The Fiscal Outlook for South Carolina's Local Governments

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The Strom Thurmond Institute has taken an interest in South Carolina state and local government finance since its inception in the early 1980s, primarily through the work of the now-retired (but not forgotten) Clemson economics professors Jim Hite and Holley Ulbrich. Holley Ulbrich is still very active in public finance issues around the state, and I'm glad to have had the opportunity to work with her for over 10 years now.

Today, in keeping with the theme of this conference, I'd like to comment on a few important factors affecting the fiscal outlook for local governments—cities, counties, and school districts—in the state. My comments may take a somewhat different angle on the term *outlook* than the other speakers at the table, however. I believe that the fiscal outlook for our local governments has more to do with the decisions local governments can make about their finances than with projections about how their revenue sources will behave in the future.

Local Government Finance Overview

Most revenues collected by local governments are affected less by fluctuations in the national and state economy than are state government revenues. In South Carolina, there is no local government income tax and the contribution from local sales taxes, which is used mostly for property tax relief, is relatively small—about 6% of the general fund budget for cities and counties, on average.

While municipalities have felt the recession's impact in reductions in business licenses and accommodations and hospitality taxes, the declines generally have not been severe. Also, although accommodations and hospitality taxes can bring in significant revenue to tourist destinations, most of that revenue is restricted to use for tourism purposes and is not available for general purposes.

Despite their unpopularity, property taxes have been a stabilizing force for local governments. In FY 1999-2000, when revenue growth from the state sales and income taxes began to slow significantly, property tax revenues to counties and school districts slowed only very slightly. Property taxes and local fees and charges tend to be more stable in recessions and have helped our local governments—at least our cities and counties—avoid some of the major budget problems we've seen at the state level over the last couple of years.

Local governments also seem more willing to make small adjustments to taxes and fees than does the state government, which helps their ability to meet their budget requirements. It's easier to change the mill rate a bit or increase a particular fee to address rising service costs than it is to make a wholesale change in the state sales tax rate or the income tax code. In fact, over the last decade or more we've seen a shift to increasing reliance on fees and charges by cities and counties as they look for new revenue sources separate from the property tax, and also look to better link payment with the service received. This trend is nationwide—not just limited to South Carolina.

In our state, municipalities have the most revenue options, counties are in the middle, and school districts have the least revenue options.

Municipalities use property taxes, licenses and permits, and fees for services. Less than 30% of municipal revenues come from property taxes, and cities receive less than 10% of their revenue from the state.

Counties get about 44% of their revenues from the property tax, and close to 20% from the state because they perform some state-mandated functions like property tax assessment and collection, courts, and jails.

South Carolina's school districts have the fewest funding options, and get close to half of their funding from the state and another 30% from property taxes.

But there are some state policies affecting local government finances that bear a second look. The three I'd like to touch on today are property taxes, property tax relief, and appropriations from the state general fund.

Property Taxes

I think that a lot of voters thought that the reduction in the property tax assessment ratio on personal vehicles from 10.5% to 6% meant that their taxes were going down overall. Well, taxes are going down on vehicles as that change is implemented, but the local governments that depended on that motor vehicle tax revenue are now simply getting it from another source. That could be higher mills on all property, or higher fees on something else. Over half of the state's counties have imposed a county vehicle registration fee to make up some or all of the revenue lost from the change to the way cars are taxed.

This change to the assessment ratio in the constitution was initiated at the state level, but its revenue effects only applied to local governments. It was property tax relief, but it came without state support. Without local governments' ability to impose appropriate fees and charges, other property owners would have shouldered the entire shift in tax burden away from vehicles.

Property Tax Relief

The state has funded property tax relief for local governments for a number of years. Property tax relief is an entitlement—if you meet the criteria, you get relief, at least as far as the money goes around. The state is obligated to pay it, even in difficult budget times.

There are two things I want you to think about property tax relief: how it affects the state budget and who it benefits.

