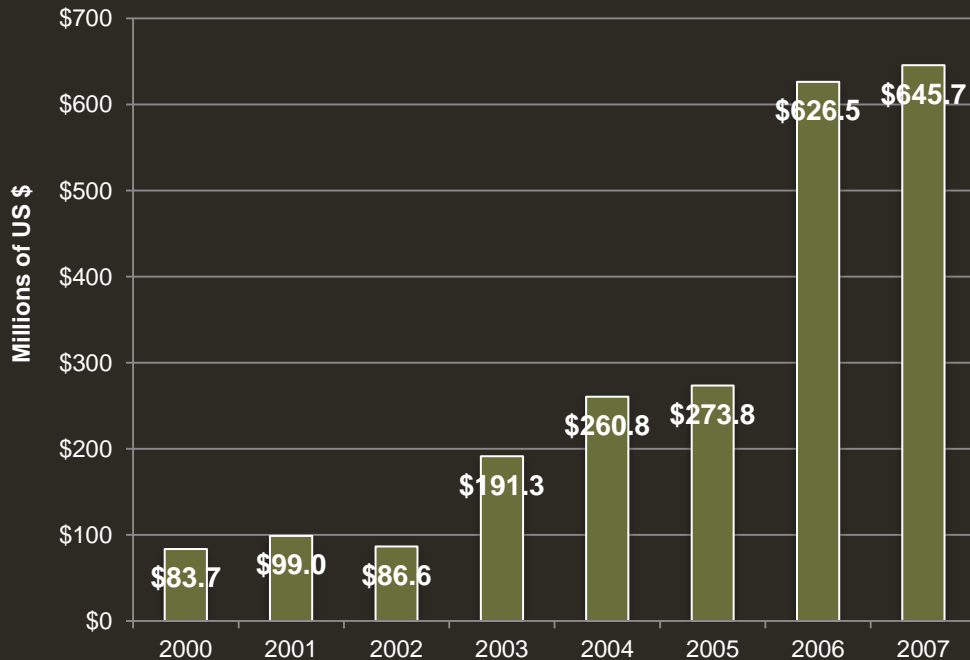
Over time, many states more heavily weighting the sales factor. South Carolina is transitioning to the Single Sales Factor in 2011.

ECONOMIC IMPLICATIONS

- Favors companies with large in-state property & employee base but large percentage of out-of-state sales.
- Disincentive for companies with large in-state sales but no physical presence to locate/invest in the state.

2 Extensive Corporate Credits

Corporate Tax Credits Carried Forward



Source: SC Department of Revenue Annual Reports, 2000 - 2007

STATE TAX CREDITS

South Carolina had 20+ credits against corporate income tax in FY 2007-2008.

- \$708.9 million in credits claimed
- 454 filers claiming credits

Investment tax credits:

- Stimulate new investment, but lower the value of existing capital.

South Carolina allows credits to be carried forward up to 15 years.

- \$645.7 million carried forward in 07-08
- 279 filers with carry forwards.

Increasing use of tax credits and carry-forwards over time.

- Reduces state corporate revenues
- Increases year-over-year variability



Corporate Income Tax

3 Other Issues

UNIFORM REPORTING

Historically, state corporate tax has been highly variable year-over-year.

- Transfer pricing across states
- Holding/passive investment companies in other states

Combined reporting of state corporate tax

- 21 states: AK, AZ, CA, CO, HI, ID, IL, KS, ME, MI, MN, MO, NE, NH, NY, ND, OR, TX, UT, VT, and WV.

FOREIGN DIRECT INVESTMENT

Lower state corporate income taxes positively influence FDI.*

- Dependent upon foreign countries' repatriation laws.

DOUBLE TAXATION

C corporations are taxed as an entity on profits. Earnings distributions are then taxed as dividend income.

CALENDAR YEAR INVESTMENT CONSTRAINTS

Deters savings for future period investment across calendar years.

See Hines (1999) and Agostini (2007), among others.



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Sales Tax

State Retail Sales and Tax Collections
(billions of US \$)



Source: SC Department of Revenue

Declining Sales Tax Collections

Since 2004, gross sales have steadily increased (pre-recession) while sales tax collections have declined.

- 10/1/2006: food tax reduced to 3%
- 11/1/2007: food tax reduced to 0%
- In 2007, gross sales *increased* 4% while tax collections *decreased* 5%.

