

POLICY UPDATE

South Carolina's Shifting Tax Burden

BY VANESSA SUMO

Soaring real estate prices have ratcheted up property tax assessments across the country. In South Carolina, the Legislature responded to constituent uproar by passing a new property tax plan in June that exempts owner-occupied homes from paying taxes which fund public school operations. In order to cover the ensuing revenue gap, the statewide sales tax rate will rise from 5 percent to 6 percent, except on groceries, which fell to 3 percent from 5 percent in October. Homeowners will see the exemption in their tax bills by the end of 2007, and sales taxes will increase beginning June of that year.

If every South Carolinian were alike, then this new tax plan would affect everyone in the same way. They would simply pay for school funding out of one pocket instead of the other. Naturally, this is not the case. One taxpayer may own a sprawling mansion and the other a modest bungalow, while a third may rent. One may take home \$300,000 a year and the other \$30,000. These differences matter in how people will be affected by the changing tax environment.

Ellen Saltzman, an economist at Clemson University, has looked into how reducing property taxes while increasing sales taxes will change residents' tax burdens. She finds that under the new tax plan, homeowners will stand to gain more from the tax swap the higher their income and the more valuable their home. For instance, since incomes tend to be proportional to home values, then a resident of, say, the Beaufort school district who belongs to the top 1 percent of the income distribution will see his tax burden fall by 0.66 percent of his income, more than double the savings that poorer residents in the lowest 20 percent bracket will get. This is because wealthier people with expensive homes will get the largest property tax cuts in total dollar terms, and at the same time will likely spend a smaller share of their income on taxed goods than on nontaxed services.

Moreover, those who rent their home will be doubly squeezed. Renters, who indirectly pay property taxes through their rent, will see their tax burden increase since rental property is not eligible for tax relief — but they will have to pay more in sales taxes anyway. Saltzman finds that a renter at the lower end of the income spectrum will have a higher tax burden than one at the top end since this group will end up paying more in sales taxes as a share of their income. Overall,

the new tax plan thus tends to be regressive since it skews the income distribution in favor of the bigger earners.

Besides equity considerations, there is also the concern that the swap would distort taxpayers' spending behavior. A higher sales tax would hurt local businesses if it encourages residents either to shop less or buy items out of state, something that has been made increasingly easy because of the Internet. Local revenues could be hit hard as well. In a recent speech, Holley Ulbrich, a retired professor and Saltzman's colleague at Clemson University, noted, "Anything that hurts retailers hurts local governments, especially cities, where the commercial property of stores and restaurants is the economic lifeblood that donates regularly in the form of business licenses, local sales tax,

hospitality tax, and property tax."

In addition, firms may choose to locate elsewhere if a significant part of their business operations is subject to the sales tax.

House prices could also be affected. Buying a home is more attractive because the property tax relief reduces the cost of housing. But home buyers will always weigh their stream of future costs against their future benefits, the quality of schools being one of them.

Thus, property tax relief will likely exert an upward pressure on house prices provided that schools maintain the same relative quality between school districts in the state under the new tax plan.

There's a question, though, of whether adequate school funding can be raised under the new tax plan. Revenue proceeds from the sales tax increase will be distributed to schools in fiscal year 2007-2008, and will be based on the amount of funds each school received in the previous year. This amount will be adjusted each year by inflation and the state's population growth. Some school representatives are concerned that this adjustment may not be enough to fund the schools' growing needs because the cost of education could rise faster than inflation and population growth.

In all, Ulbrich thinks that the new tax plan doesn't pass "the reasonable test of what is a good change in tax policy." The property tax relief was mostly intended for those whose homes have rapidly increased in value but whose incomes are fixed, particularly South Carolina's older folks. Targeted relief that is based on need and income arguably would have provided a more equitable and less costly solution. **RF**

Homeowners will see the exemption in their tax bills by the end of 2007, and sales taxes will increase beginning June of that year.
