

A PROPOSAL TO STABILIZE STATE REVENUES AND SPENDING

PRESENTED TO THE SPECIAL AD HOC COMMITTEE

OF THE SOUTH CAROLINA SENATE

BY

WILLIAM GILLESPIE

CHIEF ECONOMIST

FEBRUARY 7, 2008

## INTRODUCTION

WHEN I CAME HERE 24 YEARS AGO, AS A SENIOR ECONOMIST FOR THE BOARD OF ECONOMIC ADVISORS, DOCTOR JAMES MORRIS, CHAIRMAN OF THE BEA, GAVE ME ONLY ONE BIT OF ADVICE. HE SAID “THE WORST THING THE BEA COULD DO WAS TO CREATE A SURPLUS WITH ITS FORECAST.” AT THE TIME, I DIDN’T THINK THAT THIS WAS VERY PRUDENT ADVICE. IT SEEMED TO ME THEN THAT THE BEA SHOULD ERR ON THE SIDE OF CAUTION BY SHOOTING FOR A SMALL SURPLUS.

AFTER DOING THIS JOB FOR OVER TWO DECADES, TWO MAJOR RECESSIONS, THREE ECONOMIC SLOWDOWNS, FOUR ECONOMIC BOOMS, AND 24 LEGISLATIVE SESSIONS, I NOW HAVE A MUCH GREATER APPRECIATION FOR THE WISDOM IN DR. MORRIS’S ADVICE. LOOK AT THE BUDGET SITUATION THIS YEAR. THE BEA CERTIFIED OVER A HALF BILLION DOLLARS OF SURPLUS LAST YEAR. TAKING INTO ACCOUNT THE ANNUALIZATIONS OF PREVIOUS OBLIGATIONS INCURRED WITH SURPLUS FUNDS, THE STATE IS NOW FACED WITH A SHORTFALL GOING INTO THE BUDGET PROCESS, EVEN THOUGH THE BEA FORECAST IS FOR POSITIVE GROWTH. WHERE DID THE SURPLUS GO?

WHAT WE HAVE LEARNED OVER THE YEARS IS THAT THE STATE DOES NOT HAVE WELL DEFINED STANDARDS AND PROCEDURES FOR DEALING WITH SURPLUSES. I THINK THOSE OF YOU THAT HAVE BEEN THROUGH A

COUPLE OF BOOM YEARS WITH THEIR RESULTING SURPLUSES HAVE EXPERIENCED THE INTENSE POLITICAL PRESSURE TO USE SURPLUS REVENUES TO EXPAND OLD PROGRAMS, OR CREATE NEW ONES.

THIS COMMITTEE IS CONSIDERING SOME SYSTEM TO LIMIT SPENDING, PARTICULARLY IN THE BOOM YEARS. TO ME, A SPENDING LIMIT WILL NOT RESULT IN BUDGETING STABILIZATION WITHOUT A DEFINED SYSTEM IN PLACE TO DEAL WITH EXCESS REVENUES. SENATORS, I SUBMIT TO YOU THAT THE STATE'S TAX STRUCTURE IS SUCH NOW THAT REVENUE COLLECTIONS WILL BE QUITE LIMITING THROUGH FUTURE UPS AND DOWNS IN THE REVENUE CYCLE. WHAT IS NEEDED, I THINK, IS A SYSTEM TO SMOOTH OUT THE USE OF REVENUES THROUGH THE FULL REVENUE CYCLE BY MEANS OF A REVENUE STABILIZATION FUND.

#### **HALF-CENTURY OF REVENUE EXPERIENCE**

I BROUGHT SOME HISTORY WITH ME TODAY TO HELP YOU SEE THE LONGER-RUN PICTURE AND TO UNDERSTAND WHY I BELIEVE SMOOTHING IS NECESSARY. THERE IS NO SET TIME PERIOD FOR OUR REVENUE CYCLE, BUT SINCE I HAVE BEEN HERE, IT HAS BEEN ABOUT A DECADE. ANY SYSTEM THAT YOU PUT IN PLACE SHOULD BE DESIGNED TO STAND THE TEST OF AT LEAST A DECADE.

TO HELP YOU UNDERSTAND WHY REVENUE STABILIZATION IS NEEDED , I HAVE PREPARED A REVENUE AND ECONOMIC HISTORY THAT SPANS 5 DECADES. IT'S QUITE REVEALING. YOU CAN SEE FROM THE FIRST GRAPH ON REVENUE GROWTH THAT WE HAVE ALWAYS HAD BOOMS AND BUSTS IN OUR REVENUE STREAM. OUR REVENUES HAVE ALWAYS SPIKED COMING OUT OF A RECESSION. LOOK AT 1959, 1966, 1977, 1984, 1993, AND 2006. OF COURSE, THERE ARE SOME SIGNIFICANT DIPS IN OUR REVENUE GROWTH, ALSO. LOOK AT 1955, 1961, 1968, 1975, 1980, 1985, 1991, 2001 THROUGH 2003, AND 2008.

