SPECIAL REPORT

The Fiscal Sustainability of the South Carolina revenue and Expenditure system 1998-2010

By

Holley Hewitt Ulbrich, Ph.D.

March 15, 1999

THE STROM THURMOND INSTITUTE

CLEMSON UNIVERSITY SOUTH CAROLINA 1889

Acknowledgments

This project was funded in part by the Self Family Foundation.

The contributions of the following staff of the Strom Thurmond Institute of Government and Public Affairs are also gratefully acknowledged: Ellen Saltzman for research assistance and editing and Martha Morris for word processing assistance.

The main report and four working papers can be found on the
Institute's Web page at
www.strom.clemson.edu

Strom Thurmond Institute of Government and Public Affairs
Clemson University
Perimeter Road
Clemson, South Carolina 29634-5203
Telephone: 864.656.4700 Fax: 864.656.4780

THE FISCAL SUSTAINABILITY OF THE SOUTH CAROLINA REVENUE AND EXPENDITURE SYSTEM 1998-2010

BY

HOLLEY HEWITT ULBRICH, PH.D.
ALUMNI PROFESSOR OF ECONOMICS EMERITUS
SENIOR FELLOW, STROM THURMOND INSTITUTE
CLEMSON UNIVERSITY

THIS REPORT SUMMARIZES A FOUR-PAPER SERIES OF WORKING PAPERS

NO. 1: STATE REVENUE: PROJECTIONS TO 2010 BY H. H. ULBRICH
NO. 2: IMPACT OF BUSINESS INCENTIVES ON GENERAL REVENUE: PROJECTED FISCAL COSTS BY D. V. RAINEY
NO. 3: STATE EXPENDITURES: PROJECTIONS TO 2010 BY D. V. RAINEY
NO. 4: LOCAL GOVERNMENT REVENUES AND EXPENDITURES: PROJECTIONS TO 2010 BY H. H. ULBRICH

STROM THURMOND INSTITUTE OF GOVERNMENT AND PUBLIC AFFAIRS
CLEMSON UNIVERSITY
CLEMSON, SOUTH CAROLINA

March 15, 1999

The Fiscal Sustainability of the South Carolina Revenue and Expenditure System 1998-2010

In 1997, a team of researchers from the Strom Thurmond Institute generated projections of South Carolina General fund revenues and expenditures through fiscal year 2009-10, based on plausible assumptions about inflation, population growth, and personal income growth over the next decade and beyond.[1] This year, we revisited our projections for the fiscal year just ended and developed revised projections based on actual or appropriated data for the most recent fiscal year, new legislation and other developments, and slight modifications of the assumptions.

This report summarizes a series of four working papers that address state revenues, expenditures, the fiscal cost of business incentives, and local revenues. The fifth paper in the 1997 fiscal sustainability series on the state retirement system was intended as a one-time project and will probably not be revisited for another four or five years. The two revenue papers review the projected versus actual figures for the most recent fiscal year (1997-98 for the state, 1995-96 for local government) and develop revised projections through 2009-10. Data are not yet available for comparing the projected versus actual fiscal cost of business incentives, which will be done in the third year of this ongoing project. Since last year's expenditure projections were based on appropriations approved for the current fiscal year, comparison of projected to actual expenditures will be done for the first time next year.

Shortfalls and Surpluses

In the current analysis, both expenditure growth and revenue growth are projected to be lower than last year's projections because of a downward adjustment of the inflation rate—from 3.0% to 2.5% per year. The most credible state revenue projection combined with the expenditure projection indicates small revenue shortfalls through 2009-10. A projected revenue shortfall of $118 million in fiscal year 1998-99 will probably not materialize because spending needs can be adequately met by the 1997-98 surplus. The revised projections, however, do not suggest such a windfall coming to the rescue in future years. The largest projected shortfall of $258 million comes in 1999-2000, then the projected shortfalls gradually diminish to $68 million in 2009-10 (Table 1, Figure 1).

