

SPECIAL REPORT

THE FISCAL SUSTAINABILITY OF THE SOUTH CAROLINA REVENUE AND EXPENDITURE SYSTEM 1997-2010

By

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REVENUE AND EXPENDITURE SYSTEM
1997-2010**

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**This report summarizes
a series of five working papers**

- No. 1 - State Revenue: Projections to 2010 by Holley Hewitt Ulbrich**
- No. 2 - Local Revenue: Projections to 2010 by Holley Hewitt Ulbrich**
- No. 3 - State Expenditures: Projections to 2010 by James C. Hite**
- No. 4 - Business Incentives: Projected Fiscal Costs by Daniel V. Rainey**
- No. 5 - State Pension Funds: Assets and Obligations by E. Lewis Bryan**

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Preface

This report is a revision of *The Fiscal Sustainability of the South Carolina Revenue and Expenditure System, 1997-2010* dated October 2, 1997, and replaces that publication.

Two revisions affect the content of the paper. First, downward adjustments in the Local Government Fund and *all other* spending categories changed projected total general fund spending. These adjustments also affected projected general fund shortfalls and surpluses. Second, projected property tax revenue was revised upward, increasing projected total revenue to local governments and raising projected local revenue growth rates.

Minor corrections were made in the discussions of the revenue components projection method and homeowners' property tax relief. The report was also reorganized to make it easier for the reader to follow the main findings of the report.

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FISCAL SUSTAINABILITY OF THE SOUTH CAROLINA REVENUE AND EXPENDITURE SYSTEM, 1997-2010

FINDINGS AT A GLANCE

Methods and Assumptions

- The project focused on revenue and spending in the **South Carolina General Fund** in fiscal years 1996-97 through 2009-10.
- Key assumptions include: **personal income growth** of 5.5 percent per year, **inflation** of 3 percent per year, and **state population growth** of 1 percent per year (faster for the over-65 and prison populations, a bit slower for the student population).
- The effects of **business tax incentives and property tax relief** approved in recent legislative actions were emphasized in projections of future revenue and spending.

Major Findings for 2009-10

- The most credible **revenue projections** for 2009-10 are in the range of **\$7.8 to \$7.85 billion**.
- The cost of **business incentives** to the General Fund, which excludes the effect of fee-in-lieu on property taxes, is projected to be **\$248 million**.
- The projected cost of **property tax relief** is **\$336 million**.
- **Expenditures**, projected independently of revenue, come to **\$7.64 billion**.
- **Three quarters of total spending** is in education, corrections, Medicaid/social services, property tax relief, homestead exemption reimbursement, Local Government Fund, and debt service.
- Future spending on **education, corrections and Medicaid** will be heavily influenced by population growth.
- The **projected surplus** in 2009-10 is between **\$157 million** and **\$204 million**, but projected spending exceeds projected revenue through 2004-05.
- There is **little margin of error** left in the budget system for new tax breaks or new programs. Until 2004-05, spending cuts or revenue increases will be needed just to balance the budget.
- The **South Carolina Retirement Systems** are substantially actuarially underfunded if retirees continue to receive cost-of-living adjustments.

Implications

- **Possible added expenses or reduced revenue** that could affect projected general fund revenue and expenditures include:
 - **Transportation and infrastructure needs**, including deferred maintenance;
 - **Program improvements**, especially in education;
 - Eliminating the **underfunding in the state retirement fund**;
 - **A recession or a hurricane** (lower revenue, higher spending);
 - **Rising medical costs for retirees**;
 - **Any new borrowing** beyond that authorized in 1997;
 - **Any new tax breaks** (property tax on autos, income tax for the elderly, sales tax on food).
- Legislators do have **new money** to allocate each year. But revenue must grow at 4 percent per year just to keep pace with inflation and population growth.
- **Hidden spending cuts** occur when agency budgets do not keep pace with inflation and population growth. Examples include longer lines at the Division of Motor Vehicles, larger classes, more potholes, higher college tuition, raises less than cost of living for state employees.
- Any **further tax cuts** may have to be explicitly paid for with tax increases, fee increases or spending cuts.

The Fiscal Sustainability of the South Carolina Revenue and Expenditure System 1997-2010

This fiscal sustainability project was undertaken in order to offer a basis for assessing the budgetary impact of recent and proposed legislative policy actions that might affect either state revenue or state expenditures. Researchers attempted to develop plausible estimates of future revenue and expenditures in the South Carolina General Fund as well as the projected revenue stream for local governments through fiscal year 2009-10. In order to ensure that the revenue and expenditure projections were unbiased, these projections were made independently and compared only toward the conclusion of the project.

Recent policy actions were singled out for closer review, including newly enacted business tax incentives and the property tax relief for homeowners initiated in 1994. Proposed actions considered were various changes in the sales tax, further income tax relief for the elderly, and elimination of the property tax on personal vehicles. Because it may have a delayed impact on the general fund, the fiscal health of the state retirement system was also examined.

How Much Revenue?

There is no good method to determine how much revenue a state needs in order to meet its citizens' legitimate demands for publicly provided goods and services. South Carolina is more or less in line with neighboring states in per capita state and local revenue and spending combined (including education), although state funds account for a larger share of South Carolina's total than in other states. This comparison suggests that the state has settled on an acceptable level of revenue.