THERE ARE SOME FUNDAMENTAL REASONS FOR THOSE SWINGS THAT ARE RELATED TO IMBALANCES IN OUR ECONOMY, USUALLY CREATED BY INORDINATE EVENTS, MANY TIMES BY SPIKES IN OIL PRICES, AND SOMETIMES BY EXTREME SWINGS IN FEDERAL MONETARY AND FISCAL POLICIES. AND WITH THESE IMBALANCES USUALLY CAME INFLATION. THE NEXT GRAPH SHOWS YOU A HISTORY OF THE CPI. LOOK AT THE LOW RATES FOLLOWING THE KOREAN WAR. MY SON DOESN'T BELIEVE ME WHEN I TELL HIM THAT I GREW UP WITH INFLATION OF ONLY A LITTLE MORE THAN ONE PERCENT AND YOU COULD GET A HOME MORTGAGE FOR 3 PERCENT. YOU SHOULD ALSO LOOK AT THE LAST GRAPH ON OIL PRICES. THANKS TO THE TEXAS RAILROAD COMMISSION OIL PRICES WERE STABLE THEN.



BUT WE HAVEN'T SEEN THOSE CONDITIONS SINCE. YOU CAN SEE THAT THE VIETNAM WAR POPPED THE LID OFF OF INFLATION DURING THE 1960'S, EVEN THOUGH OIL PRICES CONTINUED TO BE STABLE. AS PRESIDENT JOHNSON PUT IT, WE COULD HAVE GUNS AND BUTTER. WHAT WE GOT DURING THE 1960'S WAS HIGH INFLATION AND RISING INTEREST RATES. YOU CAN SEE ON THE NEXT GRAPH THAT THE PRIME RATE ROSE DURING THE 1960'S.

GOING INTO THE 1970'S, WITH THE VIET NAM WAR STILL GOING ON, OIL MARKETS BEGAN TO TIGHTEN. THE WORLD CHANGED WITH THE ARAB EMBARGO AT THE END OF 1972. I LEFT THE BUREAU OF LABOR STATISTICS THEN TO WORK FOR THE PETROLEUM DIVISION OF THE COST OF LIVING COUNCIL TO HELP ADMINISTER MANDATORY PRICE CONTROLS THAT WERE IN PLACE AT THAT TIME. MAYBE THAT'S WHY INFLATION ROSE TO OVER 11 PERCENT BY 1975 AND THE PRIME RATE WENT OVER 8 PERCENT, WHICH WAS UNHEARD OF IN THOSE DAYS.

ALTHOUGH I WAS NOT IN SOUTH CAROLINA DURING THE LATE 1970'S, I HAVE BEEN TOLD THAT THE REVENUE ESTIMATE IN THE BUDGETING PROCESS WAS NOT A PROBLEM THEN. BECAUSE OF THE HIGH RATE OF INFLATION, REVENUES WERE FLOWING INTO THE STATE. THERE WAS NO BEA TO MAKE A FORECAST. I DON'T KNOW IF THIS WAS TRUE, BUT I HAVE BEEN TOLD BY SOME OLD VETERANS IN OUR BUDGETING SYSTEM THAT

SENATOR GRESSETTE WOULD DECIDE HOW MUCH THE STATE NEEDED TO SPEND AND THAT WAS THE REVENUE ESTIMATE. LOOK ON THE REVENUE CHART AT THE SECOND HALF OF THE 1970'S. GROWTH EXCEEDED 11 PERCENT FOR FIVE YEARS. EVEN DURING THE 1975 ECONOMIC SLOWDOWN, GROWTH EXCEEDED 6 PERCENT.

### **FEDERAL RESERVE UNDER PAUL VOLCKER**

BY THE BEGINNING OF THE 1980'S THE CPI EXCEEDED 13 PERCENT, THE PRIME RATE EXCEEDED 20 PERCENT, AND OIL EXCEEDED A CRIPPLING \$40 PER BARREL. ECONOMISTS COINED THE TERM "MISERY INDEX", WHICH EQUALED THE SUM OF THE CPI AND THE PRIME RATE OF INTEREST. IN 1980, THE MISERY INDEX WAS OVER 30.

FINALLY, THE FEDERAL RESERVE SAID THAT'S IT. THEY WERE GOING TO FIGHT INFLATION. UNDER CHAIRMAN PAUL VOLKER, THE FED ADOPTED MONEY SUPPLY GROWTH TARGETS. THE IDEA WAS THAT IF IT CONTROLLED THE GROWTH IN THE MONEY SUPPLY TO LEVELS IN LINE WITH REAL GROWTH IN THE ECONOMY, THERE WOULD NOT BE EXTRA DOLLARS CHASING A LIMITED NUMBER OF GOODS, AND PRICES WOULD HAVE TO STABILIZE. AND IT LOOKS LIKE IT WORKED. LOOK AT THE DROP IN THE CPI FROM 8.6 PERCENT IN 1981 TO 2.2 PERCENT IN 1986. AND THE PRIME RATE DROPPED FROM 20 PERCENT TO UNDER 8 PERCENT BY 1987. EVEN THE PRICE OF OIL DROPPED.

BUT BRINGING INFLATION IN LINE WAS NOT WITHOUT A COST. OUR ECONOMY WENT INTO A RECESSION IN THE EARLY 1980'S. TO ILLUSTRATE TO YOU THE SEVERITY OF THAT RECESSION, THE NEXT CHART SHOWS TOTAL PERSONAL INCOME IN SOUTH CAROLINA MINUS INFLATION. LOOK AT THE NEGATIVE FIGURE FOR 1980. THAT MEANS THAT INFLATION OUTSTRIPPED INCOME AND WE WENT INTO THE HOLE ECONOMIC WISE. YOU COULD CALL THAT A SOUTH CAROLINA MISERY INDEX.