Property tax relief is a direct expenditure by the state. State funds are transferred to local governments to make up for revenues they don't collect on eligible properties. (They're not *additional* revenues to local governments!) These state funds come from income tax revenues, which means that all of us are paying for tax relief for some of us. That's not necessarily a bad thing, but it's certainly become a big bill. In FY 1984-85, state expenditures on property tax relief were $22 million. For FY 2003-04, the state's Board Economic Advisors recently projected these programs to total $491 million.

I believe that the current budgetary impact of property tax relief shows the down side of adopting ongoing entitlement-based tax relief in good economic times, because the expenditure burden can become heavy in tough economic times. The General Assembly should strongly consider linking some future tax relief to revenue availability, rather than political expediency.

For my second point, property tax relief in our state is not needs-based. If you're 65 or over, you get your homestead reimbursement whether you live in a modest bungalow or a mansion on the water. School tax relief flows to everyone, but there is no mechanism to assist lower income homeowners of any age with their county or municipal property tax bills. And renters get no help at all—their landlord passes on his taxes in their rent.

Many states use property tax circuit breakers to aid homeowners and renters. These usually work as income tax refunds for homeowners or landlords. It's time for South Carolina to restructure property tax relief to ensure that deserving people of any age or housing type benefit. Circuit breakers could also help reduce "sticker shock" at reassessment for persons with limited income. They're also a more equitable way to address the concern of rising property taxes driving out elderly widows from the family home than is the 15% cap on assessed value growth at reassessment that can be adopted by counties.

Appropriations from the General Fund

Cities and counties share an annual pot of money from the state that is based on a percentage of the general fund. It's called the Local Government Fund, which some of you may know as state aid to subdivisions. It's currently around $220 million, a sizeable chunk. The Local Government Fund has endured mid-year budget cuts along with other state agencies, but that's not what I want to talk about. What I want to talk about is more serious for local governments in the long term, and also less visible.

Remember state property tax relief? It used to be appropriated from the general fund, but several years ago those funds were moved off budget to the Trust Fund for Tax Relief. Well, that didn't only insulate property tax relief from mid-year general fund budget cuts. It also reduced the base on which the Local Government Fund is calculated. As a result, the state's cities and counties are now getting around $20 million less in revenue than they would have gotten if those revenues used for property tax relief had remained in the general fund.

And even more serious, the state's two reserve funds, the General Reserve Fund and the Capital Reserve Fund, are also determined based on the level of the general fund. As the amount of revenue in the general fund goes down—whether through sagging revenues in a poor economy or through accounting maneuvers—our reserve funds suffer.

In FY 2000-01, for instance, which was before we saw any drawdowns of these funds, these two reserve funds together would have been about $17 million higher if the property tax relief funds had not been moved off budget. While that $17 million wouldn't have averted the current budget shortfall, every little bit helps. These reserve funds play an important role in mediating the effect of economic downturns on the state's general fund. The General Assembly should reevaluate the level and operation of these two reserve funds to ensure that they perform as needed. For the state's school districts in particular, which are very dependent on state aid, moderating fluctuations in the general fund is important, indeed.

Summary

In summary, the fiscal outlook for our local governments depends on maintaining and improving local government's ability to use a variety of revenue sources in a flexible manner. South Carolina's local governments—particularly cities and counties—have benefited from the flexibility they got starting with Act 208 in the mid-1970s and continuing in more recent years with expansions in local sales, accommodations, and hospitality taxes. This increasing revenue flexibility, along with revenue stability from the property tax, has helped keep the state's local governments out of the budget problems that so many states are experiencing at this time. It has also allowed them to make up revenue losses from the changing assessment ratio on motor vehicles.

The fiscal outlook for our local governments also depends on the stability of state funding. The Local Government Fund and other state revenues (such as education funding) provide an important foundation to local government budgets. Slippage in the Local Government Fund over time will slow advances at the local level and should be corrected. Also, the state's reserve funds should be redesigned to better insulate state and local governments from the effects of economic downturns. State property tax relief to local governments can placate taxpayers, but its future role should be reconsidered to better address issues of state revenue availability and equity among beneficiaries.

Our local governments are partners with the state in providing public services. Let's let them make the right decisions for their residents.