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WHEN IT COMES TO TAXES IN SOUTH CAROLINA: FOCUS ON REMAINING COMPETITIVE

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A common misperception is that the burden of taxes on an economy is simply equal to the tax revenue generated. In reality, taxes cost society much more than is generated in revenue. The additional costs come in many forms, including: administrative costs, enforcement costs, compliance costs, ‘excess burdens,’ and costs associated with resources spent by individuals and groups to avoid the tax, both before the tax is implemented (lobbying) and afterwards (evasion). High taxes are extremely costly to a state’s economy. Countless studies find that higher taxes lead to significant reductions in economic growth. The purpose of this chapter is to explain the true costs of taxation, review the empirical literature on taxation and economic growth, and to examine South Carolina’s overall tax burden relative to other states.¹

WHY TAXES COST MORE THAN THEY TAKE

Just because a tax is levied on one specific group of individuals does not mean they will be the ones who bear the eventual burden of the tax. This concept is known in the economics literature as ‘tax shifting.’ A tax imposed on business assets, for example, might lead to higher prices for consumers, shifting some of the burden forward to consumers. Similarly, a tax imposed directly on consumers of a product will lead to reduced demand, shifting some of the burden backward onto the companies producing the good or service that is taxed.²

One thing is certain, however, and that is: all taxes are borne by *individuals*. A ‘business’ cannot bear taxes. Instead, business taxes fall on the owners, employees, suppliers, or customers of the business.

¹ This chapter is based on Ross and Hall (2007).

² For additional information on where the actual burdens of different taxes fall, see Pechman (1985) and Fullerton and Rogers (1993).

According to the U.S. Census Bureau, state and local governments around the nation took in more than \$1 trillion in combined tax revenue during fiscal year 2005-06.³ Figure 4.1 summarizes the sources of tax revenue for South Carolina in 2005-06. Combined state and local government tax revenue in South Carolina was over \$12 billion, with \$7.75 billion levied at the state level.

Figure 4.1: South Carolina 2005-06 Tax Revenue by Source

	State	Local	Total
Tax Revenue	\$7,759,797,000	\$4,684,355,000	\$12,444,152,000
Property	\$9,808,000	\$3,950,238,000	\$3,960,046,000
Sales and gross receipts	\$4,200,121,000	\$286,839,000	\$4,486,960,000
General sales	\$3,186,306,000	\$95,908,000	\$3,282,214,000
Selective sales	\$1,013,815,000	\$190,931,000	\$1,204,746,000
Motor fuel	\$511,834,000	n/a	\$511,834,000
Alcoholic beverage	\$143,034,000	\$186,000	\$143,220,000
Tobacco products	\$32,056,000	n/a	\$32,056,000
Public utilities	\$44,173,000	\$71,663,000	\$115,836,000
Other	\$282,718,000	\$119,082,000	\$401,800,000
Individual income	\$2,727,251,000	n/a	\$2,727,251,000
Corporate income	\$296,753,000	n/a	\$296,753,000
Motor vehicle license	\$156,077,000	\$21,604,000	\$177,681,000
Other taxes	\$369,787,000	\$425,674,000	\$795,461,000

Source: U.S. Census Bureau (2009).

What these revenue numbers exclude, however, are the many distortions in economic activity, and in the behavior of individuals, that occur in response to these taxes. Figure 4.2 helps to illustrate these costs. The direct cost of taxation is the obvious accounting cost—individuals who pay the tax will have less money to spend on other goods and services. The tax revenue generated does measure this reduction in private economic spending resulting from the tax. However, there are other significant costs.

The first hidden cost of taxation comes from the political process itself. The indirect costs of lobbying and rent seeking (upper left box) reflect the resources devoted by individuals attempting to alter tax policy decisions within the political process. Interest groups will devote substantial time and effort into fighting against the imposition of a tax, or an increase in tax rates, as well as to secure reductions in tax rates, or their repeal.