NONETHELESS, EVEN DURING THIS SEVERE ECONOMIC CORRECTION, STATE REVENUES CONTINUED TO GROW AT RATES OF 4.8 PERCENT OR MORE. PART OF THIS GROWTH COULD BE ATTRIBUTED TO A LAG IN THE EFFECTS OF INFLATION, BUT THE MAIN REASON WAS BECAUSE OF TAX BRACKET CREEP UNDER OUR INDIVIDUAL INCOME TAX. THE STATE DID NOT INDEX BRACKETS FOR INFLATION THEN. MORE AND MORE TAX FILERS SAW THEIR INCOMES TAXED AT HIGHER EFFECTIVE TAX RATES BECAUSE OF TAX BRACKET CREEP. IN 1984, MY FIRST ANALYSIS HERE WAS OF OUR INCOME TAX CODE. I FOUND THAT FOR EACH ONE PERCENT GROWTH IN INCOME, WE REAPED 1.44 PERCENT GROWTH IN INCOME TAXES.

#### **FEDERAL RESERVE UNDER ALAN GREENSPAN**

ALAN GREENSPAN CHANGED THE FED BALL GAME IN 1987 WHEN HE TOOK OVER. THE USE OF MONEY SUPPLY TARGETS WAS ABANDONED. THE FED TOOK AN AGGREGATE APPROACH TO CONTROLLING INFLATION. I'M



STILL NOT SURE WHAT THAT MEANT, BUT I DO KNOW THAT EVERY TIME THE GNP WOULD BEGIN TO GROW MORE THAN 2 TO 3 PERCENT THE FED WOULD RAISE RATES, TO HEAD OFF INFLATION BEFORE IT GOT TOO HIGH. AND AFTER THE ECONOMY WENT INTO A RECESSION, IT WOULD LOWER RATES.

RAISING RATES TO HEAD OFF INFLATION HAD ITS COSTS TOO. LOOK AT HOW THE FED SPIKED INTEREST RATES IN 1989. THEN LOOK AT OUR DISMAL REVENUE GROWTH IN 1991 AND 1992. I KNOW THAT SENATOR McCONNELL AND SENATOR MARTIN REMEMBER HOW THE STATE HAD TO CUT SPENDING BECAUSE OF THE SEVERE DECLINE IN OUR REVENUE STREAM. EVEN WITH SPENDING CUTS, THE STATE'S RESERVES WERE NOT ADEQUATE TO COVER SUCH A DRASTIC SWING IN REVENUES, IN LARGE PART BECAUSE WE DID NOT HAVE HIGH INFLATION TO HELP PROP UP OUR REVENUE STREAM. ALSO, THE STATE HAD BEGUN TO PARTIALLY INDEX THE INCOME TAX BRACKETS AND TAXPAYER'S INCOMES HAD INCREASED IN REAL TERMS, BOTH OF WHICH REDUCED SOMEWHAT THE EXTRA KICK FROM TAX BRACKET CREEP. THE STATE FINISHED 1992 WITH A DEFICIT BEYOND OUR RAINEY-DAY RESERVE.

THE STATE COVERED THAT DEFICIT BY CHANGING OUR METHOD OF ACCOUNTING FOR THE SALES TAX FROM A CASH BASIS TO AN ACCRUAL



BASIS, SHIFTING ONE MONTH'S OF SALES TAX COLLECTIONS FROM 1993 BACK INTO 1992.

THE CREDIT RATING AGENCIES TOOK A DIM VIEW OF OUR FINANCIAL BEHAVIOR THEN AND LOWERED OUR AAA CREDIT RATING.

### **RECOVERY FROM 1992 RECESSION**

DURING THE RECOVERY PERIOD FOLLOWING THE 1991-1992 RECESSION, THE STATE WORKED TO RECOVER ITS AAA RATING. STANDARD AND POOR'S INSISTED THAT THE STATE REBUILD ITS DEPLETED RESERVES, REFORM ITS BUDGET PROCESS, ADJUSTS ITS INCOME TAX WITHHOLDINGS TABLES TO DECREASE SPRING REFUNDS, STOP USING SURPLUSES TO FUND ONGOING PROGRAMS, AND RETURN TO A POSITIVE GAAP BALANCE.

THE STATE REBUILT ITS RESERVES, REFORMED ITS BUDGET PROCESS BY IMPLEMENTING THE BEA CERTIFICATION REQUIREMENT AND OTHER ACTIONS, AND LOWERED SPRING REFUNDS BY OVER \$100 MILLION BY ADJUSTING THE WITHHOLDINGS TABLES. TO ADDRESS THE SURPLUS ISSUE, THE STATE ADOPTED THE RULE TO USE ONLY SURPLUSES CERTIFIED BY THE BEA. MOREOVER, THE STATE PASSED THE CARNELL-FELDER ACT WHICH LIMITED REVENUES AVAILABLE FOR APPROPRIATIONS TO 75% OF THE INCREASED REVENUE ESTIMATED BY

THE BEA. IN A COUPLE OF YEARS, WE ACHIEVED A POSITIVE GAAP BALANCE AND STANDARD AND POOR'S RESTORED OUR AAA RATING.

