THREE KINDS OF CAPS AND THEIR CONSEQUENCES
ASSESSMENT, MILLAGE AND SPENDING CAPS

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SOUTH CAROLINA CITY AND COUNTY MANAGERS ASSOCIATION

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Introduction

When I was a child, my brother, my sister, my cousin and I shot caps with a cap gun on the 4th of July. A little gun powder, smoke, noise, no potential to do any actual harm. That's the kind of caps any local government could live with. Then there were other caps—ski caps, baseball caps, caps meant to shield us from sun or cold, which could be removed when we didn't need them. Again, the kinds of caps that any local government could live with.

But today's caps on millage and on assessments, and the proposed new cap on spending growth, are all punitive and potentially harmful. They are symptomatic of a basic mistrust on the part of the General Assembly not just of local government but even of themselves. In 2006, legislators were not sufficiently satisfied with all the existing restrictions on raising and spending money that already constrained local governments. They added both assessment caps and millage caps in a year when the house was up for re-election.

In 2008 we elect not only the House but also the Senate, so incumbents need to take some accomplishment to the voters in their re-election campaigns. The temptation to impose further politically popular but damaging restrictions in the form of spending caps is going to be hard to resist.

Why Caps?

The argument from the anti-tax coalition is that we have had runaway growth of spending in South Carolina, and the existing limit on spending growth—the rate of growth of personal income—is not sufficiently tight. This group wants to freeze real spending per person to prevent any further expansion in the size or scope of government, and the tool of choice is a cap that is based on population growth plus inflation. Not even the relevant rate of inflation, which would be the state and local government Gross Domestic Product (GDP) deflator, which is based on the cost of supplying government services. Instead, the proposal is to use the Consumer Price Index (CPI). This proposed cap would take its place along with the assessment caps approved by referendum in 2006 and the millage caps in Act 388, also passed in 2006.

This coalition is part of a national movement that began in California in 1978 with Prop 13 and spread to other states, with the most drastic and unworkable restrictions in Colorado called TABOR, or Taxpayer Bill of Rights. In some places, such as Prince George's County, Maryland, the caps were so restrictive that they were repealed by a referendum after six years.

The logic of the matched set of three caps goes something like this:

1. Rapidly appreciating home values have resulted in a revenue bonanza for local governments at the expense of homeowners, and local governments have spent every dime of the extra revenue. *Solution:* cap the growth of assessments as some eleven other states have already done.

2. If assessment caps slow the growth of the tax base and the growth of revenue, local governments will respond by increasing the mill rate. So we have to close off that option by limiting the growth of the mill rate. *Solution:* millage caps. Not the most effective tool, but perhaps there was a certain lack of imagination.

3. Ah, but those sneaky local governments have other revenue sources besides property taxes. School districts don't have much in the way of revenue tools, but cities and counties have other taxes like sales and hospitality and accommodations, plus they can levy fees and charges to keep sucking money out of the pockets of the poor taxpayer. *The solution?* Cap spending, so even if the school boards and city and county councils can manage to generate more revenue, they can't spend it. Caps on spending will eliminate the temptation to raise more revenue from sources outside the property taxes.

Growth of Local Government Spending

Do we have runaway local government spending in South Carolina? Has it really grown that much faster than population plus CPI? Yes and no, but more no than yes. In the last six years, those two measures, CPI and population growth, have had a combined average annual growth rate in South Carolina of 3.8 percent. Revenue from property taxes has grown at an average rate of 6.5 percent per year, and spending by all local governments has grown at a rate of 6.9 percent per year. So there is an element of truth in the widespread assertion about rapid growth of government revenue and spending. However, there are a couple of mitigating factors.

First, most economists compare growth of government to growth of personal income, so that the share of government keeps pace with but does not exceed general economic growth over time. Personal income growth during that period averaged 6 percent, so the growth in local government income and spending is only slightly greater than the growth of personal income.

Second, the areas with rapid growth—along the coast, the midlands, and along I-85, especially close to Charlotte—have had to make huge investments in infrastructure to keep up with the needs of growth.

Third, both state and local government spending in South Carolina are well below the national average. In 2005, local government revenue per capita, including intergovernmental aid, was only 76 percent of the national average. Combined state and local government revenue per capita in South Carolina was about 90 percent of the U.S. average. The same ratios hold for spending, because the difference between revenue and spending is relatively small. So government spending is growing at about the rate of personal income, but we're still below average.

Growth of Property Tax Base

The property tax is still the workhorse of local governments, particularly school districts. So part of the evaluation of the two current caps on millage and assessment as well as the potential spending cap requires a closer examination of what has been happening to property taxes—to assessed values and to tax rates or mill rates.