Obviously, constitutional constraints prohibit deficits, so these shortfalls (should they occur) would have to be addressed either by spending cuts or tax and fee increases unless an unusually strong economy succeeds in generating additional revenue. The current economy is quite strong, which could make the near term projections for 1998-99 and

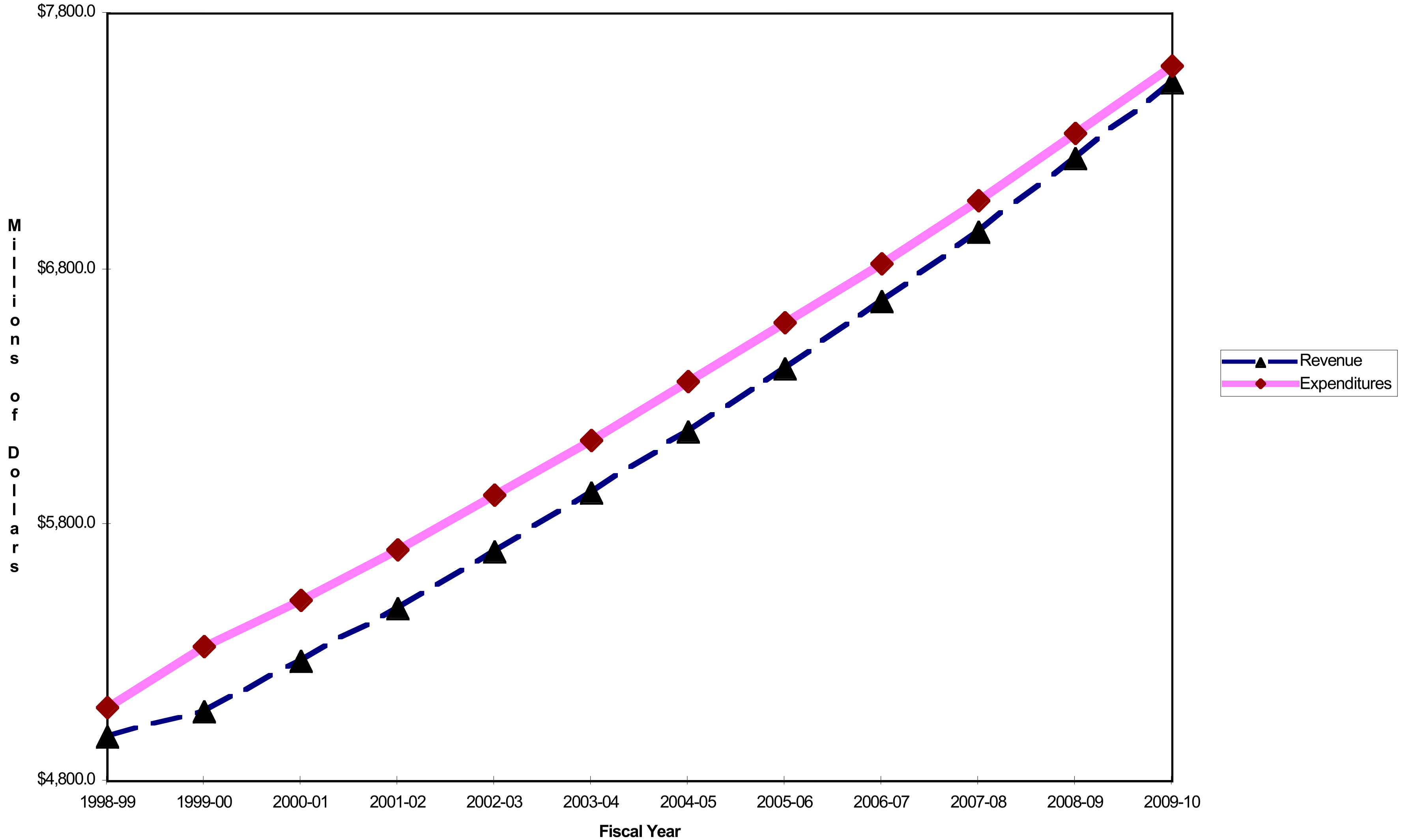
[1]Holley H. Ulbrich, *The Fiscal Sustainability of the South Carolina Revenue and Expenditure System*, 1997-2010 (Clemson, SC: Strom Thurmond Institute of Government and Public Affairs, November 17, 1997).