### **CARNELL-FELDER SET-ASIDE**

THE CARNELL-FELDER SET ASIDE WAS SORT OF A SPENDING LIMIT IN THAT IT LIMITED NEW APPROPRIATIONS TO 75% OF THE BEA'S ESTIMATE OF NEW MONEY. IT WAS ALSO A RESERVE FUND BECAUSE IT ACTUALLY SET THE MONEY ASIDE FOR ONE YEAR. I BROUGHT WITH ME THE OLD GRAPHS THAT I USED TO BRIEF THE CREDIT RATING AGENCIES BACK THEN. THE BLACK LINE WAS THE AMOUNT OF NEW MONEY ESTIMATED BY THE BEA, THE BLUE AND GREEN AREAS WERE THE AMOUNTS OF THE GENERAL AND CAPITAL RESERVES, AND THE YELLOW WAS THE CARNELL-FELDER SET ASIDE. THE ARGUMENT THAT I MADE WAS THAT THE NEW MONEY ESTIMATE WAS LESS THAN OUR RESERVES; THEREFORE, WE COULD HAVE ZERO GROWTH IN ACTUAL REVENUES, WHICH EQUATED TO A SHORT, MILD RECESSION, AND STILL NOT DEplete OUR RESERVES. I NOTED THAT WE HAD NEVER HAD NEGATIVE REVENUE GROWTH. AT THAT TIME I DID NOT HAVE OUR REVENUE HISTORY GOING BACK TO LOW INFLATION DAYS AFTER THE KOREAN WAR, SO I DID NOT KNOW THAT WE ACTUALLY DID HAVE A YEAR OF NEGATIVE GROWTH.

I CAN'T REMEMBER THE YEAR THAT STANDARD AND POOR'S RESTORED OUR AAA RATING, BUT I'M PRETTY SURE THAT IT WAS IN A

YEAR BEFORE THE BLACK LINE WENT BEYOND OUR RESERVES. I'M SURE IT WAS BEFORE THE STATE REPEALED THE CARNELL-FELDER SET ASIDE IN 1998.

### **THE 2000-2001 RECESSION AND THE 9-11 ATTACKS**

THE STATE RECOVERED FROM THE 91-92 RECESSION WITH A BOOM. LOOK AT THE 9.9% REVENUE GROWTH IN 1993. THAT WAS EXTRAORDINARY BECAUSE INFLATION WAS LESS THAN 3%.

THE RE-CONSTITUTED BEA FOLLOWING THE 91-92 RECESSION TOOK A MORE CONSERVATIVE APPROACH TO FORECASTING. THE BEA'S APPROACH WAS "SHOW ME THE MONEY." THAT MEANT THAT THE BEA WOULD NOT PUT NEW MONEY INTO ITS ESTIMATE UNTIL IT WAS PRETTY CERTAIN THAT THE MONEY WAS THERE.

AS A CONSEQUENCE, THE BEA ESTIMATE TENDED TO FOLLOW INCREASED REVENUE GROWTH. DURING THE 1990'S SURPLUSES BECAME THE ROUTINE, RATHER THAN THE EXCEPTION. I CAN'T REMEMBER HOW MANY TIMES THE BEA RAISED ITS ESTIMATE AT THE BUDGET CONFERENCE COMMITTEE, BUT BACK THEN IT WAS PRETTY ROUTINE. AND ALONG WITH THIS PATTERN OF SURPLUSES CAME A GENERAL EXPECTATION THAT THEY WOULD CONTINUE. AND WITH THIS EXPECTATION CAME AN ATTITUDE THAT FUNDING RECURRING



OBLIGATIONS WITH SURPLUSES WASN'T ALL THAT RISKY, BECAUSE REVENUE GROWTH WOULD FIX THE PROBLEM IN THE FUTURE.

### **RECESSION OF 2000-2002**

THEN CAME THE DISASTROUS RECESSION IN THE EARLY 2000'S, AGAIN FOLLOWING ANOTHER RISE IN OIL PRICES, AND A SPIKE IN INTEREST RATES BY THE FED. AFTER GREENSPAN DID WHAT I CALL HIS KILLER 0.5 PERCENT RATE INCREASE IN MAY 2000, THE BEA REACTED IMMEDIATELY. I HAD THE DISTINCT HONOR TO DELIVER A MESSAGE FROM THE BEA TO THE CONFERENCE COMMITTEE THAT THE BEA HAD JUST TAKEN \$100 MILLION OFF THE TABLE.

GREENSPAN'S ACTION SET OFF A DOWNWARD SPIRAL THAT WAS EXACERBATED BY THE IMPACT OF THE TERRORISTS ATTACKS IN SEPTEMBER 2001. OUR REVENUE STREAM WENT NEGATIVE IN 2002, THE FIRST TIME SINCE THE KOREAN WAR ERA. THAT EXPERIENCE DESTROYED THE NOTION THAT THE IF THE BEA KEPT ITS NEW MONEY ESTIMATE WITHIN OUR RESERVES, THE STATE COULD WEATHER A MILD RECESSION. LOOK AT THE REVENUE GRAPH. WE HAD FOUR BAD YEARS IN A ROW. WE DEPLETED OUR RESERVES, CUT AGENCIES, AND RAIDED TRUST FUNDS. NEEDLESS TO SAY, STANDARD AND POOR'S DID NOT CONSIDER US AAA MATERIAL.



## RECOVERY FROM 2001-2003 RECESSION

THE STATE RECOVERED FROM THE 2000-2003 RECESSION WITH A BOOM, JUST ABOUT THE SAME AS IT ALWAYS HAS. LOOK AT THE NICE GROWTH RATES OVER 2005, 2006, AND 2007. DURING THIS RECOVERY THE BEA CONTINUED ITS "SHOW ME THE MONEY" POSTURE, WITH ITS ESTIMATES LAGGING BEHIND THE RECOVERY, CREATING SURPLUSES. LAST YEAR YOU HAD ABOUT A HALF BILLION IN SURPLUS MONEY FOR APPROPRIATIONS.