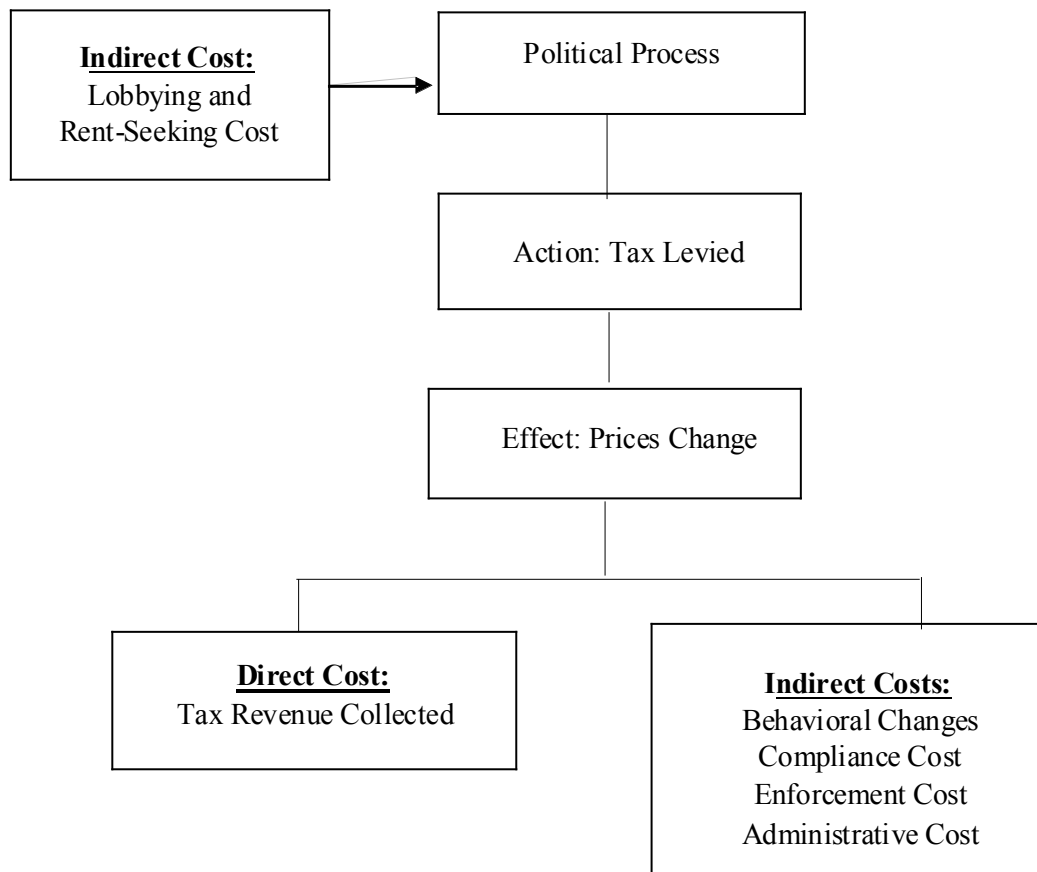
To illustrate, suppose the legislature is considering a proposal to levy a new tax on unhealthy fast food. Further suppose that Hardee's estimates this new tax will cost the company \$2 million. At this point, Hardee's would be willing to spend up to \$2 million to prevent the imposition of the tax. They may hire lobbyists, make campaign contributions, attempt to secure media attention, or attempt to fight the legality of the tax in court. Once the

³ Available at <http://www.census.gov/govs/www/estimate06.html>.

tax is imposed, they will continue to devote resources toward attempting to get the tax repealed, the rate lowered, or to secure an exemption from the tax. Resources spent in this manner are wasteful for precisely the reasons discussed in Chapter 3—they are taken away from other productive activities (which includes investments in capital equipment, buildings, or hiring more workers). In the terminology of Chapter 3, this is ‘unproductive entrepreneurship.’ It is important to note that these costs are present even if the tax is not enacted by the legislature. Simply the threat of imposing a new tax creates these costs.

To see the magnitude of these exemptions in practice, one only needs to skim the *Sales & Use Tax Exemptions Fiscal Year 2008-2009* which outlines the exemptions to specific taxes.⁴ Sobel and Garrett (2002) estimate the level of rent seeking to be somewhere between 3.8 to 5.4 percent of the state’s total tax revenue, implying an additional indirect cost of \$473 to \$672 million in wasted resources in South Carolina devoted to altering policy. To reduce these costs, many economists advocate broad-based uniform taxes rather than allowing rates and exemptions to vary across different goods and services (Holcombe 2001). Without the ability to individually reduce their own tax rate, any one particular industry is less likely to expend effort to lobby for changes. A tax that targets one specific industry, such as South Carolina’s beer tax, tends to generate larger indirect rent-seeking costs.