Each of the three caps is based on the assumption that there is a pattern of skyrocketing property tax burdens in South Carolina that is not validated by the facts. What are the facts? Have property tax burdens skyrocketed in South Carolina so that we need both assessment caps and millage caps? Has local government spending and revenue increased so rapidly that we need to impose tighter constraints?

Growth of the property tax base owner-occupied housing. The state average growth rate for the property tax base as a whole was 5.9 percent per year from 2000 to 2005. However, the owner-occupied housing part of the property tax base has been growing at about 9.5 percent a year over the same period. It's hard to separate changes in assessed value from changes in the property tax base that result from new construction, but we can make an educated guess.

Between 2000 and 2005, the number of housing units in South Carolina increased from 1.75 million to 1.93 million, an increase of about 1.9 percent a year—somewhat faster than the rate of population growth of about 1.5 percent over the same period. Most of the new construction is at the middle to upper end of the price spectrum, so what's left is probably no more than a 7 percent a year increase in assessed value of an owner-occupied property's assessed value. That 7 percent a year represents an average, and hardly anyone is average. Some homes hardly appreciated at all. Those in downtown Charleston or Hilton Head appreciated a whole lot.

A growth in value of only 7 percent a year sounds disappointing if you are counting on your house as an appreciating asset to provide for your retirement. It's not much better than you can do on bonds or CDs. But 7 percent a year sounds really high when it translates in a whopping 40 percent increase in assessment on South Carolina's five year reassessment schedule. If your income was just keeping place with inflation, it would have grown by only 13.4 percent so even with a stable or slightly declining mill rate, the assessed value of your house and therefore your tax bill would be growing much faster than your income. And the sticker shock effect of five-year reassessment was compounded by the effect of the 1994 tax relief program which essentially eliminated school property taxes for homeowners, because the percentage increase in your tax bill was a lot more than the percentage increase in your home's value.

Here's a simple example. Suppose you owned a home that was worth $150,000 in 2000. To make it simple, we'll assume that the house is in one of the 17 counties without a local option sales tax. City and county taxes on the full assessed value of $6,000, with an average mill rate of 124.2, come to $745. School taxes are levied on only $2,000 of the assessed value, at an average school mill rate of 144.2, which comes to $289, for a total bill of $1,034. (Note that we are ignoring the distinction between debt service and operating millage for schools for the sake of making a point.)

Fast forward to 2005. This home has appreciated 7 percent a year to $210,000. Your city and county mill rate has gone up a little, not much, to 129.4, so your city and county tax bill is now $1,087. Millage rose in part because of the car tax relief and also depreciation of industrial property, so some of the tax burden was being shifted to residential and commercial property. Worse yet, your assessed value for school purposes has gone from $2,000 to $4,400, an increase of 120 percent, because the school property tax relief only applied to the first $100,000 of market value, or $4,000 of assessed value. Your school millage has also risen slightly for the same reasons that city and county millage increased slightly, so your new tax bill for schools in 2005 is $647, a 124 percent increase.

Your total tax bill has risen from $1,034 to $1,734. So a 40 percent increase in assessment over five years, combined with modest millage increases and the sticker shock effect of the property tax relief, translated into a 68 percent increase in your tax bill. And that's just for an average sort of house. (The local option sales tax also figures into the equation in 29 counties, because growth in sales tax revenue has been slower than growth in home values.)

	2000	**2005**
Market value of home	$150,000	$210,000
Assessed value at 4%	$6,000	$8,400
City and county mills	124.2	129.4
City and county tax	**$745**	**$1,087**
Assessed value for school purposes	$2,000	$4,400
School mills	144.2	147.0
School tax	**$289**	**$647**
Total tax	**$1,034**	**$1,734**

Where the growth was. Six counties-- Dorchester, Beaufort, Charleston and Georgetown, and Lexington-- had growth rates for property tax base in general and owner-occupied property tax base in particular that were well in excess of that rate, some from new construction, some from rising home values. So the complaints were from a limited number of counties, but they were very vocal. The 2005 legislative hearings that led to assessment caps and millage caps were held for the most part in areas of the state that were experiencing that kind of housing inflation.

Impact of Assessment Caps

Most of the attention in the media and among local officials has been focused on the effects of millage caps and possible spending caps, because the impact of assessment caps is going to take time to manifest itself. But if it's a sleeper, it's a sleeping giant, not a sleeping beauty. Let me just call your attention to two inevitable consequences of assessment caps.

First, the good news. The housing boom has finally run its course. We won't be seeing that kind of appreciation in home values again for a while. That's also bad news, because the growth of the property tax base is going to slow down even if we didn't have assessment caps, but the assessment caps are going to put the brakes on even base growth and revenue growth harder in some areas than in others.