IT SEEMS THAT THE FED JUST CAN'T COTTON TO GOOD TIMES. IT RAISED RATES AGAIN, BRINGING ABOUT STAGNATION IN THE REAL ESTATE MARKET. COUPLED WITH A BOUNCE BACK IN OIL PRICES AND THE SUBPRIME LENDING PROBLEM, THIS YEAR WE'RE IN A DOWNTURN OF THE REVENUE CYCLE AGAIN. FORTUNATELY, THE BEA'S "SHOW ME THE MONEY" POSTURE HAS PUT THE STATE IN A DECENT POSITION THIS YEAR BECAUSE THE BEA ONLY BUILT IN 3% GROWTH, ANTICIPATING A DOWNTURN IN THE REVENUE CYCLE.

## LESSONS FROM HISTORY

BEFORE I GET INTO THE SPECIFICS OF HOW A REVENUE STABILIZATION FUND MIGHT WORK, LET ME SUM UP SOME LESSONS FROM OUR REVENUE HISTORY.

1. WE CAN'T COUNT ON WASHINGTON TO ADOPT POLICIES THAT WILL RESULT IN STABLE GROWTH IN SOUTH CAROLINA. THERE WILL ALWAYS BE LARGE FLUCTUATIONS IN GROWTH OF OUR REVENUE STREAM. YOU NEED SOME SORT OF SMOOTHING OUT SYSTEM.
2. YOU CANNOT ANTICIPATE AN OUTSIDE SHOCK THAT WILL TRIGGER EITHER INFLATION OR A RECESSION. YOU MUST HAVE SOME SORT OF SAFETY VALVE TO HANDLE INFLATIONARY OR OTHER SHOCKS.
3. YOU CAN NO LONGER COUNT ON EXCESSIVE INFLATION PROPPING UP REVENUE GROWTH. WE MAY REVERT TO PERIODS OF EXCESSIVE INFLATION, BUT IT WON'T CAUSE THE EXTRA SPIKE IN REVENUES.
4. YOU CAN NO LONGER COUNT ON THE EXTRA REVENUE KICK FROM TAX BRACKET CREEP. WHEREAS THE KICK WAS 1.44 IN 1984, IT IS NOW IN THE RANGE OF 1.05. IT IS THEREFORE RISKY TO COUNT ON EXTRA GROWTH TO SOLVE THE ANNUALIZATION PROBLEM.
5. WE CANNOT COUNT ON A 5% RESERVE TO GET US THROUGH ANY DOWNTURN OTHER THAN A MILD RECESSION.

## REVENUE STABILIZATION PROPOSAL

THE BASIC PRINCIPLE OF THIS PROPOSAL IS SIMPLE IN CONCEPT. IN TIMES OF ABOVE AVERAGE REVENUE GROWTH THE STATE SETS ASIDE THOSE REVENUES ABOVE AVERAGE GROWTH INTO A TRUST FUND TO BE USED WHEN THE STATE HAS BELOW AVERAGE REVENUE GROWTH.

AVERAGE GROWTH IS DETERMINED OVER A 10 YEAR PERIOD, WHICH IS GENERALLY IN LINE WITH THE TWO MOST RECENT REVENUE CYCLES. AS I MENTIONED TO YOU AT YOUR LAST MEETING, I THOUGHT THAT THE MEASUREMENT OF THE AVERAGE PERIOD SHOULD BE IN THE UP COMING 10 YEARS TO ACCOUNT FOR A DECLINING REVENUE STREAM. BUT SINCE THEN I HAVE COME TO REALIZE THAT LOOKING INTO THE FUTURE WOULD INJECT TOO MUCH OF THE "HUMAN" ELEMENT INTO THE PROCESS. THEREFORE, THE AVERAGE REVENUE FIGURE SHOULD BE CALCULATED EACH YEAR OVER THE MOST RECENT 10 YEAR PERIOD.

THE RED, GREEN, AND BLUE BAR GRAPH ILLUSTRATES THIS CALCULATION FOR FIVE 10-YEAR PERIODS. I HAVE COMPARED THE GROWTH RATE IN THE GENERAL FUND TO GROWTH RATES FOR PERSONAL INCOME AND THE CPI + POPULATION. AS YOU CAN SEE FOR THE MOST RECENT 10-YEAR PERIOD, PERSONAL INCOME GREW AN AVERAGE OF 5.32%, THE GENERAL FUND 4.50%, AND THE CPI+POPULATION 3.87%. UNDER THIS CONCEPT, REVENUE IN EXCESS OF 4.5% WOULD BE PUT ASIDE

INTO THE TRUST FUND. WHEN REVENUE GROWTH IS LESS THAN 4.5%, REVENUES WOULD BE USED FROM THE TRUST FUND UP TO THE 4.5% MARK.

IF YOU WERE TO USE PERSONAL INCOME GROWTH AS THE MARK, YOU WOULD NOT PUT AWAY ENOUGH FUNDS TO SMOOTH OUT REVENUES OVER THE FULL REVENUE CYCLE. IF YOU USE CPI+POPULATION YOU WOULD PUT AWAY MORE THAN ENOUGH FUNDS TO SMOOTH OUT REVENUES OVER A RECESSION.