Table 1. Projected South Carolina Budget Shortfalls / Surpluses, 1998-2010 (in millions)

FISCAL YEAR	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
General Fund Revenue												
Components Method	$4,968.8	$5,068.8	$5,267.2	$5,475.5	$5,693.8	$5,923.0	$6,162.4	$6,412.3	$6,673.2	$6,945.7	$7,230.2	$7,527.5
Constant Growth of Tot. Rev. Method	$5,030.1	$5,223.0	$5,423.3	$5,631.3	$5,847.3	$6,071.5	$6,304.4	$6,546.1	$6,797.2	$7,057.9	$7,328.5	$7,609.6
General Fund Expenditures												
Total w/ Trust Fund for Tax Relief	$5,086.7	$5,327.1	$5,505.1	$5,703.6	$5,914.2	$6,132.9	$6,360.0	$6,588.4	$6,825.7	$7,072.3	$7,328.7	$7,595.2
Surplus / (Shortfall):												
High	$ (56.5)	$ (104.1)	$ (81.8)	$ (72.3)	$ (67.0)	$ (61.4)	$ (55.6)	$ (42.2)	$ (28.5)	$ (14.5)	$ (0.1)	$ 14.4
Low	$ (117.8)	$ (258.4)	$ (237.9)	$ (228.1)	$ (220.5)	$ (209.9)	$ (197.6)	$ (176.1)	$ (152.5)	$ (126.7)	$ (98.4)	$ (67.7)

Note: The "high" estimate is the difference of revenue over expenditures using revenue projections from the "Constant Growth of Total Revenue" method, and the "low" estimate is that difference using the "Components" method.

Figure 1. Component Revenue and Expenditure Projections, 1998-99 to 2009-10



1999-2000 too conservative. However, the research team continues to contend that a real growth rate in excess of 2.5% a year cannot be sustained over the next twelve fiscal years.

State Revenues

Actual recurring general fund revenue for 1997-98 was $4,844, $41 million higher than the 1997 upper bound projection of $4,803 and $109 million more than the lower bound estimate of $4,735, or 1-2% higher than anticipated. Reasons for this underprojection include greater-than-anticipated personal income growth (5.8% versus a projected 5.5%), which accounts for about $35 million of additional revenue. Also, the two major state revenue sources, individual income and retail sales tax, grew faster relative to income than they have in the past. Individual income tax revenue was up 8% and retail sales tax revenue 6.6%. Other revenue sources that significantly exceeded expectations were earnings on investments and miscellaneous taxes (all but individual and corporate income, sales, insurance, alcoholic beverage, and business/corporate licenses), which brought in $217 million compared to the state's original forecast of only $164 million.

Last year's report used four alternative methods for projecting future general fund revenues. This year, only two methods are employed. The first method is the simpler of the two because the projection is based on growth of *total* revenue. This method starts with the total general fund receipts from fiscal year 1997-98 and applies a constant annual growth rate to this figure to arrive at a projection for 2009-10. Using this method, future general fund revenue was computed using three alternative growth rates of personal income—5%, 5.5%, and 5.8%—and the historical income elasticity of total revenue, which measures the responsiveness of revenue to income growth. Projected total revenue outcomes for the fiscal year 2009-10 were $7,610 million, $7,957 million, and $8,167 million, respectively. The $7,610 million figure, which corresponds with a personal income growth rate of 5%, is considered the most plausible, though each of these figures lies within the boundaries of last year's revenue projections.