Second, the long-term effects. The market value issue is going to play out in some really undesirable ways over time. New construction and properties that are sold go on the books at the new market value, which may be considerably more than 15 percent appreciation over five years. There are going to be huge disparities in assessments and tax bills over time for owners of similar properties, making the property tax even more inequitable and generating more backlash. That's what happened in California, where this silly idea originated.

Finally, there appears to be an organized effort underway to repeal the market value provision that increases the assessment when property is sold. That's a tough call. The market value provision increases the inequity between owners of similar properties, but the reassessment of the property at the time of sale is the principal source of base growth in many fast growth counties.

Millage Growth and Millage Caps

Millage growth over the same five year period averaged zero overall, with an average annual increase of 2.2 percent for cities and special districts, 0.5 percent for school districts, and negative growth averaging 1 percent a year for counties. So why are there millage caps? Primarily to ensure that assessment caps do not result in increased mill rates to compensate.

The millage caps imposed by Act 388 of 2006 are more restrictive than the supermajorities required in the past, and the list of exceptions is very limited. Some school districts that had more fiscal autonomy have lost it, and those that had less didn't get any more. These caps could limit the ability of local governments to maintain service levels in the face of rising energy and health care costs, or stand in the way of a willing buyer of services and a willing provider of services, which is what millage caps can do and spending caps definitely would do.

If local governments are only dealing with millage caps and no new spending caps, what might we expect?

- There will be a temptation to raise millage by the maximum allowed every year in case added revenue is needed in future years. That temptation will be reinforced by the slowdown in tax base growth in many areas because of both assessment caps and the housing slump. So after many years of very slow to negative millage growth, we can expect to see a change to compensate for slow base growth.
- There will be pressure to expand the list of exceptions so they aren't limited to Acts of God.
- There will definitely be a shift to other revenue sources. Counties that don't have local option sales taxes are more likely to adopt them in order to take some of the sting out of millage hikes, and they probably aren't going to go for 100 percent property tax relief, either. The trend toward more reliance on fees and charges is likely to accelerate. Both of these trends may, unfortunately, only encourage the General Assembly to enact spending caps.
- The impact of millage caps will be very uneven. The nine counties that have been growing rapidly know that population growth is not a simple linear matter—5 percent more people doesn't necessarily equal 5 percent more service costs. Rather, there's an initial jump to provide infrastructure, and then the cost depends on where the growth is—how close the new development is to existing service providers and facilities and how compactly the homes are sited, both of which reduce service costs. So there will be more pressure on cities and counties to try to ensure smart growth patterns, which is the only silver lining in this cloudy picture. In counties losing population, spending doesn't necessarily fall much just to serve fewer people—there's lots of fixed expenses in city and county government.
- There is likely to be more pressure from the business community, including owners of rental property, to get some kind of relief. Businesses pay 43 percent of the sales tax in South Carolina. They pay more sales tax but receive no property tax relief. The shift in burden away from homeowners toward everyone else has taken a sharp turn toward the worse, meaning less equitable. Most of the new property tax relief went to owners of high-end homes, while most of the increased sales tax is paid by businesses and low to middle income households.

- Local governments would benefit from efforts to broaden the base of the property tax in order to mitigate the effects of assessment and millage cap, even without new spending caps. Two important issues in protecting the property tax base are resisting efforts by some individuals and firms to convert 6 percent second homes and rental properties to the 4 percent owner-occupied residential property rate, and legislation to rein in the abuse of the farm and forest classification. Strengthening the base of the sales tax by eliminating some exemptions (especially the $300 cap on cars) and broadening coverage of services will also help those 29 counties with local option sales taxes.

Spending Caps: Anticipating the Legislation

Spending caps that are linked to population growth and consumer price index will seriously tie the hands of local governments in terms of ability to provide should services to their citizens. Before enacting any such caps, The General Assembly needs to look closely at the disastrous experience with TABOR in Colorado and to consider carefully whether the caps will include capital spending financed by bonds, or whether they apply to enterprise funds or just the general fund. Any legislation would have to address what happens in a recession when the base for calculating next year's cap has declined. Obviously, local governments would want to work to establish the narrowest base to which the cap applies and the largest previous year's spending in that base if there is going to be any flexibility at all.

Conclusion

Imposing spending caps would imply a lack of trust in the competence and judgment of local elected officials. If South Carolina is still committed to the home rule that was created four decades ago, then local officials need to have the power and the flexibility to make taxing and spending decisions at the local level.

If the property tax is truly to be a stable, dependable local revenue source, then the legislature needs to resist the temptation to constantly tinker with the composition of the tax base, the assessment rates, and the restrictions on millage under which local governments operate. Good tax policy requires both flexibility and stability for those who must collect and spend local taxes, as well as adequate revenue and a fair distribution of the tax burden among taxpayers. Assessment caps, millage caps and spending caps do not meet those tests of good tax policy.