Figure 4.2: The Cost of Taxation*



⁴ This report is available at <http://www.bcb.sc.gov/BCB/bea/exemptions.pdf>.

Furthermore, unlike private markets in which you must pay prices for the things you purchase, with government it is often possible to receive the benefits of government programs while making *others* pay. Thus, there will be additional lobbying and rent-seeking costs associated with the fight over which programs will be funded, or who will obtain the benefits, when the revenue is spent. For example, the American Association of Retired Persons was among the groups that successfully lobbied for the funding of a one-time \$2.9 million for seniors to receive home and community based services such as home delivered meals in 2009.⁵ To secure this funding they had to compete against other groups who also wanted additional government funding. The existence of this opportunity for rent seeking, and a tax system that allows for frequent amendments, winds up allocating state resources to those with the most political power, and not necessarily to welfare enhancing programs or to those most in need (Holcombe 2001).

Returning to Figure 4.2, the tax itself will cause additional indirect costs, highlighted in the lower right box in the figure. The first of these costs, the behavioral changes, is associated with distortions in the behavior of producers and consumers in response to the tax. To economists these costs are known as the ‘deadweight cost’ or ‘excess burden’ of taxation. Whenever a tax is imposed, individuals will substitute away from the activity that is taxed to other activities that are now comparatively cheaper. As an illustrative example, suppose South Carolina imposes a new \$100 tax on each candy bar sold in the state. Further assume this would drive the price so high that candy bar sales would fall to zero. The tax would collect no revenue, but it clearly would still have a cost to society. Consumers who like to eat candy bars are now worse off because they are not consuming them, and the producers of candy bars are worse off as well due to the lower number of candy bars sold.

Consumers may also change where they make their purchases to avoid the tax, or if possible, where they live. South Carolinians living on the Georgia border might now drive to Georgia to buy candy bars, or chocolate lovers might even decide to move to another state. These are all costs of taxation that must be considered, and the easier it is for consumers to find substitute goods, move, or shop across the border the larger are these indirect costs.

It is important not to forget that business firms will also have an incentive to change their behavior in response to taxes. When a tax reduces the profitability of any one use of a business’s resources, it means that other uses become *more profitable by comparison*, and the firm will make adjustments as a result, further increasing the behavioral costs of the tax. Like the consumer, firms can also move to areas that impose lower taxes. Again, the easier it is for firms to change their behavior in response to a tax, the larger will be the indirect behavioral costs of taxation.

The other indirect costs in Figure 4.2 are the compliance, enforcement, and administrative costs. Every tax must be administered and enforced by a taxing authority, and there will be costs associated with these activities. These are the least expensive indirect costs as a share of tax revenue, generally amounting to less than three percent (Payne 2003). Compliance costs, however, are considerable at 22.2 cents per dollar of tax revenue (Moody, Warcholik, and Hodge 2005). This cost includes the hours of book keeping, the time spent filling out tax forms, the hiring of accountants to address changes in tax laws, etc.

⁵ Legislative update March 17, 2009 vol. 26, no. 09 <http://www.scstatehouse.gov/reports/hupdate/lu2609.htm#e3>
AARP South Carolina News
http://www.aarp.org/states/sc/advocacy/articles/general_assembly_continues_to_protect_older_south_carolina.html

All told, these costs add up to between \$0.60 and \$0.82 for every \$1.00 of tax revenue raised. In other words, one dollar of taxes costs the South Carolina economy somewhere between \$1.60 and \$1.82. This has significant implications for cost/benefit analysis of government projects funded through taxation. A project with benefits of \$150 million that requires \$125 million in taxes to fund is not efficient to undertake once these additional costs of taxation are considered.

While total state and local tax revenue in South Carolina amounts to around \$12 billion, the true cost of these taxes on the South Carolina economy is in the range of \$19 to \$22 billion.

SOUTH CAROLINA'S TAX BURDEN: A COMPARISON

In 2006, South Carolina's total state taxes per capita were the 47th highest in the nation at \$2874 according to the U.S. Census. This was lower than Georgia's \$3321 and North Carolina's \$3384.

This is not the best measure of tax burden though, because some states are simply richer than others. Thus, a more appropriate measure of tax burden is tax revenue as a percent of state income. Using this measure, South Carolina's tax burden is higher. According to calculations by the Federation of Tax Administrators, South Carolina's total state and local tax burden as a percent of income is the 44th highest in the nation.⁶ As a percent of income, South Carolina has the lowest tax burden of our neighboring states.

