

South Carolina's Education Funding Puzzle



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Putting It All Together
Two Cents for Education: The Sales Tax and Schools
(The second in a series)

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LEAGUE OF WOMEN VOTERS OF SOUTH CAROLINA

South Carolina's education finance system is incredibly complicated. The most cynical observers suggest that this is done on purpose to obscure what is really going on. More likely, however, the complexity is a product of a piecemeal cobbling together of the education funding mechanism over time. Regardless of the cause, this is the second in a series of reports to attempt to simplify one of the most complex pieces of the puzzle, the Education Finance Act.

Six Cents Plus

South Carolina's state general sales tax rate is six percent, around the national average rate. The sales tax was adopted at a rate of three percent in 1951 to build schools, replacing one-room school houses, and provide bus transportation to consolidated schools. The fourth penny of sales tax was adopted in 1969 to improve educational instruction and increase teacher salaries. So from the beginning, there has been a close link between the sales tax and education.



The fifth penny was added in 1984 specifically to fund the programs of the Educational Improvement Act. The sixth penny was added in 2006 to pay for school property tax relief for homeowners.

Local governments can also add another penny of local option sales tax on a county-by-county basis. Twenty-nine of the forty-six counties have a local option sales tax. Counties can also adopt a time-limited capital projects tax to fund particular projects, sometimes including school construction. But most of the money from these local option sales taxes must go to property tax relief from city and county taxes, and with the remainder earmarked for the general funds of counties and cities. Sometimes the capital projects tax includes school construction.

some tangible presence in the state, like a warehouse or a retail outlet. This restriction is within the power of Congress to change. Not only does it reduce state revenue, it also handicaps in-state merchants in malls and on Main Street because they have to collect the tax.

The third way to generate more revenue from the sales tax is to broaden the coverage of services, which have grown much faster than tangible goods as a share of consumer spending. The biggest class of exemptions is services. Higher income households tend to spend more on services, while lower income households spend relatively more on tangible goods. So a sales tax with limited coverage of services is more of a burden on poorer households.



South Carolina taxes only 36 services, including dry cleaning, restaurant meals, and hotel/motel accommodations. Admissions are subject to a separate but equivalent tax, but because these taxes are not part of the general sales tax, none of the funds are earmarked for education.

In 2005, the Federation of Tax Administrators identified 168 different services that were subject to sales tax in one or more states. South Carolina ranked 28th out of 45 states in the number of services subject to tax. Among the more common services subject to retail sales taxes are transportation (including rental cars, airplane departures, etc.) household services (such as landscaping and lawn care, cleaning, pest control), automotive services, vending machine sales, maintenance and repair services and health clubs, self-storage, and telephone answering services. The state could raise as much as 33% more revenue at the same tax rate with broader coverage of services.

A strong sales tax that grows with population and inflation is fundamental to funding public education in South Carolina. Citizens who want to support education funding need to urge their legislators to take a closer look at these three sales tax issues in order to make the sales tax more productive and distribute the cost of public education more fairly among our citizens.

This fund is used to provide compensation for lost property tax revenue to school districts resulting from Act 388 and earlier relief legislation. The homestead exemption for the elderly and disabled costs approximately \$175 million a year. The original property tax relief program enacted in 1994 had been capped in 1995 at \$249 million. Both of these sums come out of the General Fund. If the extra penny of sales tax does not generate enough revenue to fully fund the promised relief under Act 388, the difference must be made up by the General Fund. In 2010 the sixth penny generated \$496 million and the cost of the promised property tax relief was \$616 million, so that \$118 million had to be taken from the General Fund to honor that pledge. .

In the first year (FY 2006-07), the school districts were fully reimbursed for their revenue based on their millage for that year. In subsequent years, districts were reimbursed by formula. The total reimbursement increases each year by a factor reflecting population growth and inflation, an amount that must be provided regardless of how much additional revenue comes in from the sales tax. The distribution of that increase among school districts is based on student population growth in each district.

Strengthening the Sales Tax

One way to improve funding for education in South Carolina is to strengthen the base of the sales tax by broadening the coverage--the number of goods and services on which sales tax is collected. Because the sales tax is so important in funding education, any changes in the sales tax that affect sales tax revenue will impact the funds available for the schools.

There are basically three ways to get more revenue at the same rate out of the sales tax. The first way is to revisit the long list of tangible goods that are exempt from the sales tax, ranging from food (added to the exempt list in 2006) to prescription drugs and all but \$300 of the sales tax on a car, boat, motorcycle or airplane.