Once a state settles on a revenue level that appears to balance the public's desire for services with its reluctance to pay taxes, then there are several guidelines to suggest how fast revenue ought to grow. At a minimum, revenue should keep pace with the combined growth of inflation and population (4.1 percent per year for South Carolina between 1985 and 1995) so that the real (inflation-adjusted) per capita level of services can be maintained. If revenue grows slightly faster than inflation and population, then some improvements in services can also be provided. In recent years, the state's general fund revenue has been growing at about 4.8 percent per year, which is adequate to maintain and even slightly expand or improve services.

Alternatively, one can focus on pressures for growth on the expenditure side. With this approach, revenue requirements are determined by the spending growth needed to fulfill past legislative commitments (such as property tax relief, state aid to local governments, and debt service), maintain existing services, and address the specific needs of groups that may be grow-

ing at different rates than the overall state population (prison inmates, school pupils, elderly). This method would develop a spending target and then determine how rapidly revenue would have to grow in order to meet that target. This method is closer to the process used in most states' budgeting, including South Carolina. For projection purposes, both methods are important, because the key to a state's fiscal health is the balance between revenue and spending. If either is expected to grow faster than the other, legislators have a policy challenge to bring them back into balance. That measure of balance over time was the ultimate purpose of this study.

Revenue and Expenditure Projections

General fund revenue and expenditure projections (Appendix 1) were made using the same assumptions for key variables: population growth of 1 percent per year (with faster growth of over 65 population), personal income growth of 5.5 percent per year, and inflation of 3 percent per year. Population growth was calculated from projections provided by the U.S. Bureau of the Census. The state's chief economist recommended the income growth rate and the inflation rate based on past experience. If these assumptions about future population growth, income growth, and inflation are correct, then general fund spending and revenue will have to grow at least 4 percent per year just to maintain constant real expenditures per capita, that is, to account for the increased cost of serving a larger population at a higher price level.

Revenue Elasticities

The responsiveness of revenue to changes in the tax base is a key factor in revenue projections. The tax base may be corporate income tax, personal income tax, retail sales tax, or some other economic measure. These tax bases, in turn, are very sensitive to changes in personal income. Economists use the term *income elasticity* to measure the relationship between revenue and personal income. The income elasticity of a particular tax is a measure of how much revenue from that tax changes when personal income changes. Both revenue changes and personal income changes are expressed in percentage terms, so elasticity is defined as the ratio of the two percentage changes. For example, if sales tax revenue rises nine percent for every ten percent increase in personal income, it has an income elasticity of 0.9. Underlying every revenue projection is an assumed income elasticity, whether it is stated expressly or implied. Some of these income elasticity measures for South Carolina taxes appear in Table 1.

Revenue Projections

Future general fund revenue was projected in four ways. The first estimate was based on the South Carolina State Budget and Control Board's (BCB) projections through 2004-05. The Budget and Control Board projections are fairly optimistic in terms of elasticities and expected personal income growth. Because these projections were developed in 1996, they do not fully reflect the impact of recent legislation or actual 1996-97 revenue. In adapting and extending these projections, the BCB's projected revenue for 1996-97 was replaced with actual 1996-97 data now available; then revenue was projected to 2009-10 using the same overall growth rate that was implicit in its projections. This method yielded estimated 2009-10 revenue of \$8.33 billion.

Table 1
Elasticities of South Carolina State Tax Bases
With Respect To Personal Income

Tax Base	National^a	State Budget and Control Board	South Carolina 1986-1997 (historical)^b	Infrastructure Study (estimated)^c
Individual Income Tax	1.215	1.1	1.051	1.006
Corporate Income Tax	0.670	N/A	0.35	1.01
Retail Sales Tax	0.660	0.9	0.817	1.006
Alcoholic Beverages	0.254	N/A	0.19	N/A

N/A = not available.

^a National elasticity estimates for personal income tax, corporate income tax, retail sales tax, motor fuels, and alcoholic beverages are taken from Russell S. Sobel and Randall G. Holcombe, "Measuring the Growth and Variability of Tax Bases over the Business Cycle," *National Tax Journal* XLVIV (December 1996), pp. 535-552.

^b South Carolina historical elasticities are calculated from actual tax data for 1985-86 to 1996-97, a period when there were relatively few changes in the structure of these taxes

^c *South Carolina Infrastructure Study*, prepared by Rutgers University, Wilbur Smith & Associates, Siemon, Larsen & Marsh, and Sandstone Environmental Associates, Inc. for the South Carolina Advisory Commission on Intergovernmental Relations (Columbia, SC: SCACIR, May 1997).

An even more optimistic projection, which extends to 2009-10 and beyond, is found in the recent *South Carolina Infrastructure Study*. The projection was made in real terms, but when it was converted to current dollars, it came to \$8.7 billion. However, the underlying elasticities and income assumptions in the study appear to be very optimistic, and the study does not take adequate account of recent changes in the tax structure.