Figure 4.3 shows South Carolina's taxes as a share of personal income compared to the overall U.S. average. The first set of columns show the comparison for state taxes only, while the final set of columns show combined state and local taxes. A positive number in the 'difference' column means South Carolina's taxes are higher than the U.S. average.

⁶ http://www.taxadmin.org/FTA/rate/06stl_pi.html.

Figure 4.3: Taxes as a Percent of Personal Income: South Carolina versus the U.S. Average, 2006

	State Only			State and Local		
	S.C.	US Avg.	Difference	S.C.	US Avg.	Difference
Tax Revenue	5.97	6.48	-0.50	9.58	10.89	-1.31
Property	0.01	0.11	-0.10	3.05	3.27	-0.22
Sales and gross receipts	3.23	3.03	0.20	3.45	3.75	-0.30
General sales	2.45	2.07	0.39	2.53	2.57	-0.04
Selective sales	0.78	0.97	-0.19	0.93	1.18	-0.26
Motor fuel	0.39	0.33	0.07	0.39	0.34	0.06
Alcoholic beverage	0.11	0.04	0.07	0.11	0.05	0.06
Tobacco products	0.02	0.13	-0.11	0.02	0.14	-0.11
Public utilities	0.03	0.10	-0.07	0.09	0.22	-0.13
Other	0.22	0.36	-0.14	0.31	0.45	-0.14
Individual income	2.10	2.24	-0.14	2.10	2.45	-0.35
Corporate income	0.23	0.43	-0.20	0.23	0.48	-0.25
Motor vehicle license	0.12	0.17	-0.05	0.14	0.19	-0.05
Other taxes	0.28	0.49	-0.20	0.61	0.75	-0.13

Sources: U.S. Census Bureau (2009) and Bureau of Economic Analysis (2008).

Total state taxes as a percent of personal income in South Carolina are approximately nine and a half percent, just less than one and a half percent lower than the U.S. average. This difference is relatively small—South Carolina’s state taxes are just under the average state. When examining individual state tax sources, nine out of the thirteen categories fall below the U.S. average, most notably state property taxes, state income taxes, and state corporate taxes. However, these differences are less than half a percent from the U.S. average.

When local taxes are included, the picture remains mostly unchanged, with the exception that because many other states have local option sales taxes, South Carolina’s state and local sales tax burden is below the U.S. average. In addition, because of South Carolina’s relatively low local residential property taxes we fall further below the U.S. average on relative property taxation. Nonetheless, the conclusion remains that relative to other states South Carolina is just under or at the U.S. average. South Carolina tax policy needs to continue to focus on remaining a relatively low tax state.

LIVING ON THE EDGE

Earlier we discussed how the behavioral costs of taxation become larger when it is easier for people to avoid the tax. According to the U.S. Census, 40.9 percent of the state’s 2008 population lived in counties bordering other states. This is up from the 2000 and 1990 Census when the share in border counties was 40.8 and 40.4 percent, respectively. South Carolina’s total population has increased over the last decade nearly twelve percent, but it has grown even faster in border counties.

In addition, two of South Carolina’s Metropolitan Statistical Areas (MSA’s), which are defined in part by the magnitude of mobility within the area, spill directly across the

border of the state.⁷ The implication is that the indirect costs of taxation can easily rise with increases in the tax rates because a considerable portion of the state's consumers, producers, and workers can easily cross the border to escape high taxes.

While we have seen that South Carolina's tax burden is essentially at the U.S. average, let's take a closer look at how South Carolina compares to our neighboring states. Figure 4.4 shows total taxes as a percent of personal income for South Carolina and its neighbors. The left half of the table includes only state taxes, while the right half includes both state and local taxes.

Figure 4.4: Taxes as a Percent of Personal Income: South Carolina versus Neighboring States, 2006

	State Only		State and Local	
	Tax Burden % of Income	Difference from SC	Tax Burden % of Income	Difference from SC
Georgia	5.66%	-0.32%	10.31%	0.73%
North Carolina	7.22%	1.25%	10.51%	0.94%
South Carolina	5.97%		9.58%	
Average		0.46%		0.83%

Sources: U.S. Census Bureau (2009) and Bureau of Economic Analysis (2008).

