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WRITTEN TESTIMONY SUBMITTED TO THE SOUTH CAROLINA TAX REALIGNMENT COMMISSION REGARDING SALES AND USE TAX EXEMPTIONS PROPOSAL

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Thank you for the opportunity to submit written testimony. My name is Matthew Gardner. I am the Executive Director of the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group based in Washington, DC. ITEP's research focuses on federal and state tax policy issues, especially as they affect lower- and middle-income taxpayers.

My testimony today offers several broad thoughts on the implications of the proposals for sales and use tax reform laid out so far by the Tax Realignment Commission (TRAC). The testimony stresses that while base-broadening is of paramount importance in achieving a more sustainable state sales tax, policymakers should be aware of the need for low-income refundable tax credits to mitigate the impact of such reforms on low-income families—and should carefully examine the state's long-term structural deficit before making a decision that the entire revenue gain from these important changes should be devoted to reducing the state sales tax rate on currently taxable items.

Broadening the Base Must Be the First Step Toward Tax Reform

South Carolina's sales tax laws, like those of most other states, are weighed down by dozens of antiquated, often ineffective tax exemptions for specific types of goods and services. Every one of these exemptions undoubtedly has its defenders, but the net impact of these tax breaks is to force the sales tax rate on the remaining tax base even higher—a basic relationship that was illustrated most dramatically in South Carolina in 2006 when the state simultaneously reduced the state sales tax rate on groceries and *increased* the tax rate on all other taxable retail sales.

If base-broadening reforms are not enacted, lawmakers will almost certainly be forced to raise the state sales tax even higher in order to ensure that revenue collections keep pace with the cost of funding public investments. The TRAC proposals to eliminate or pare back many of the existing sales tax exemptions for tangible goods, services and intangibles would unquestionably reduce the pressure to continually ratchet tax rates upward. The TRAC proposals also would reduce the discriminatory tendencies of the state sales tax rules: in general, a consumer's sales tax liability should depend on how much they spend, not on which items they choose to purchase. These are commendable changes, and represent an important first step toward tax reform.

Broadening the Base to Include "Necessities" Will Hurt Low-Income Families

However, the TRAC recommendations show a worrying focus on taxing the "necessities" that represent a large share of low-income families' spending. Taxing groceries, residential utilities and prescription drugs—even at a lower rate—would likely make the state's sales tax even more regressive than it currently is. (This is true even though states taxing groceries must exempt purchases made with food stamps.) Even if the TRAC recommendation to reduce the sales tax rate on the newly broadened base is followed, the result could be an increase in the unfairness of the South Carolina sales tax.

For this reason, a low-income tax credit to help mitigate the impact of sales tax base expansion on low-income families could be vital to ensure that low-income South Carolinians aren't pushed further into poverty by the TRAC recommendations. This could take the form of an Earned Income Tax Credit modeled after federal law (an action taken recently by North Carolina and Louisiana), or could be a separate tax credit designed to offset some of the sales taxes paid by low-income consumers, as lawmakers from Georgia to Arizona to Kansas have enacted in recent years.

Is Revenue-Neutrality an Appropriate Goal?

The increased willingness of state lawmakers to recommend sales tax base expansion is one of the most welcome developments in state tax policy in recent years, and it is heartening to note that policymakers in neighboring Georgia and North Carolina are evaluating similar options at the same time. The near-universality of this debate in state houses across the nation is a testament to the basic sensibility of this reform strategy.

But the Commission's recommendation of "using 100 percent of any additional revenue that may be generated under this proposal…to lower the state sales and use tax rate" is less obviously sound. The recommendation implies that the current level of sales tax revenue is sufficient to fully fund public investments in fiscal year 2011, an assertion that is contestable at best. The difficulty of forecasting the revenue yield from previously-untaxed services, and the absence of a precise measure of the state's long-term "structural deficit" (that is, the long-term imbalance between revenue and spending) makes it difficult to know what amount of rate reduction would be appropriate. While this question is best left to the judgment of state policymakers, a cautious approach to sales tax rate reduction would be prudent.

Conclusion

The crisis of sustainability and equity facing South Carolina's sales tax system is not new—and not unique. South Carolina and 44 other states have faced the ever-growing problem of shrinking retail sales tax bases through much of the last fifty years. The draft recommendations on sales tax base expansion put forth by the Tax Realignment Commission represent an important step toward achieving a more sustainable and less discriminatory tax system.

But the recommendations made by TRAC present two dangers: first, the focus on taxing "necessities" consumed by low-income families makes it likely that these recommendations would fall most heavily on families living below the poverty line. Second, the TRAC commission's stated intention to enact revenue-neutral reform is problematic not only because the state may face a long-term structural deficit but because the revenue yield of the newly taxed services is difficult to forecast. The TRAC commission's draft proposal could be more fairer and more sustainable by coupling low-income tax relief with a more cautious approach to sales tax rate reduction.

Thank you for the opportunity to submit testimony.