The third revenue projection was based on elasticities. The weighted average elasticity of the individual income tax, corporate income tax, retail sales tax, and the two taxes on alcoholic beverages is 0.758, based on actual data from 1990 to 1997. This elasticity value means that a 10 percent increase in personal income will on average generate a revenue increase from these sources of 7.6 percent. This same revenue elasticity was then applied to the remaining 15 percent of state revenue. The historical elasticity method resulted in a more conservative projection of \$7.8 billion for general fund revenue in 2009-10.

Finally the revenue from the individual income tax, corporate income tax, and sales tax was projected separately to 2009-10 (Table 2). For the individual income tax, two revenue projections were developed, one using the historical elasticity and the other using the Budget and Control Board's elasticity. Then these two projections were adjusted for the expected revenue loss from business tax incentives and income tax exclusions for the elderly. This adjustment yielded a range for individual income tax revenue in 2009-10 of \$3.67 billion to \$3.97 billion, depending on which projection was used. A single projection of the corporate income tax based on the Budget and Control Board's growth rate yielded revenue of \$207 million in 2009-10

Table 2
Projected State Revenue by Components, 2009-10
(in millions of dollars)

Components	Revenue
Individual Income Tax	\$3,675 to 3,967 ^a
Corporate Income Tax	\$207
Sales Tax	\$3,036
Other Revenue Sources	\$930
Total^b	\$7,848 to \$8,140

^a Lower figure based on historical elasticities; higher based on Budget and Control Board's growth rate.

^b Detail may not sum to totals due to rounding.

after adjustments for business tax incentives and income tax exclusions. A similar procedure for the sales tax resulted in projected revenue of \$3.04 billion. The remaining 18 percent of general fund revenue from many small sources was projected using BCB growth rates. Depending on the individual income tax projection used, this method yields revenue in 2009-10 of 7.85 to 8.1 billion (Table 3).

The two projections for 2009-10 based on historical elasticities (\$7.8) and revenue components (\$7.85) are considered most credible because they are based on recent past revenue experience and incorporate information specific to each of the component taxes. In addition, the projection based on revenue components reflects recent changes in business tax incentives. For this reason, the revenue components projection is used for comparison with projected expenditures.

Table 3
Alternative Revenue Projections, 2009-10
(in millions of dollars)

Method	Revenue Projection
BCB Growth Rates	\$8,334
S.C. Infrastructure Study	\$8,700
Historical Elasticities	\$7,801
Sum of Revenue Components	\$7,848 to \$8,140

Note: 1996-97 actual revenue equals \$4,587 million.

Expenditure Projections

Spending was projected independently of revenue. While the 2009-10 revenue projections were based on actual revenue in 1996-97, the spending projections were based on the 1997-98 appropriations bill. The 1997-98 appropriations bill was used because it reflected the most current spending decisions; that is, what the legislature planned to spend in the current policy environment. Also, the appropriations bill was the only available source of the line item detail required.

On the expenditure side, about 75 percent of 1997-98 and projected 2009-10 spending goes to fund K-12 education, higher education, corrections, Medicaid/social services, state aid to local governments, and debt service. A variety of smaller categories make up the remaining portion of state general fund expenditures.

Population growth is a major factor affecting spending on K-12 education, higher education, corrections, and Medicaid/social services. For these four categories it was assumed that increases in spending would be driven by population growth in the target population, holding real spending per person constant. The student population for both K-12 and higher education is projected to grow less than one percent per year, a bit slower than the general population. The high-risk population of males aged 18-30 is expected to grow slowly at about half a percent per year. However, stricter sentencing guidelines will more than offset this slow growth of high-risk population, resulting in a projected prison population growth of two percent per year. Finally, the elderly population is expected to grow by 2.5 percent or more per year after 2005, which will heavily impact outlays for Medicaid.

South Carolina has three main programs that return funds to local governments: the Local Government Fund, homestead exemption reimbursement, and school property tax relief. Because the Local Government Fund is 4.5 percent of general fund revenue in the most recently completed fiscal year, the 2009-10 expenditure projection of \$324 million was calculated using the 2007-08 revenue components projection of \$7.2 billion. The homestead exemption projection for 2009-10, \$64.1 million, was based on the projected growth rate of the age 65 and over population. The school property tax relief projection was based on the projected growth in value of new housing construction. The projected cost to the state for school property tax relief is \$336 million in 2009-10.

Debt service costs were based on outstanding debt and the newly authorized bond issue from the 1997 session of the General Assembly, without building in any additional borrowing over the next 13 years. All remaining miscellaneous expenditures were assumed to remain constant in real per capita terms, that is, to grow at the rate necessary to accommodate population growth and inflation. Based on these projections combined, general fund spending for 2009-10 is projected to be \$7.64 billion (Table 4).

Surpluses, Shortfalls, and *New Money*

The state's general fund is likely to experience revenue shortfalls in the near term. The components method shows revenue shortfalls from 1998-99 to 2004-05 with surpluses after that period. The surpluses in later years reflect declining expenditures for debt service because no new

Table 4
Projected Total Expenditures
(in millions of dollars)

	1997-98	2009-10
	Appropriations	Projections
Corrections	\$ 383.1	\$ 728.8
Education	2,115.1	3,386.3
Medicaid/Social Services	441.7	776.1
Aid to Local Govts ^a	434.6	723.6
Debt Service	149.9	185.5
All Other Spending ^b	1,151.5	21,843.6
Total	\$4,675.9	\$7,643.9

^a Includes Local Government Fund, homestead exemption reimbursement, and school property tax relief.