BEA estimated \$2.75 billion in tax revenues were not collected on items exempt sales tax in FY 2007-08

Shifting Consumption Patterns

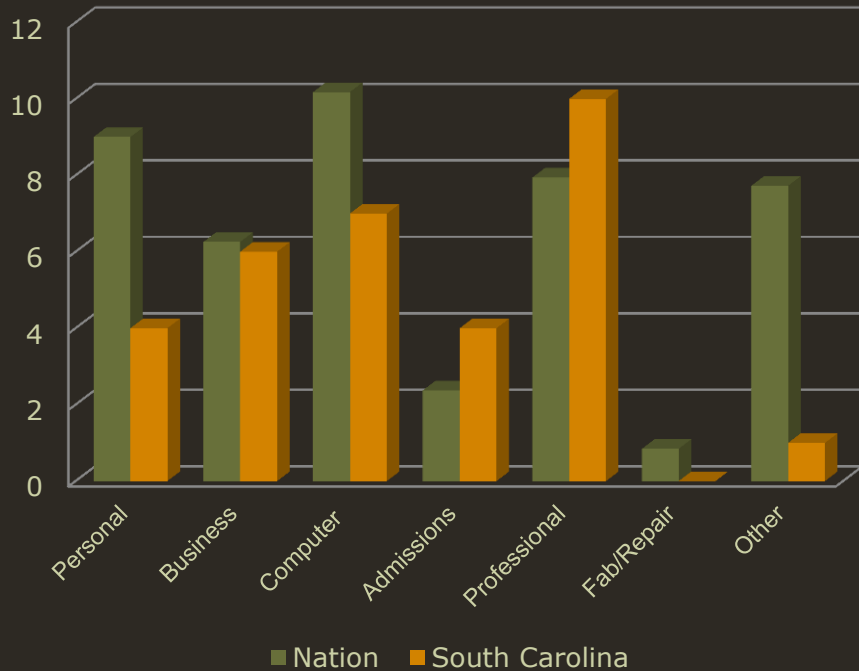
Consumption patterns have shifted from goods to services in South Carolina.

- In 1965, 54% of consumption was goods while 46% was services.
- In 2008, consumption was comprised of 26% goods and 74% services.

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Narrow Range of Taxable Goods and Services

Taxed Services by Type



Source: FTA

EXEMPT GOODS & SERVICES

Of the 168 services that are taxed in the US...

- South Carolina taxes 21%
- National average is 33%

South Carolina currently exempts 120 goods from sales tax.

An estimated 40.8% of gross retail sales were taxed in SC in 2007.

- Down from 50% in 1998-1999.

IMPLICATIONS

- Sales tax collections will continue decreasing if consumption pattern trends continue.
- High dependence on specific goods which may be more volatile in response to economic conditions.
- Inequity among taxation of goods & services.



Sales Tax

2 Tax Caps & Business Inputs

SALES TAX CAPS

South Carolina caps on the maximum sales tax paid per transaction currently include...

- Motor Vehicles (airplanes, cars, motorcycles, boats): \$300
- Manufactured Homes: \$300
- Musical Instruments (for religious organizations): \$300
- Firefighting Trucks: Lesser of 5% or \$300

Sales taxes are analyzed and modeled as regressive taxes

- Caps, dependent upon the level and category, can increase the regressive nature of the sales tax

BUSINESS INPUTS

Business inputs estimated to account for 50% of sales tax revenue in SC.*

- Reduces production efficiency (first order distortion)
- Tax pyramiding exists where sales in all facets of production are taxed.
- Encourages vertical integration to avoid taxation.

Prior to sweeping policy change, a thorough evaluation should be made and alternatives considered.

**Sources: Cline, R., Neubig, T., and Phillips, A. March 2006. Total State and Local Business Taxes. Ernst & Young Council on State Taxation.*

Ring, R.J., 1999. Producer's Share and Consumer's Share of the General Sales Tax. National Tax Journal, 52:1, 79-90.