The second way to generate more revenue is to persuade Congress to lift the moratorium on taxing internet purchases. Congress has that power. At present, states can only require internet sellers to collect sales tax on purchases by their residents if the internet seller has

The First Four Cents

The first four cents, or 2/3 of the state sales tax revenue, goes into the state's General Fund, which is the revenue for the budget that the General Assembly passes each year. Public (K-12) education is one of the big items in that budget. The Education Finance Act is paid for through the General Fund.



Sales and income taxes together provide 83% of General Fund revenue. In 2008-09, the state collected \$3.05 billion of sales tax, with \$2.46 billion going into the General Fund. Sales tax revenue tends to grow more slowly than the growth of personal income and is vulnerable to recessions when people cut back on their purchases of taxable items. So education funding needs to be placed on a more secure basis. Conversations about creating budget stabilization funds are important for ensuring enough money to fund public education.

The EIA Penny

The Education Improvement Act (EIA), passed in 1984, was the brainchild of Governor Richard Riley. A one cent hike in the state sales tax rate (from 4% to 5%) was passed, and the money from that increase did not go into the General Fund. Instead, it went into a separate fund earmarked for educational improvements. In 2009-10, that amount was \$532 million, more than \$100 million less than in the preceding four years. Per student, EIA provided \$734 in 2009-10.

The EIA was a comprehensive education reform plan containing specific programs and strategies for improving public education in the state, as well as the mechanism for the distribution of state funds for its implementation. EIA revenues do not go into the General Fund but rather are directed to a trust fund and distributed to school districts on a per pupil basis. Local school districts were not required to pay any portion of the costs of EIA programs. In FY 2010-11, the EIA penny provided \$522 million of funding for public schools. While the education Finance Act provides more funds per pupil for school districts with more poverty and smaller tax bases per pupil, EIA does not equalize education funding in the same way.



Instead, it provides the same amount per weighted pupil for each school district.

To guard against school districts reducing their existing financial effort as a result of the increased level of state funding, the Act requires that each district increase its local tax revenue effort on a per-pupil basis by not less than the annual inflation factor (called "maintenance of effort"). In addition, each school district is required to maintain the local salary supplement above the required state minimum paid to its certified employees.

The EIA was South Carolina's original blueprint for enacting a quality program of public instruction for current and future generations. A one-cent state sales tax increase provided additional funds to:

- Raise student performance by increasing academic standards;
- strengthen the teaching and testing of basis skills;
- elevate the teaching profession;
- improve leadership, management and fiscal efficiency;
- implement quality controls and reward productivity;
- create more effective partnerships among schools, parents, community and business; and
- provide school buildings conducive to improved student learning.

The General Assembly sets the specific spending priorities for EIA each year. In FY 2009-2010, the biggest category (\$136 million) was for students at risk, followed by \$92 million for teacher salary supplements.

The Property Tax Relief Penny

The sixth penny came about in 2006 when the General Assembly passed Act 388, which significantly changed the way schools are funded in South Carolina.

Act 388 eliminated all taxes for school operations on owner-occupied residential property and reimbursed school districts for the revenue loss with the additional revenue from the sixth penny of sales tax. The act took effect on June 1, 2007. In order to reduce the impact on lower income households, the sales tax on food was first reduced to 3% and later eliminated.

The roots of Act 388 can be traced to 1993 and 1994, when protests against rising property assessments, chiefly in Lexington and Charleston Counties, led to pressure on legislators for property tax relief. At the same time, a lawsuit about inequitable school funding was wending its way through the courts and the legislature realized that part of the possible resolution might be to shift a larger share of education funding to the state.

Legislation in 1994 provided state-funded property tax relief for school operating taxes on the first \$100,000 of market value of owner-occupied residential property. The estimated cost to reimburse school districts for this earlier property tax relief was \$249 million in FY 2005-06, the last full year before the implementation of Act 388. This sum was appropriated through the state's General Fund.

Beginning in June 2007, the state retail sales tax was increased from 5% to 6% while the sales tax on food was reduced at first to 3% and later eliminated. The food tax reduction/exemption cost the state \$354 million in revenue in FY 2009, but was intended to provide some relief for lower-income households that did not benefit from property tax relief because they were renters or because the value of their owner-occupied residences was less than \$100,000. However, the food tax exemption reduced EIA revenue by about \$60 million a year and has resulted in less revenue for property tax relief as well. EIA was compensated for the revenue loss the first year but not in later years.

The revenue from the one cent sales tax increase (the sixth penny) was directed outside the General Fund to a special Homestead Exemption Fund, which also receives the relief funds for school taxes for the homestead exemption for the elderly and disabled and the relief funds for the earlier property tax relief on the first \$100,000 of value of owner occupied residential property.