^b All items not explicitly broken out in other projections.

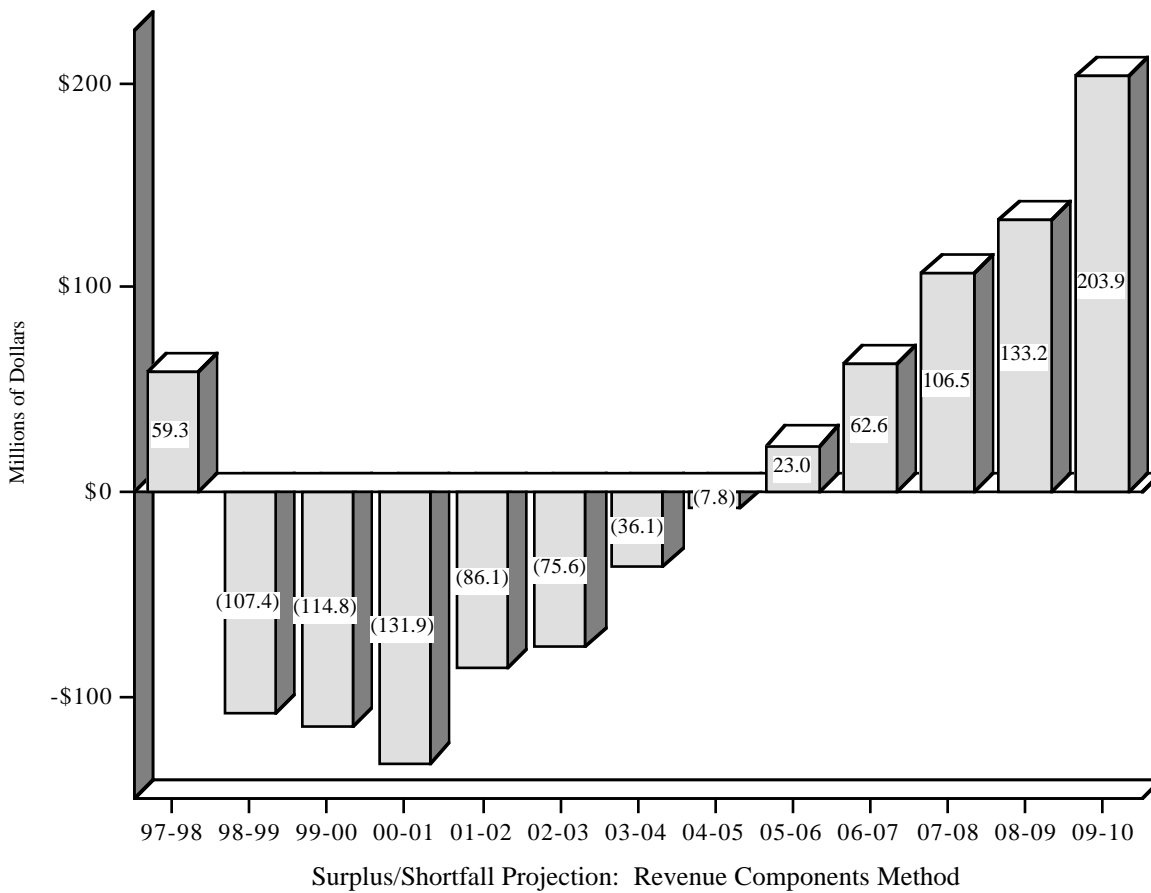
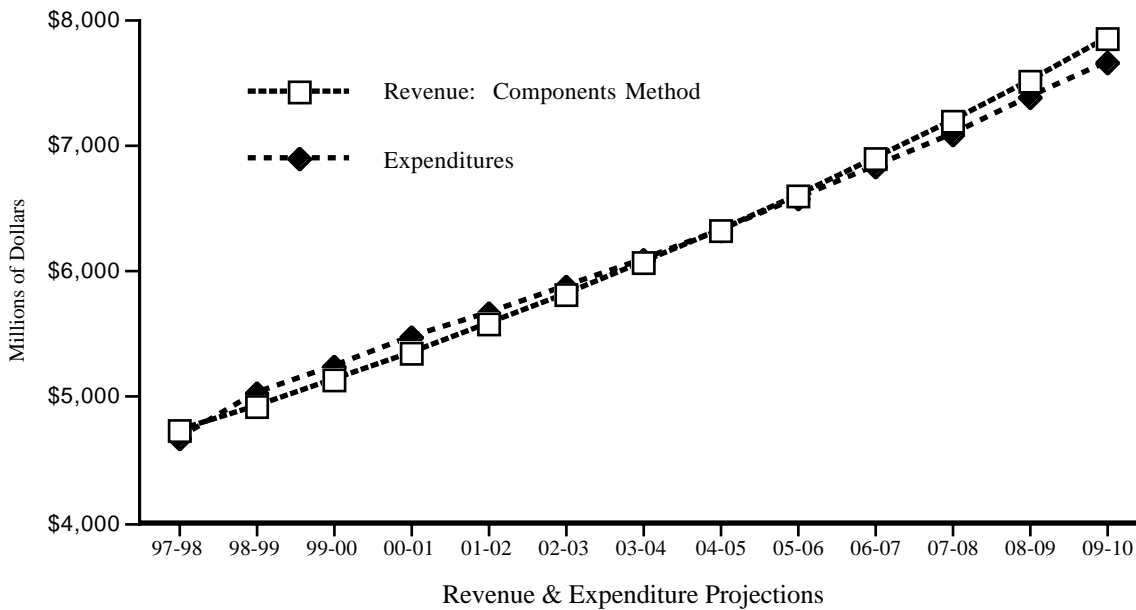
borrowing was assumed past the 1997 bond bill. Figure 1 shows the annual revenue, expenditure and surplus/shortfall projections through 2009-10.