TO ILLUSTRATE WHY THE CURRENT SPENDING LIMIT HAS NOT BEEN LIMITING, I HAVE PREPARED THE FOLLOWING GRAPH ON PERSONAL INCOME GROWTH COMPARED TO THE GROWTH IN THE FUNDS TO WHICH THE LIMIT APPLIES, NAMELY, THE GENERAL FUND, THE EIA FUND, AND THE HIGHWAY FUND. AS YOU CAN SEE, THE REVENUES TO SUPPORT THESE FUNDS ALL GREW LESS THAN PERSONAL INCOME. SINCE ALL THESE FUNDS WERE PROHIBITED FROM RUNNING A DEFICIT, REVENUE SOURCES, NOT PERSONAL HAVE BEEN THE LIMITING FACTOR.



### **TO WHAT DOES THE 4.5% MARK APPLY**

A KEY COMPONENT OF THIS PROPOSAL IS TO WHAT FACTOR DOES ONE APPLY THE 4.5% GROWTH RATE. I THINK THAT THE BEST WAY TO MAKE THE SMOOTHING PROCESS WORK IS TO APPLY THE GROWTH MARK TO THE BEA'S REVENUE AVAILABLE FOR APPROPRIATION IN THE PREVIOUS YEAR'S BUDGET. OFF-SETS OF ONE-YEAR DURATION WOULD BE APPLIED TO THAT BUDGET AND NOT CARRIED FORWARD.

### **WHAT ABOUT LONG TERM TAX CUTS OR REVENUE INCREASES?**

A SPECIAL PROVISION WOULD HAVE TO BE ADDED TO HANDLE REVENUE DECREASING OR INCREASING MEASURES THAT LASTS FOR MORE THAN A YEAR. UNDER CURRENT LAW, THE BEA IS REQUIRED TO CERTIFY THE REVENUE IMPACT OF ANY REVENUE PROVISION IN THE BUDGET. THE BEA MAKES ADJUSTMENTS TO THE REVENUE ESTIMATE FOR SEPARATE LEGISLATION AT ITS CLEAN-UP MEETING FOR THE BUDGET CONFERENCE COMMITTEE. TO HANDLE LEGISLATION WITH AN IMPACT BEYOND THE BUDGET YEAR, SUCH AS A CUT IN TAX RATES, YOU COULD PUT IN A PROVISION TO REQUIRE THAT THE BEA CERTIFY THE PROSPECTIVE IMPACT ON THE LONG-RUN MARK AND REQUIRE AN APPROPRIATE ADJUSTMENT IN THE CURRENT BUDGET. THIS CERTIFICATION COULD CHANGE THE LONG RUN CALCULATION, DEPENDING ON THE NATURE OF THE PROVISION.