The second and potentially more accurate method of projection examines each of several major components of general fund revenue separately. Historical elasticities of the revenue components are used in conjunction with the assumed rate of personal income growth to predict changes in future component revenue streams. In addition, adjustments are made for legislative changes in the tax code.

Separate projections were developed for the individual income tax, the retail sales tax, the corporate income tax, an alcoholic beverage/beer and wine tax, and a category named "all other revenue sources" (Table 2). Of the two revenue projection methods used in this analysis, the components-based projections are the lower of the two, suggesting that revenue shortfalls are more likely to occur.

Table 2
Projected Total General Fund Revenues by Major Components
1998-99 and 2009-10

Revenues	*1997-98 Actual*	*1998-99 Projected*	*2009-10 Projected*
Individual Income Tax	$2,095	$2,178	$3,529
Corporate Income Tax	194	187	405
Retail Sales Tax*	1,742	1,808	2,733
Alcohol/Beer and Wine	127	129	153
All Other Revenues	694	666	708
Total	**$4,844**	**$4,969**	**$7,527**

**including casual sales*
Note: Detail may not sum to totals due to rounding.

Projections for the individual income tax assume that income tax revenue will continue to grow at the same rate with respect to income as it did over the period 1986-1995. If personal income grows at 5%, individual income tax collections are expected to grow at a rate of 4.93% before adjusting for legislative changes of the last few years. Individual income tax revenue is then adjusted for projected revenue losses due to the expanded retirement exemption, tuition tax credits, job development fees and retraining agreements. After these adjustments, projected revenue from the individual income tax for is $3,529 million for 2009-10.

With no major changes to this tax in recent years, retail sales tax revenue growth is projected, as last year, on a basis of an income elasticity of 0.76. Projected revenue for 2009-10 is $2,733 million.

The income elasticity used to project the corporate income tax, which is quite high (1.48), is based on revenue growth from 1986 to 1995, the period before recent business incentives took effect. Since that time, revenue from this source has been impacted by the job tax credit, investment tax credit, Economic Impact Zone credit, and Aid to Families With Dependent Children credit, which are used as business development incentives. After these adjustments, the projected revenue from this tax in 2009-10 is projected to be $405 million.

Beer and wine are taxed separately from other alcoholic beverages, but both taxes are based on volume rather than price. This form of tax tends to grow very slowly over time. These taxes are projected to continue to grow at the past, slow rate of 1.55% a year, yielding revenue of $153 million in 2009-10.

All other recurring general fund revenues were up about $22 million in 1998 because of a few unusual items, such as debt service transfers, the unclaimed property fund, good earnings on investments, and an exceptional year of estate tax revenues. This report uses the South Carolina Board of Economic Advisors' forecast for 1998-99 and 1999-2000 and beyond 2000, the historic average growth rate of 1.638% per year. Projected revenue in 2009-10 for this group of sources is $708 million.

In summary, the research team believes that the most credible revenue projection for 2009-10 is between $7,527 million and $7,610 million. This range for possible future general fund revenue is somewhat less than the 1997 report's projections for the same year because of the assumption of a lower rate of inflation and therefore a lower rate of personal income growth.

Business Incentives

Business incentives make the state more attractive to relocating and expanding firms by reducing their cost of doing business. Firms attracted to the state by such programs contribute to the state's economic growth and prosperity. But business incentives also come with a fiscal cost to the state—they reduce potential tax revenues. Future projections of state general fund revenue must factor in revenue adjustments associated with these programs.

Several changes were made to the package of business incentives in the 1998 legislative session. These changes include a moratorium on corporate income taxes for companies that invest in counties with unemployment rates that are at least twice the state average and a change in the investment tax credit from a flat 5 percent of investment to a graduated scale based on the useful life of the property. Also, qualified service facilities are now able to qualify for the job tax credit if they meet certain requirements about wage levels and the number of jobs created.