Other Tax Revenues



Other Tax Revenues

South Carolina levies a number of other special purpose taxes and fees. A complete discussion of comprehensive tax reform would need to include these as well.

| General Fund Tax Revenue Source | FY 2009-2010 Collections |
|----------------------------------|--------------------------|
| Insurance Tax | \$ 158,647,299 |
| Beer and Wine Tax | \$ 99,229,717 |
| Corporation License Tax | \$ 73,412,950 |
| Alcoholic Liquors Tax | \$ 57,463,218 |
| Business License (Tobacco) Tax | \$ 35,257,195 |
| Documentary (Deed Stamp) Tax | \$ 31,003,309 |
| Admissions Tax | \$ 26,164,045 |
| Bank Tax | \$ 15,672,134 |
| Workers' Comp Insurance Tax | \$ 12,944,957 |
| Aircraft Tax | \$ 5,356,653 |
| Private Car Lines Tax | \$ 3,957,024 |
| Savings and Loan Association Tax | \$ 3,421,963 |
| Coin-Operated Device Tax | \$ 1,723,124 |
| Retailers' License Tax | \$ 799,436 |
| Estate Tax | \$ 72,908 |
| Total | \$ 525,125,932 |

Source: Comptroller General's Year End Press Release, FY2010



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Achieving a Comprehensive Plan for Economic Growth



Comprehensive Plan

Key Observations

South Carolina's Tax Structure is Becoming Narrower and More Targeted, Providing Advantages to Some Over Others

Corporate Income Tax

- A small number of firms receive a large amount of credits.
- Credits primarily accrue to larger, new firms over smaller and/or established firms, effectively creating dichotomous tax schedules.

Property Tax

- Property value appraisal increases and local spending drive the increase in property tax.
- Varying assessment rates plus targeted exemptions create an uneven and non-competitive distribution of tax burden.
- Fee-in-lieu of tax (FILOT) arrangements help mitigate the effect of unequal assessment rates, but accrue only to large, new investment, in effect placing smaller and/or established investment in a higher relative tax schedule.



Comprehensive Plan

Key Observations

...continued

Personal Income Tax

- South Carolina's tax structure is evolving into an effective 2-tier system with rates of 0% and 7%.
- High marginal tax rate (on low taxable income), large standard deductions, and highly targeted exemptions.

Sales Tax

- South Carolina taxes relatively little of its retail sales, requiring higher taxes on a narrower range.



Comprehensive Plan

NEXT STEPS

To develop a proposal for a revenue-neutral, optimal tax structure that:

- Remains revenue-neutral.
- Minimizes inefficiencies (mechanisms that push the economy away from market equilibrium and reduce economic output).
- Improves equity in distribution of tax burden.
- Accounts for secondary and tertiary impacts (dynamic versus static analysis).

Impact of a 1% increase in national marginal tax rates:*

| | Change in Taxable Income due to Income Effect (0.15) | Change in Taxable Income due to Substitution Effect (0.4) | Total Revenue Raised |
|--|--|---|---|
| Static Analysis | None | None | \$7.5B |
| Analysis with Behavioral Response | +\$1.1B | -\$7.7B | \$5.0B (less \$400M payroll tax reduction) |

Source: Feldstein, Martin (2006). "Effect of Taxes on Efficiency and Growth," Remarks to National Association for Business Economists, 3/14/2006.



Comprehensive Plan

DATA INPUTS NEEDED

Complete, detailed datasets with at least 5 years of history.

1. Individual tax return data (AGI, taxable income, deductions, credits, liability, etc.)
2. Firm-level corporate tax return data (industry, liability, credits, county, etc.)
3. Detailed retail sales (industry, county, category, etc.)
4. Property-level valuation data (market value, taxable value, classification, last reassessed, exemptions, etc.)

Based on demonstrated models of economic growth, the development of an optimized tax structure with lower rates and a broader base can be developed that will facilitate economic growth, prosperity, and job creation for South Carolina.

This data is **necessary** to begin the analysis.



Comprehensive Plan

Identifying the Correct Data

| General Fund Revenues FY 2007-2008 | Source |
|---------------------------------------|--|
| \$6,392,394,378 | SC Comptroller General, Year End Press Release (http://www.cg.sc.gov/publications/yearendpressreleases.htm) |
| \$6,658,503,000 | SC Comptroller General, CAFR (http://www.cg.sc.gov/publications/cafrfy2007.htm) |
| \$6,392,394,378 | SC Board of Economic Advisors, Historical Analysis (http://www.budget.sc.gov/webfiles/OSB/historical/Historical_Analysis_-_2009.pdf) |
| \$6,902,645,004 | SC Board of Economic Advisors, Monthly General Fund Tables Closeout (http://www.bcb.sc.gov/webfiles/BCB_BEAMonthly%20Revenue/BEA_Gen_Fund_tables_July_2008.pdf) |
| \$6,046,424,881 | SC Department of Revenue, Annual Report (http://www.sctax.org/NR/rdonlyres/048A56C4-5242-4BC8-A8C8-7891023E8072/0/0708AnnualReport.pdf) |



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Thank You