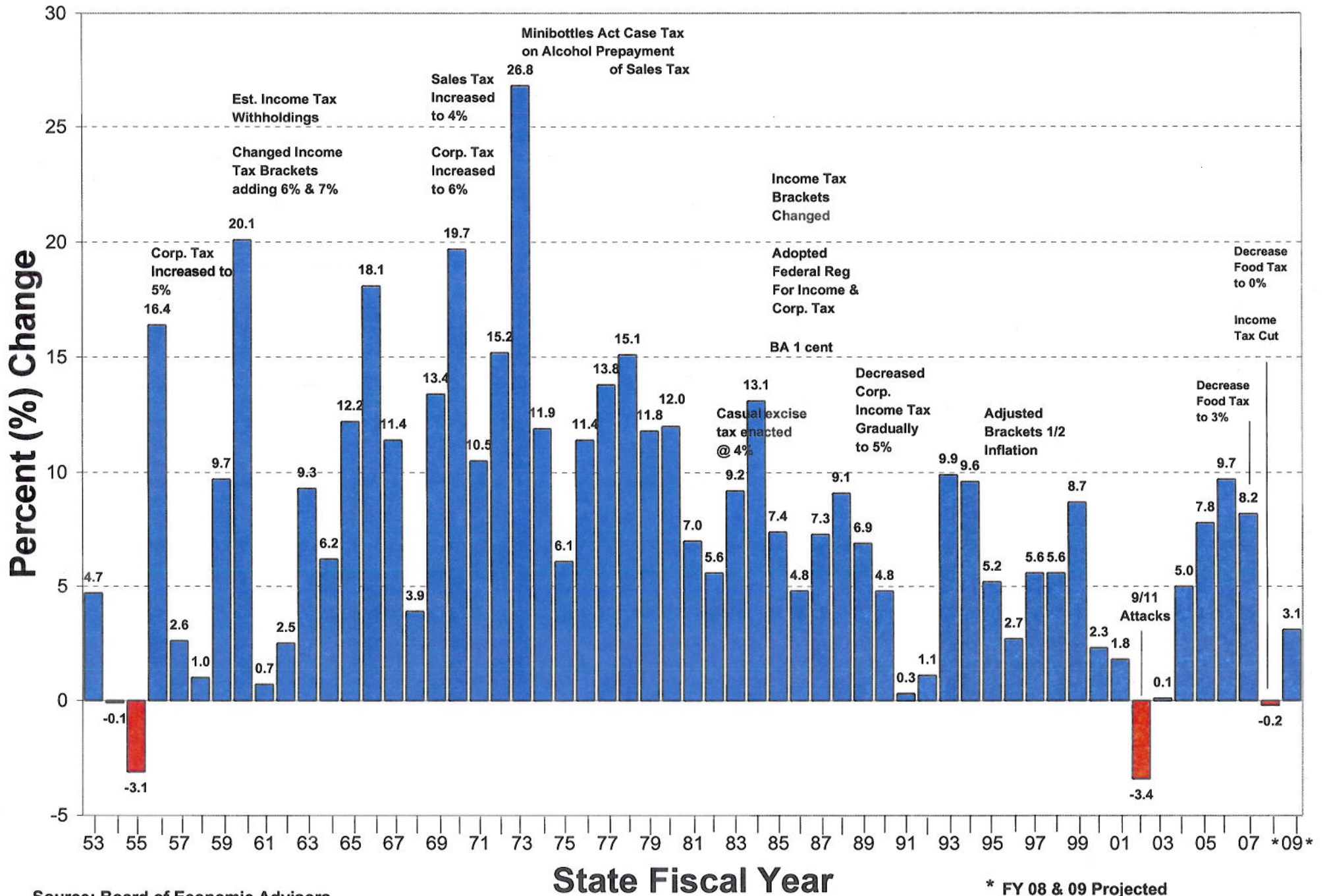
## **SAFETY VALUE FOR REVENUE SHOCKS**

THERE ALSO HAS TO BE SOME SAFETY VALUE FOR SHOCKS IN OUR REVENUE STREAM. AS I'VE SHOWN WITH HISTORY, MAJOR SHOCKS DON'T OCCUR ALL THAT OFTEN, BUT WHEN THEY DO OCCUR THEY CAN CHANGE OUR REVENUE STREAM DRAMATICALLY. THESE ARE EVENTS THAT WOULD IMPAIR THE SMOOTHING OUT EQUATION. ONE PROVISION YOU COULD DO TO PROTECT THE STATE FROM INFLATION SHOCKS IS TO ADD A PROVISION THAT THE BEA COULD ADD UP TO 1% TO THE MARK IF INFLATION WENT ABOVE 5%, PROVIDED THAT THE BEA COULD MAKE A FINDING THAT SUCH AN ADJUSTED WAS NECESSARY TO KEEP UN-NEEDED SURPLUSES FROM ACCRUING. DOWNWARD ADJUSTMENTS WOULD BE HANDLED THE SAME WAY.

## **SUM-UP**

TO SUM UP, BY USING THE 10-YEAR REVENUE MARK, YOU WILL NOT BE TAKING ANY FUNDS FROM CURRENT PROGRAMS, BUT JUST LIVING WITHIN YOUR REVENUE BASE. THOSE WHO WANT TO INCREASE PROGRAMS WOULD HAVE TO FIND ADDITIONAL SOURCES OF REVENUES, RATHER THAN EXPAND PROGRAMS OUT OF UNFORESEEN SURPLUSES. AS FOR TAX CUTS, I THINK THAT THIS SYSTEM WOULD PLACE MORE ACCOUNTABILITY ON THE BUDGET PROCESS TO IDENTIFY THE PROGRAM AREAS TO TAKE THE CUTS.