The combined impact of the state's business incentive programs on the state's corporate and individual income tax revenues is projected to be $294.7 million in 2009-10 (Table 3). The total fiscal impacts of business incentives rise to $353.4 million in 2009-10 after adding in the projected effect on local property tax revenues of the fee-in-lieu-of-tax program.

Incentives Affecting Corporate Income Tax Revenue

Four business incentive programs affect gross corporate income tax receipts. The job tax credit program allows an income tax credit for each employee hired as long as the company maintains a minimum level of employment (10 workers for manufacturing firms). The investment tax credit (only available in Economic Impact Zone counties) allows firms to reduce their corporate income tax liability by one to five percent of actual investment, depending on the expected life of the property. (The investment tax credit was not estimated in last year's report.) The AFDC credit program allows corporations to reduce their tax liability for hiring former AFDC recipients. The Economic Impact Zone credit program allows firms to obtain a credit of 10% of the first $10,000 of wages for employees displaced by the closing or realignment of a federal facility. The fiscal cost of these incentive programs on corporate income tax receipts is projected to be $104.0 million in 2009-10.

Table 3
Projected Fiscal Impact of South Carolina Business Incentive Programs
1998-99 and 2009-10
(in millions)

Program	*1998-99*	*2009-10*
Corporate Income Tax	**$42.2**	**$104.0**
Job Tax Credit	$12.2	$44.9
Investment Tax Credit	21.5	34.9
Economic Impact Zone Credit	2.7	7.6
Aid to Families With Dependent Children Credit	5.8	16.6
Individual Income Tax	**$29.3**	**$190.7**
Job Development Credit	$9.5	$152.5
Retraining Agreements	19.8	38.1
Local Property Tax Reductions (FILOT)	**$34.5**	**$58.7**
Total Fiscal Costs Excluding FILOT	**$71.4**	**$294.7**
Total Fiscal Costs, All Programs	**$106.0**	**$353.4**

Note: Detail may not sum to totals due to rounding.

INCENTIVES AFFECTING INDIVIDUAL INCOME TAX REVENUE

Two incentive programs impact individual income tax revenue. Job development credits allows corporation to obtain a refund from withholdings of employee income tax payments, to be used for infrastructure improvements, employee retraining, pollution control equipment, and purchases of real property. Retraining agreements allow companies to receive a refund on individual income tax withholdings as reimbursement on training expense incurred by the firm. The overall fiscal impact of these two programs is projected to be $190.7 million in 2009-10.

STATE EXPENDITURES

The bulk of state spending falls into five areas: education (K-12 and post-secondary), corrections, state aid to local governments, social services, and debt service. These five categories account for about three-quarters of total general fund spending (Table 4). In general, the expenditure projections assume that spending would just keep pace with inflation rate at a rate of 2.5% and population growth based on projections from the U.S.

Census. This method assumes that the General Assembly will choose to maintain future spending at current real (inflation-adjusted) per capita levels.

Population growth in specific age cohorts is a major factor affecting spending on education, corrections, and Medicaid/social services. In these areas, it is assumed that increases in spending will be driven by population growth in the relevant population as well as inflation. These assumptions result in projected spending in 2009-10 of $2.1 billion for K-12 education and $1.1 billion for post-secondary education. Higher-than-average growth in the prison population drives projected corrections operations and juvenile justice spending, while probation spending and the cost of operating new prisons is projected to grow more slowly. Total corrections spending is expected to come to $698 million by 2009-10.

The bulk of social service spending is for Medicaid, which accounts for 75 percent of spending in this category in the current year. Inflation plus more rapid growth in the over-65 age group, which accounts for a disproportionate share of Medicaid spending, are projected to drive Medicaid spending to $594 million by 2009-10. Total social service spending is projected to be $762 million in 2009-10.

The state has a number of programs to aid local governments. These programs include the Local Government Fund, school property tax relief, and reimbursement for the homestead exemption for the elderly, the inventory tax reimbursement and the depreciation property tax reimbursement. Beginning in 1998-99, funding for the latter four programs will go through the new Trust Fund for Tax Relief rather than the general fund. However, these state outlays are grouped with other forms of state spending rather than being removed from the general fund in order to allow comparability with last year's report. For this reason, the 1998-99 general fund revenues and appropriations reported here will differ from figures reported by other sources by the amount of this fund.