When only state taxes are considered, South Carolina's tax burden is lower than North Carolina, but not Georgia's. Both North Carolina and Georgia have slightly higher taxes as a percent of personal income. On average, our neighboring states have tax burdens that are .46 higher as a percent of income. When both state and local taxes are considered, South Carolina's tax burden is, on average, 0.83 less than surrounding states. The combined state and local tax burden in South Carolina remains slightly lower than our neighbors.

Figure 4.5: Comparison of 2006 State Tax Rates

	Individual Income		Corporate Income		Sales	
	Tax Rates	Brackets	Tax Rates	Brackets	Tax Rate	Food Exempt
Georgia	1.0-6.0	6	6	1	4*	Yes
North Carolina	6.0-7.75	3	6.9	1	4.25*	Yes
South Carolina	.0-7.0	6	5	1	6.0	Yes

Notes: * Georgia and North Carolina food sales are subject to local sales taxes. Source: Federation of Administrators at http://www.taxadmin.org/fta/rate/tax_stru.html.

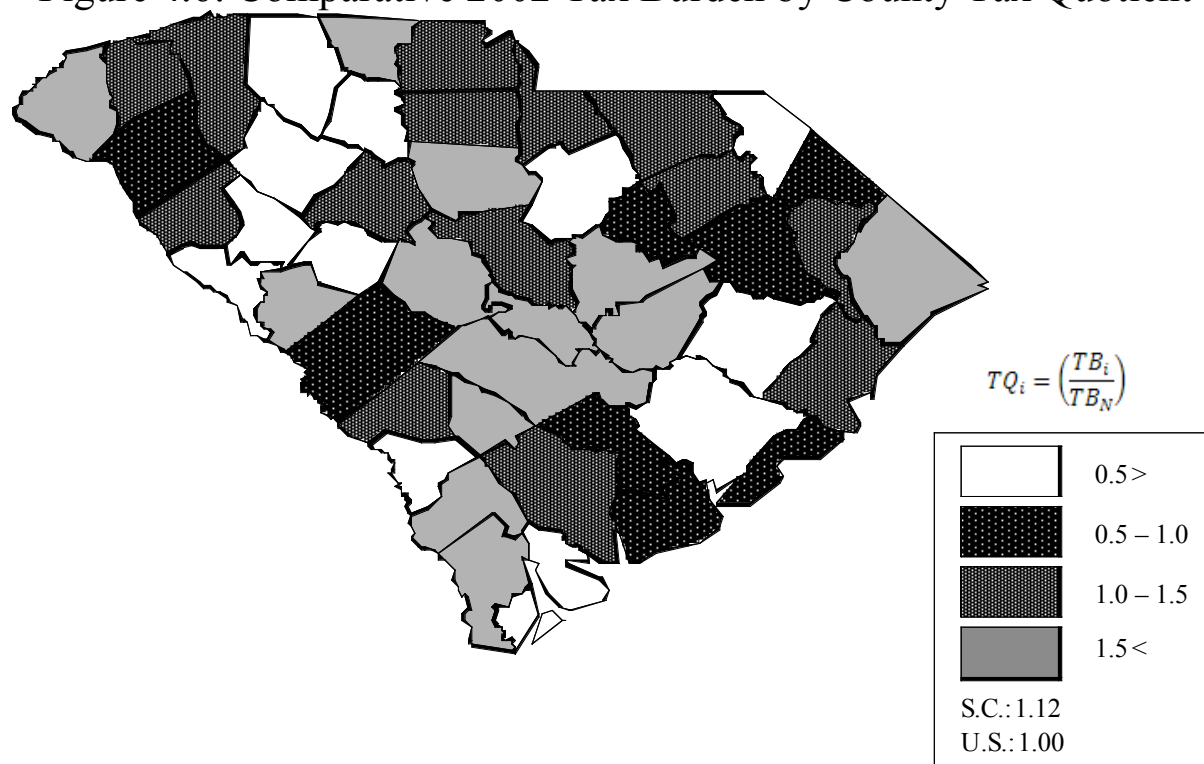
⁷ The purpose of MSA's are to identify areas of high economic and social interaction, where component counties must have either 25 percent of employed residents commuting to the central county or at least 25 percent of the employment filled by a resident of the central county (Hammond 2003).