In spite of the projected shortfalls, the General Assembly will have *new money* in the next seven years. However, this new money that legislators normally count on is not expected to be adequate to meet the projected increase in spending in some years. These spending projections assume that agencies will be given enough resources to maintain existing service levels. *De facto* spending cuts occur when agency budgets do not keep pace with inflation and population growth, resulting in longer lines at the Division of Motor Vehicles, larger classes, more potholes, higher college tuition, and raises less than the cost of living for state employees. Any significant increase in outlays beyond existing programs or reduction in revenue through tax changes can be expected to create shortfalls that will not be made up out of new money. Any new tax cuts or any increases in spending programs would have to be explicitly paid for with increases in taxes or fees or with spending cuts.

A Cautionary Note

Although these revenue and spending projections are conservative in terms of the expected response of revenue to economic growth, they are actually optimistic in terms of the future economic climate or possible unforeseen events. For example, a recession or a hurricane could result in more frequent or larger shortfalls. Rising medical costs for state retirees, which come out of the general fund, are not reflected in these projections. In addition, these projections do not allow for added spending on infrastructure needs including deferred maintenance, additional debt beyond that already authorized, or program improvements (especially in education). Furthermore, these projections also assume that the General Assembly will not authorize any new tax relief beyond that currently in place.

Figure 1



Key Policy Changes

These revenue and expenditure projections reflect three recent legislative policy changes that will have a significant impact on the general fund in the foreseeable future. Two major policy changes, expanded business tax incentives and the 1994 property tax relief program for homeowners, were adopted in the last few years. A lesser policy change was the expansion of tax relief for the elderly. The impact of these three changes is reflected in the revenue and spending projections in tables 2, 3, and 4.

Business Tax Incentives

Like most states, South Carolina attempts to offer a highly competitive package of tax inducements to bring new industry and jobs into the state. It is difficult to measure the economic impact of these incentives, either in stimulating growth or in keeping income from falling and unemployment from rising. Certainly the state enjoys more jobs and a higher income than it would in the absence of such incentives. Researchers involved in this study do not believe, however, that in the current climate of labor scarcity incentives can substantially increase the personal income growth rate above 5.5 percent (2.5 percent after adjusting for inflation) that was assumed in the above revenue projections.

Even if business incentives succeed in raising the state's personal income growth rate, the fiscal impact and the economic impact of business tax incentives are also not the same. Economic impact refers to what happens to jobs, output, and personal income. Fiscal impact refers to the effect on state and local revenue and expenditures. The revenue effect alone is likely to be negative. Bartik¹ finds that a cut in taxes of 10 percent will only lead to a 1 percent to 6 percent increase in economic activity. Increased economic activity will cause tax revenue to increase; but because the responsiveness of state tax systems to income increases is less than one to one, the increase in revenue will be less than 1 percent to 6 percent and more in the range of 0.8 percent to 2.9 percent. Thus, while business incentives may indeed be a useful development tool, they can have a negative impact on state revenue.

In 1995 and 1996, a number of business tax incentives were authorized that affect state revenue. Job tax credits, Economic Impact Zone credits, and Aid to Families with Dependent Children credits can be subtracted from a firm's corporate income tax liability. Job development fees and job retraining programs reduce revenue from the individual income tax. The state has also revised the fee in lieu of taxes (FILOT) program in ways that will impact property tax revenue to local governments. These incentives are similar to those offered by neighboring states, except that South Carolina offers a development tax credit in lieu of a state investment tax credit. In dollar terms, however, South Carolina's business tax incentives are somewhat more generous on average than in neighboring states.

Because these incentives are relatively new, the current cost in foregone revenue (Table 5) is deceptively low—\$17 million in 1996-97, of which \$9 million comes from the corporate in-

¹ T.J. Bartik, "Taxes and Local Economic Development: What Do We Know and What Can We Know?," National Tax Association, Proceedings of the 86th Annual Conference, 1994, p. 102-106.

come tax (primarily job tax credits) and \$8 million from individual income taxes (retraining agreements). By 2009-10, however, business incentives are projected to cost the general fund an estimated \$248 million, of which \$85 million is reduced corporate income tax revenue and \$163 million is reduced individual income tax revenue. The job development fees (\$140 million) and job tax credits (\$63 million) account for most of the projected revenue lost.