The Local Government Fund provides funds to cities and counties on a formula basis in the amount of 4.5% of general fund revenues from the last completed fiscal year. Creation of the Trust Fund for Tax Relief in 1998-99 removes these funds from the general fund base in the current and future years, a change that will result in a reduction in the Local Government Fund of about $16 million in 2000-01. The Local Government Fund is projected to cost $285 million in 2009-10, including the adjustment for the impact of the trust fund.

The School Property Tax Relief program is currently the largest category of state aid to local governments. This program exempts the first $100,000 dollars of owner-occupied residential property from taxes for school operating costs. With a current outlay of $240 million, this program is projected to cost $521 million by 2009-10. The homestead exemption reimbursement for the elderly, blind, and disabled is projected to grow from $53 million to $77 million. The inventory tax and depreciation property tax reimbursement programs are projected to result in payments to local governments of $84 million in 2009-10. Total aid to local government, not including grants to local governments by various state agencies, is projected to be $974 million in 2009-10.

Debt service is conservatively estimated to increase by $9 million annually (as it has in the past), resulting in a projected $251 million in 2009-10. All other expenditures were assumed to keep pace with inflation and overall population growth and are projected to come to $1.7 billion in 2009-10. Total general fund expenditures for 2009-10, including the Trust Fund for Tax Relief, are projected to be $7.6 billion.

Table 4
Appropriated and Projected General Fund Expenditures
by Major Components
(in millions)

Expenditure	*1998-99 Appropriations*	*2009-10 Projected*
Education	$2,312.7	$3,204.4
Corrections	387.1	697.6
Medicaid/Social Services	480.6	761.8
Aid to Local Governments*	572.7	974.1
Debt Service	152.4	251.4
All Other Spending	1,181.2	1,706.0
Total	**$5,086.7**	**$7,595.2**

**includes funds reserved for the Trust Fund for Tax Relief.*
Note: Detail may not sum to totals due to rounding.

Local Government

The final paper in this year's series addresses the fiscal situation facing school districts and counties and cities, with emphasis on revenues. The fiscal health of local governments is examined because the state government has responsibilities to its political subdivisions, and so fiscal pressures on local governments are likely to be translated into demands for more state aid. Two methods of revenue projection were used: projections based on total revenues and projections of major revenue components, such as property tax, intergovernmental revenue, and fees and charges. Projections of future local expenditures were also made. This year's projections for local governments are more optimistic than those in the 1997 report due to the fact that revenue for the most recent available year (1995-96)—the starting point for this paper's revenue projections—was higher than last year's report had projected.

Projections Based on Total Revenues and Total Expenditures

Overall projections through 2009-10, based on average rates of growth of revenues and expenditures for the years 1999-90 to 1995-96, predict surpluses for both categories of local governments. For school districts, a simple projection shows revenues of $8.7 billion and spending of $8.2 billion in 2009-10. For counties and cities combined, continued revenue growth at a rapid pace (8.2%) would generate revenue of $6.1 billion in 2009-10, more than adequate to fund projected spending of either $3.6 billion in 2009-10 (projected at the personal income growth rate of 5%), or $4.7 billion (projected at the recent past growth rate of 7%). A further inspection of the individual components that make up total local government revenues paints a similar picture.

Revenue Projections Based on Revenue Components

The major revenue sources for local governments are property taxes, intergovernmental revenues, and various fees, charges, and miscellaneous revenues.

For the property tax, projections were made for each major class of property based on historical growth. In 2009-10, projected property tax revenue, including school property tax relief and homestead exemption reimbursement funds from the state and local option sales taxes (almost all of which goes to property tax rollback), ranged from $1.8 to $2.3 billion for counties and cities and $3.2 to $4.2 billion for school districts, for a total of $5.0 to $6.4 billion.