Finally, Figure 4.5 demonstrates that South Carolina has a higher or the same tax rates over its neighbors in two of the three most visible taxes: individual income, corporate income, and general sales taxes. South Carolina has a lower state corporate tax rate than both of its neighboring states, but the individual income tax and sales tax are higher than both. South Carolina has the highest state sales tax rate at least two percent higher than neighboring Georgia and North Carolina.

TAX DIFFERENTIALS WITHIN SOUTH CAROLINA

Let us now take a closer look at the tax burden in South Carolina by examining local tax burdens by county.⁸ Figure 4.6 shows the tax quotient for each county in South Carolina from the most recent Census of government finances, which was in 2002. The tax quotient is calculated as the amount of the county's revenue generated through county and local taxation relative to the same measure for all counties in the nation. A tax quotient greater than one, for example, would imply that the county has an above average reliance on tax collections relative to other counties in the United States and is likely at a competitive disadvantage in terms of business and household location decisions.

Figure 4.6: Comparative 2002 Tax Burden by County Tax Quotient



⁸ In South Carolina, municipal governments are fiscally more important than county governments. The figure above aggregates municipal taxes up to the county level. Thus there may be areas within a county that have a tax quotient above or below the county average. However, for the purpose of examining how tax differentials vary geographically within South Carolina, as well as their impact on employment and number of business establishments, the county level is an appropriate unit.

Notes: TB_i represents share of total county government revenue that comes from county and local tax revenue. TB_N represents the average of this same calculation for all U.S. counties. Each county's tax quotient (TQ_i) is then determined by dividing the county's tax burden by the nation's tax burden ($TQ_i = TB_i \div TB_N$). Source: Authors' calculations from U.S. Census Bureau (2009).

A tax quotient below one, which would indicate a tax burden lower than the U.S. average, is found in 19 of the 46 counties in South Carolina. Nonshaded counties are those with tax quotients of 0.5 or lower ($0.5 >$). The average county in South Carolina has a tax quotient of 1.12, with the largest being Bamberg County with 2.90 and Marlboro County being the lowest at 0.05. Across all South Carolina counties, there is a negative relationship between the tax quotients and both 2002 employment and Census reported business establishments. A one-percent increase in the county's tax quotient is associated with a -0.07 percent decline in that county's reported number of business establishments and a -0.02 percent decline in employment.

TAXATION AND ECONOMIC GROWTH: THE EMPIRICAL EVIDENCE

Over the past thirty years a considerable amount of economic research has been undertaken in an effort to understand the relationship between taxes and economic growth. While some minimal level of government is necessary to support the institutions of capitalism, governments generally grow way beyond this optimal level. This is an issue explored in more detail in Chapter 12.

In a study for the Joint Economic Committee of the U.S. Congress, Richard Vedder and Lowell Gallaway (1998) examine the relationship between the size of government and economic growth. They found that the amount of state and local spending that maximized economic growth to be 11.42 percent of Gross Domestic Product. In 2007, South Carolina state and local spending was 12.15 percent of State Gross Domestic Product, suggesting that South Carolina state and local government exceeds the size necessary to maximize economic growth.⁹ In terms of percentage points, that may not seem like a lot of difference, but it represents over a billion dollars in state and local spending in South Carolina. However, state and local spending has increased by 41 percent between the years 1997-2007 (adjusted for inflation), while overall State Gross Domestic Product grew at only 24 percent. Thus, state and local government grew at nearly double the rate of growth over roughly the last decade.

Looking specifically at taxes, there is a large literature showing a strong negative relationship between taxes and economic growth. Mullen and Williams (1994) find that higher marginal income tax rates hurt economic growth. Jay Helms (1985) finds that taxation used to fund transfer payments significantly retards economic growth. Bartik (1992) provides an excellent summary of the research on state and local taxes and economic growth and concludes that state and local taxes have a consistently negative effect on state and city economic growth. In terms of business location decisions, it is not surprising that he finds tax decisions play a much larger role in studies that look across suburban jurisdictions than across

⁹ Vedder and Gallaway (1998) looked at state and local spending over time, and thus used Gross Domestic Product (GDP). Looking at South Carolina, it is appropriate to use State Gross Domestic Product what used to be referred to as Gross State Product (GSP). State GDP in 2007 according to the Bureau of Economic Analysis (2009) was \$151,703,000,000 and state and local government expenditures were \$18,410,000,000. For a more recent look at the size of government and growth, see Taylor and Brown (2006).

states. Taxes are one part of the package that determines business location, including climate, local amenities, workforce quality, and public infrastructure. Once firms decide on a region, however, taxes can play a much larger role in their location choice.