FILOT, which saw some revisions in the 1997 legislative session, has been a popular program involving some 20 percent of announced investment statewide. In 1996-97, it is estimated that FILOT agreements covered \$1.8 billion in real and personal property value at a cost of \$20 million in revenue to local governments. By 2009-10, it is estimated that those numbers will grow to \$15.7 billion in property value and \$172 million in local government property tax revenue foregone.

Table 5
South Carolina Business Incentive Programs
Projected Revenue Costs, 1996-97 and 2009-10
(in millions of dollars)

Incentive Program	1996-97	2009-10
Corporate Income Tax Incentives		
Job Tax Credit	\$7.3	\$63.4
Economic Impact Zones	2.0	6.9
Aid to Families With Dependent Children	0	15.0
Total Corporate	\$9.3	\$85.3
Individual Income Tax Withholdings		
Job Development Fees	\$0	\$139.8
Retraining Agreements	8.0	23.0
Total Individual	\$8.0	\$162.8
Local Property Tax Reductions		
Fee-in-Lieu of Taxes (FILOT)	\$20.1	\$172.4
Total Local	\$20.1	\$172.4
Total Program Costs^a		
Total Excluding FILOT	\$17.3	\$248.1
Total All Incentives	\$37.3	\$420.5
Other Statistics		
Annual Employment Growth	7,828	9,876
Employees in Job Development Program	0	148,688
Employees in Retraining Program	29,000	83,509

^a Detail may not sum to totals due to rounding.

Homeowners' Property Tax Relief

Accurately projecting the cost of providing relief from school property taxes for the first \$100,000 of property value is a complex task. Because recent legislation has strengthened the requirement of rolling back millage after reassessment and limited increases in property taxes, the major source of additional cost for this program comes from new construction. The impact of new construction on the cost of property tax relief depends on its location, because the millage that will be applied to determining relief is the millage of the school district in which the construction occurs. While the median state relief was \$213 per homeowner, it ranged from \$532 in Lexington County to \$93 in Dillon County in 1995. Because projections incorporating all these factors are subject to considerable error, the school property tax relief projection was made using the assumption of a four percent annual compounded growth rate in eligible assessed property value (3 percent for inflation and 1 percent for growth in the tax base due to new construction). The projected cost of school property tax relief by 2009-10 under this method is \$336 million.

Income Tax Relief for the Elderly

Prior to 1996 South Carolina offered a pension exclusion on the individual income tax, a deduction of \$3,000 if claimed before age 65 or \$10,000 if first claimed at age 65. In 1996, the exclusion was broadened to cover all income for those age 65 or older, adjusted for pension exclusions. In 1997, the exclusion was increased to \$11,500.

These tax breaks are particularly significant because they are directed at the fastest growing segment of the state's population. The over-65 population is projected to grow about twice as fast as the population as a whole through 2010. While the cost of the current exclusion is estimated at \$17.4 million for 1996-97, it is projected to grow to \$44 million by 2009-10.

Proposed Policy Changes: The Cost of Additional Tax Relief

A number of tax proposals, most of which would reduce state tax revenue, are being actively entertained. Proposals for increasing the income tax exclusion for those over 65 to \$50,000, eliminating the \$300 sales tax cap on cars (which would increase revenue), eliminating the sales tax on food, and providing some relief for property taxes on personal vehicles have received the most attention.

Income Tax Relief for the Elderly

The governor's recent proposal to increase the income tax exemption to \$50,000 for those over age 65 to make South Carolina more attractive as a retirement destination could be costly in terms of revenue foregone. The state's elderly population is projected to grow at about 2 percent per year through 2010, much faster than the general population. While the exemption might attract a significant number of retirees to South Carolina, there would be little mechanism left in place to capture any state revenue from these new citizens. With school property tax relief plus the homestead exemption, the elderly would pay little property tax as well as little if

any income tax, leaving the sales tax as the only effective vehicle for collecting revenue for state and local purposes from this group.

Sales Tax Changes on Automobiles and Food

The removal of the \$300 sales tax cap on automobiles (which would increase revenue) and the elimination of the sales tax on food (which would reduce revenue) would significantly impact sales tax revenue. It is projected that the elimination of the sales tax cap on automobiles would bring in additional sales tax revenue in 2009-10 of \$338 million. The elimination of the sales tax on food, which has occurred in some other states, most recently Louisiana and Georgia, would reduce South Carolina's retail sales tax base about 25 percent. The Budget and Control Board has estimated the revenue cost from such an exemption as \$206 million in 1997-98. The cost of this change is projected to grow to \$305 million in 2009-10.

Property Tax on Personal Vehicles

The property tax on personal vehicles is a local revenue source, so proposals to reduce or eliminate this tax are usually based on a promise that the state will replace part or all of the lost revenue. South Carolina's property tax on personal vehicles tends to be high in comparison with other states because of the 10.5 percent assessment rate. This high assessment rate may account for the fact that the ratio of registered vehicles per person and vehicles per licensed driver is lower in South Carolina than in any neighboring states and lower than the U.S. average. Limited enforcement efforts directed at validating registration may also be a contributing factor. Despite an apparent underregistration problem, personal vehicles contribute one-sixth of all property tax revenue and are the second fastest growing component of the property tax base. At 1994 average mill rates, it is estimated that personal vehicles would generate \$779 million in personal property taxes in 2009-10. If mill rates continue to grow at the recent rate of 1.9 percent per year, the revenue would be \$1.03 billion in 2009-10. If the state chooses to reduce or eliminate this tax and to pick up the revenue loss to local governments, the cost in state revenue could be substantial.