South Carolina's local governments receive intergovernmental revenues from the state and federal governments, and through interlocal agreements with other local governments. Overall, school districts are projected to receive $3.9 billion in intergovernmental revenues in 2009-10, while counties and cities, which rely much more heavily on own-source revenues, are projected to receive $838 million.

School districts receive formula allocations through the Education Improvement Act (EIA) and the Education Finance Act (EFA) as well as state grants, state-shared revenues, and homestead exemption reimbursement and school property tax relief funds. These state aid categories are expected to keep pace with school population growth and inflation, totaling $3,187 million in 2009-10. Federal aid to school districts is expected to increase to $704 million, based on strong past growth.

For counties and cities, the largest portion of state aid is state-shared revenues, which are projected to be $358 million in 2009-10, while state grants are projected to be $144 million and the homestead exemption reimbursement is projected to be $42 million. Federal aid is expected to be approximately $246 million in 2009-10. Interlocal revenue is projected to be $49 million in 2009-10.

The remainder of local government revenue is comprised of licenses, permits, fees, service charges, and other miscellaneous items. Two estimates are developed for licenses, permits, fees, and service charges for counties and cities, one at recent measured growth rates, the other at the rate of growth of personal income. Only one fees and charges projection is developed for school districts. In 2009-10, school districts are projected to increase revenues from fees and charges to $334 million, while counties and cities are projected to collect between $1.1 and $3.0 billion in fees and charges—double to quadruple the 1995-96 level.

Miscellaneous local government revenues have been growing at about the same average rate as overall local revenue for counties and cities, but somewhat faster for school districts. Counties and cities are projected to collect $419 million in miscellaneous revenues in 2009-10. For school districts, two estimates are developed—one at the high historical growth rate and the other at the historic growth rate of all school district revenue. The resulting projections for miscellaneous revenues are $608 to $799 million in 2009-10. Bond and lease revenue to school districts is projected to be $1.0 billion in 2009-10. Table 5 summarizes the projections by components for local governments.

Table 5
Current and Projected Local Government Revenues
(in millions)

		2009-10 (Projected)	
Revenues	*1995-96 (Actual)*	*Low Growth*	*High Growth*
School Districts	**$4,100**	**$8,630**	**$9,824**
Property Tax[a]	1,166	2,780	3,783
Intergovernmental	2,126	3,891	3,891
Fees, Charges & Misc.[b]	808	1,959	2,150
Counties & Cities	**$2,005**	**$3,977**	**$6,310**
Property Tax[a]	840	1,613	2,067
Intergovernmental	473	838	838
Fees, Charges & Misc.	693	1,526	3,406
All Local Governments	**$6,105**	**$12,607**	**$16,134**
Property Tax[a]	2,006	4,393	5,850
Intergovernmental	2,599	4,729	4,729
Fees, Charges & Misc.	1,500	3,485	5,556

[a]Property tax totals do not include the school property tax relief fund or homestead exemption reimbursement because these revenue sources are treated as state aid.
[b]Includes revenues from bonds and leases.
Note: Detail may not sum to totals due to rounding.

Projected local government revenues in 2009-10 range from $8.6 billion to $9.8 billion for school districts and $4.0 billion to $6.3 billion for counties and cities combined. When compared to expenditure projections of $8.2 billion for school districts and expenditures of $3.6 to $4.7 billion for counties and cities, it appears that the state's local governments will be in the right range of projected revenues and expenditures to maintain fiscal balance.

Summary

The projections in this report suggest that caution is in order at the state level. The components-based state revenue projection, which takes into account legislative changes, suggests that projected revenue will not be adequate to maintain the present level of services in the face of modest inflation and population growth. Continued rapid growth in personal income may stave off revenue shortfalls in the near term, but it is not realistic to expect that such rapid growth will be sustained for the entire 12-year period of these projections.