A recent study by Holcombe and Lacombe (2004) provides strong evidence of the cross-border effect of taxes. By comparing counties located across state border from one another, Holcombe and Lacombe are able to effectively control for geographic similarities such as climate, workforce, and proximity to markets leaving only differences in state policy. Looking at the 30-year period from 1960 to 1990, they find that states raising their income tax rates faster than their neighbors had slower economic growth, leading to an average decline in per capita income of 3.4 percent. Reed (2008) also looks at the relationship between taxation and income growth at the state level from 1970-1999 using several different methodological approaches. He finds ‘robust’ evidence that taxes used to fund general fund expenditures are negatively related to growth.

Plaut and Pluta (1983) find that high taxes have a negative effect on employment growth. Interestingly they find a positive relationship between property taxes and industrial growth. They hypothesize that firms prefer locally-dominated tax systems to state-dominated tax systems that are more prevalent in the South because the benefits related to the high local property taxes are likely to accrue locally.¹⁰ Conversely, firms may avoid states where most taxes are levied at the state level because there is not as clear of a link between taxes paid and benefits received from the firm’s perspective.

Writing for the Federal Reserve Bank of Atlanta, Becsi (1996) examines how state and local taxes affect relative state economic growth. He finds a significant negative relationship between relative state marginal tax rates and relative state growth from 1961 to 1992. The effect of differences in marginal tax rates across states helps to explain not only short-run differences in growth across states, but also the persistence of growth differentials among states over time.

More recently, Poulson and Kaplan (2008, 67) also look at the effect of taxes on state economic growth. They find the following:

The analysis reveals that higher marginal tax rates had a negative impact on economic growth in the states.

...

The analysis underscores the negative impact of income taxes on economic growth in the states. Most states introduced an income tax and came to rely on the income tax as the primary source of revenue. Jurisdictions that imposed an income tax to generate a given level of revenue experienced lower rates of economic growth relative to jurisdictions that relied on alternative taxes to generate the same revenue.

Taxes not only impact where businesses locate, but also where people locate. If taxes get too high relative to the benefits received from government spending from government’s activities, people will move elsewhere. An early paper on this was by Cebula (1974) who found that migrants tended to move to areas with low property tax levels. Cebula’s work has

¹⁰ In 2006, 62.4 percent of South Carolina’s state and local tax revenue came from state taxes. This places the state right near the median of all states (62.2 percent). So South Carolina has a comparative advantage in this area over North Carolina (68.6 percent) in this respect but is nowhere near Georgia (54.9 percent).

been replicated by many others such as Niskanen (1992). Conway, Smith and Houtenville (2001) look at migration by elderly Americans and find that elderly migration is motivated in part by low personal income taxes and estate taxes. Cebula (2009) updated his earlier work to look specifically at the 2000-2005 period and he finds similar results, namely that individuals during this period ‘voted with their feet’ and were more likely to move to areas with lower tax burdens.

CONCLUSION

The aim of this chapter has been to clarify the true costs of taxation on the South Carolina economy, and to explore how South Carolina’s taxes compare to its neighbors and the nation.

According to the best economic estimates, each dollar of tax revenue really costs the South Carolina economy somewhere between \$1.60 and \$1.82. Currently using these measures of tax burden South Carolina puts itself at a slight competitive advantage in attracting businesses and households when compared to other states. The important point is to maintain this competitive advantage. However, this does not mean there is not room for reform to increase the productivity of South Carolina. As was discussed in Chapter 2, the top state income tax rates are higher than Georgia and slightly lower than North Carolina, but there are six tax brackets with an income of just over \$13 thousand dollars placing you in the top bracket for single or joint filing. The median household income in South Carolina for 2007 was \$43,508 effectively placing over fifty percent of the population in the highest tax bracket. In North Carolina a single filer must earn at least \$60,000 and \$100,000 for a joint return to enter the top bracket of 7.75 percent. In addition, our state and local governments are growing faster than overall state growth.

Empirical studies have a long history of consistently finding that state taxation hinders development and economic growth by constraining the forces of capitalism. To promote economic growth, South Carolina must find ways to keep its overall tax burden low. The next chapter will explore several specific tax reforms that can help to accomplish this goal.

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