The Fiscal Prospects for Local Governments

In 1994-95, South Carolina's 91 school districts, 46 counties, and 269 municipalities had combined revenue of \$5.5 billion. School districts received \$3.7 billion, and cities and counties took in \$1.8 billion. These local governments derive 84 percent of their revenue from property taxes, state aid, the local option sales tax, and various kinds of fees and charges. Federal aid is a minor revenue source.

Property taxes, not adjusted for credits for the local option sales tax, which is mostly used to roll back property taxes, or the state homestead exemption reimbursement, are the single most important own source revenue for South Carolina's local governments. Property taxes contributed about 65 percent of locally generated revenue on average in 1994-95. As a percentage of total revenue from all sources, the property tax generated 38 percent of city revenue, 36 percent of school district revenue, and 48 percent of county revenue in that year.

Revenue from the property tax depends on growth of the value of its various component bases, primarily residential, commercial, industrial, and personal, and increases in the mill rate. The total assessed value of real and personal property grew 4.9 percent per year between 1989-90 and 1994-95 and the average mill rate (cities, counties, and school districts combined) grew 1.9 percent per year over that same period. There is increased pressure from voters to hold down growth in the mill rate; recently enacted legislative restraints on local governments reflect this concern. The local sales tax, which functions mainly as property tax relief rather than a separate revenue source, also is expected to slow the growth of the property tax. These factors will all affect future revenue.

Two property tax revenue projections were developed based on recent growth rates in assessed property value in the various property classifications. The lower bound projection assumed average millage was fixed at its 1994 level. The upper bound projection assumed average annual millage growth at its recent rate of 1.9 percent. After allowing for FILOT and including local sales tax revenue and state property tax relief and homestead exemption reimbursement payments as local property tax revenue, these two projections yielded a range for property tax revenue in 2009-10 of \$4.1 billion to \$5.5 billion, with two-thirds going to school districts and one-third to cities and counties. Local sales tax revenue in 2009-10 was projected to come to \$572 million assuming that all counties were participating by that year. However, it was assumed that the local sales tax revenue would all be used to offset property taxes.

The state is an important funding partner for South Carolina's local governments. The state's total outlay for local governments in 2009-10 was projected to come to \$2.8 billion, which accounted for over 25 percent of projected local government revenue in that year. \$2.3 billion of that revenue will go to school districts. The Local Government Fund, accommodations tax revenue, other state-shared revenue, and state grants to cities and counties were projected to be \$547 million. The Local Government Fund has been fully funded in recent years, but could be vulnerable to one or more difficult budget years. State grants to local governments are highly variable and likely to be cut if state revenue is down. Thus, a significant share of local government funding could be at risk if state revenue falls short of what is needed to meet future expenditure demands.

Other local revenue sources include federal aid and various fees and charges. Federal aid is a relatively modest source of revenue and growing more slowly than the other sources. Other local revenue sources have been growing rapidly, especially fees and charges for cities and counties.

The analysis of components of local revenue suggests that local governments can expect between \$10.1 billion and \$11.5 billion in revenue in 2009-10. School districts are expected to receive \$6.2 billion to \$7.1 billion and cities and counties between \$3.9 billion and \$4.4 billion.

School districts can expect revenue to grow through 2009-10 at a rate that is just about equal to growth in student enrollment and inflation, with revenue growing at 3.6 percent per year in the lower bound projection and 4.6 percent per year in the upper bound projection. If cities and counties can maintain past high growth rates for "other" revenue, they can expect revenue to

grow slightly faster than population and inflation (5.2 percent per year in the lower projection, 6.0 percent for the higher projection). However, their spending demands have also been growing at a rate of 7.3 percent per year between 1989-90 and 1994-95 as they attempt to supply infrastructure (especially landfills) and law enforcement and solid waste collection services to a growing population. In addition, two of their major sources of revenue growth, fees and charges and state grants, are likely to grow much more slowly in the future than they have in the past.

The State Retirement System

Finally, the health of the state retirement system was examined independently. The state retirement system does not impact directly on the general fund other than the employer's contributed share, which is built into the labor costs of state agencies. However, if the system is unable to meet its obligations and the state is called upon to make up the deficiency and fulfill its commitments to retirees, that demand will fall on the general fund.

It is difficult to evaluate how the state retirement system could affect future spending. It is not possible to generate a precise estimate of how much a future shortfall would cost the general fund because that cost depends on the size of the deficit, the year in which action is taken, and how the cost of making up the deficit is spread over time. However, one measure of the fiscal sustainability of the state retirement system is how close the value of fund assets available to pay benefits is to the projected benefit obligation.

A retirement system has a shortfall (or surplus) if the present value of the projected benefit obligation is less (or more) than the present value of the fund assets available to pay benefits. These values include expected payments contributed by workers, interest earned, expenses, and benefit payments. State retirement systems range from seriously underfunded (Connecticut) to substantially overfunded (Tennessee), but in recent years of strong state revenue many states have reduced their shortfalls and strengthened their pension systems.²

Three estimates of the size of the total actuarial underfunding of South Carolina's state retirement system were developed for alternative measures of the size of the funding shortfall. These estimates were developed with the assistance of the retirement fund staff and the state's actuary. The estimates also depend on demographic projections for retirement system participants, interest earnings, average wages, and other factors that can change from year to year and alter the measured health of the system.

The first two projections of system underfunding do not reflect any future cost-of-living adjustments for retirees. The first method of computation used a pre-1996 convention that valued pension fund assets at amortized cost rather than market value. Using this method, the system was estimated to be underfunded by \$3.6 billion in 1994-95 with the shortfall expected to increase to \$6.3 billion by 2009-2010. In 1996 the method for valuing fund assets was changed to a market basis, which reduced the system's estimated shortfall to \$1.7 billion in 1995-96.

² Penelope Lemov, "Michigan's Big Pension Gamble," *Governing* 10 (May 1997), p. 41.

There is currently a surcharge on employers to make up the existing shortfall; state agencies pay 7.55 percent rather than 6 percent of payroll and school districts and local governments pay 6.7 percent rather than 6 percent. This surcharge will reduce the existing shortfall over time so that the system will be fully funded in 2019. At the present time the state retirement system is about 88.5 percent funded, which is well within the middle range of all states. In comparison, North Carolina's retirement system is 98 percent funded (excluding cost-of-living adjustments) and Georgia's system is 94 percent funded.

The third estimate of future system underfunding took into account future cost-of-living adjustments for retirees. While these adjustments are not required by law, it is unlikely that they will be discontinued in the foreseeable future for both political and equity reasons. If cost-of-living adjustments are factored in at an average annual rate of 3.5 percent, the current shortfall is estimated to be approximately \$6.6 billion. A current shortfall of this magnitude is a serious source of concern because it indicates that the state retirement system has only about 66 percent of the assets required to pay cost of living adjusted benefits in the future.

Appendix 1
South Carolina Revenue and Expenditure Projections, 1997-98 to 2009-10
(in millions of dollars)

	1997-98 ^a	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Revenue by Projection Method													
BCB Growth Rate	\$4,803.0	\$5,028.7	\$5,265.0	\$5,512.5	\$5,771.5	\$6,042.8	\$6,326.7	\$6,624.1	\$6,935.4	\$7,261.3	\$7,602.6	\$7,959.9	\$8,333.9
Historical Elasticities	4,778.6	4,977.9	5,185.4	5,401.6	5,626.7	5,861.3	6,105.7	6,360.2	6,625.4	6,901.6	7,189.3	7,489.1	7,801.3
Sum of Revenue Components ^b	4,735.2	4,930.2	5,130.4	5,345.9	5,572.1	5,809.8	6,059.4	6,321.8	6,597.4	6,887.1	7,191.5	7,511.5	7,847.8
Expenditures by Major Category													
Property Tax Relief	\$209.8	\$218.2	\$226.9	\$236.0	\$245.4	\$255.3	\$265.5	\$276.1	\$287.1	\$298.6	\$310.6	\$323.0	\$335.9
Homestead Exemption	51.2	52.1	53.0	53.9	54.8	55.6	56.5	57.6	58.6	59.8	61.1	62.5	64.1
Local Government Fund ^c	173.6	204.9	213.1	221.9	230.9	240.6	250.7	261.4	272.7	284.5	296.9	303.9	323.6
Corrections	383.1	410.6	447.8	482.0	504.8	528.7	553.7	580.0	607.5	636.3	664.2	695.8	728.8
Education (K-12 & Higher)	2,115.1	2,199.7	2,287.7	2,379.2	2,474.4	2,573.3	2,676.3	2,783.3	2,894.7	3,010.4	3,130.8	3,256.0	3,386.3
Medicaid/Social Services	441.7	461.7	482.6	509.5	527.4	551.6	577.5	605.0	634.7	666.5	700.3	736.9	776.1
General Obligation Debt Service	149.9	292.8	288.6	300.0	273.4	279.3	258.3	250.9	243.2	229.5	216.6	221.5	185.4
All Other Spending	1,151.5	1,197.6	1,245.5	1,295.3	1,347.1	1,401.0	1,457.0	1,515.3	1,575.9	1,638.9	1,704.5	1,772.7	1,843.6
Total Expenditures^d	\$4,675.9	\$5,037.6	\$5,245.2	\$5,477.8	\$5,658.2	\$5,885.4	\$6,095.5	\$6,329.6	\$6,574.4	\$6,824.5	\$7,085.0	\$7,378.3	\$7,643.9

^a 1997-98 expenditures from appropriations act. Expenditure projections for later years are based on these appropriations. Revenue projections are based on actual 1996-97 revenue.

^b Adjusted for projected revenue losses from business tax incentives and income tax exclusions. Individual income tax component projection based on historical elasticities.

^c Based on projected revenue by components; full formula funding assumed.

^d Detail may not add to totals due to rounding.