# Percent Change in S.C. General Fund Revenues

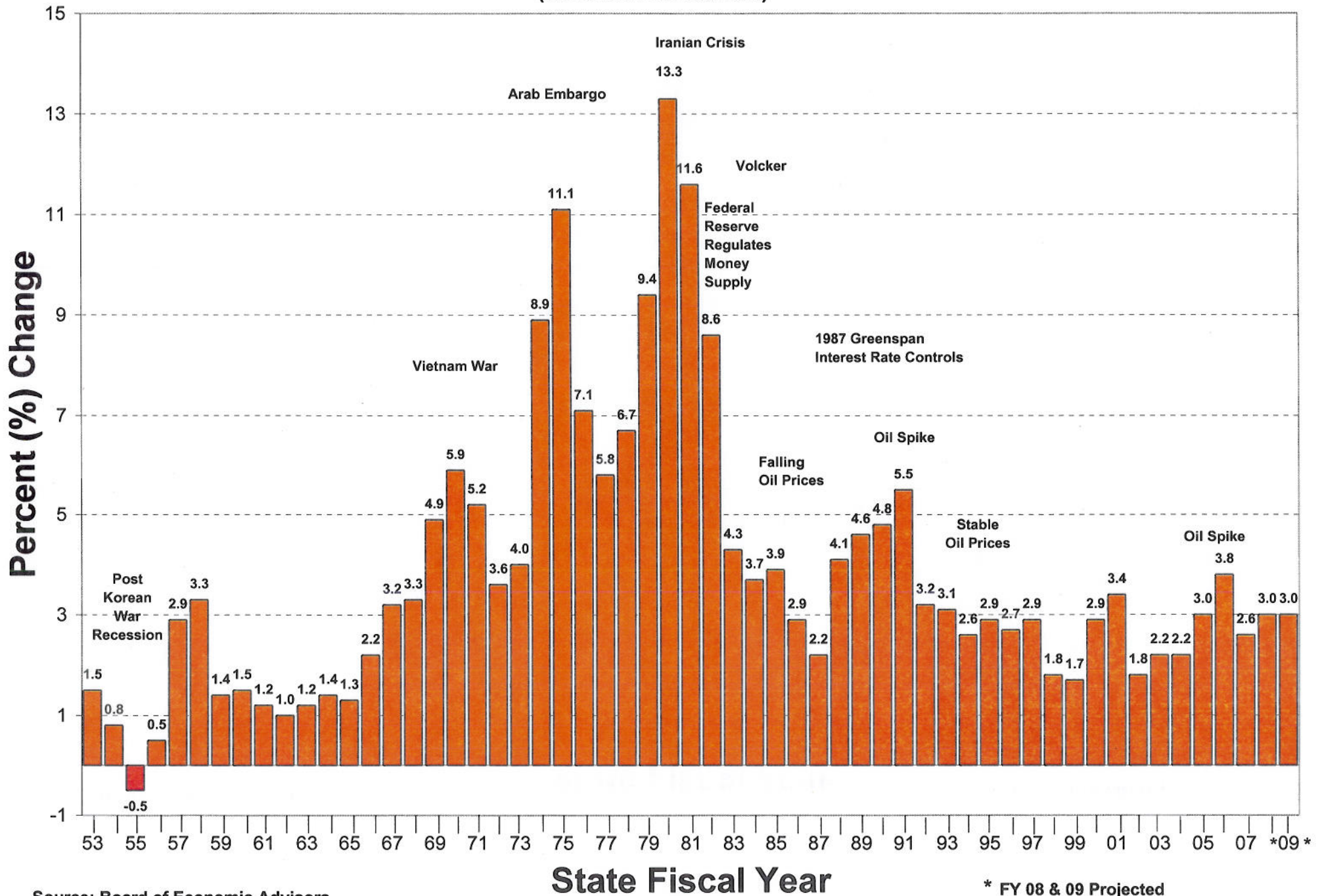


Source: Board of Economic Advisors

\* FY 08 & 09 Projected



# Percent Change in Consumer Price Index (All Urban Consumers)

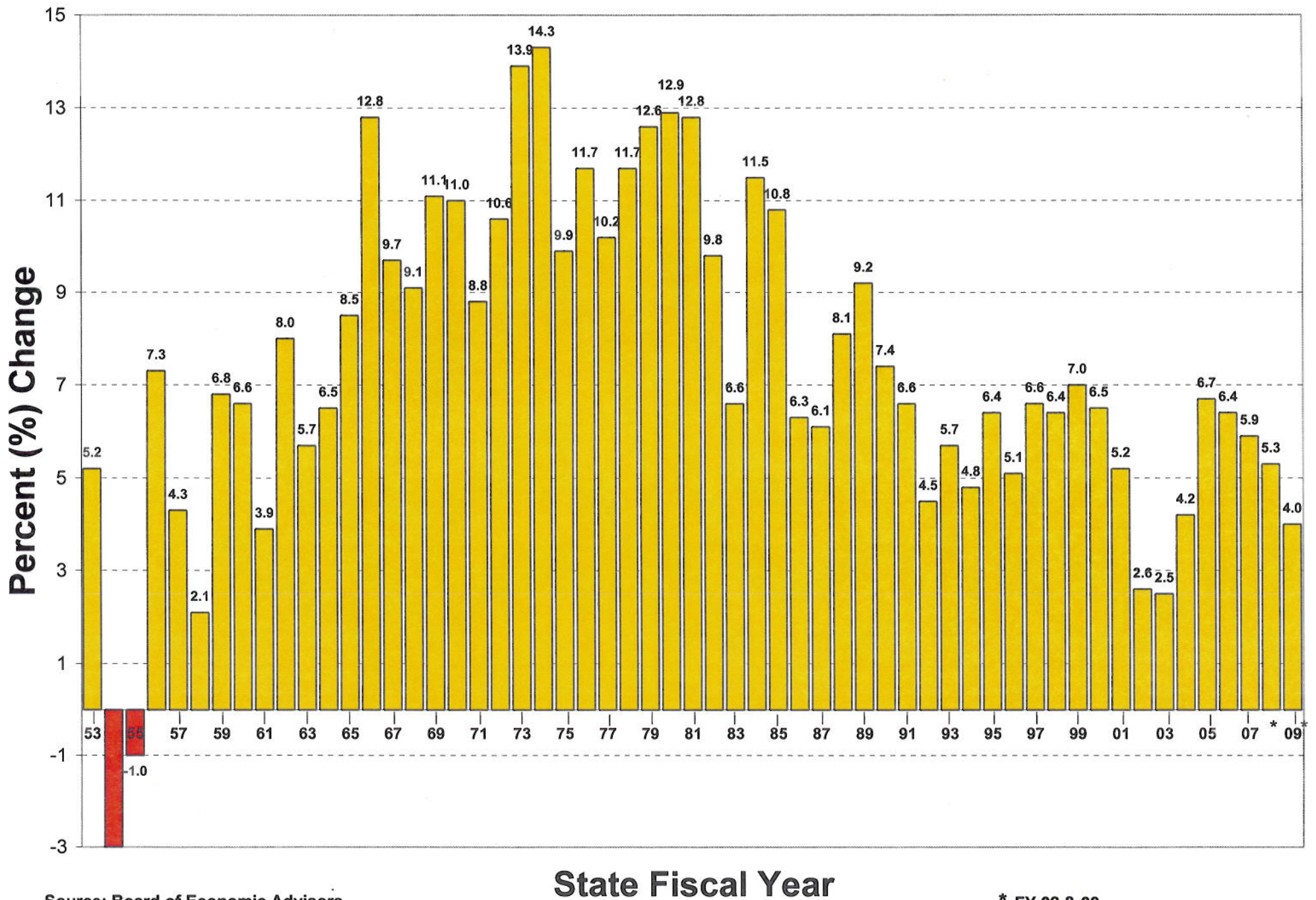


Source: Board of Economic Advisors

\* FY 08 & 09 Projected



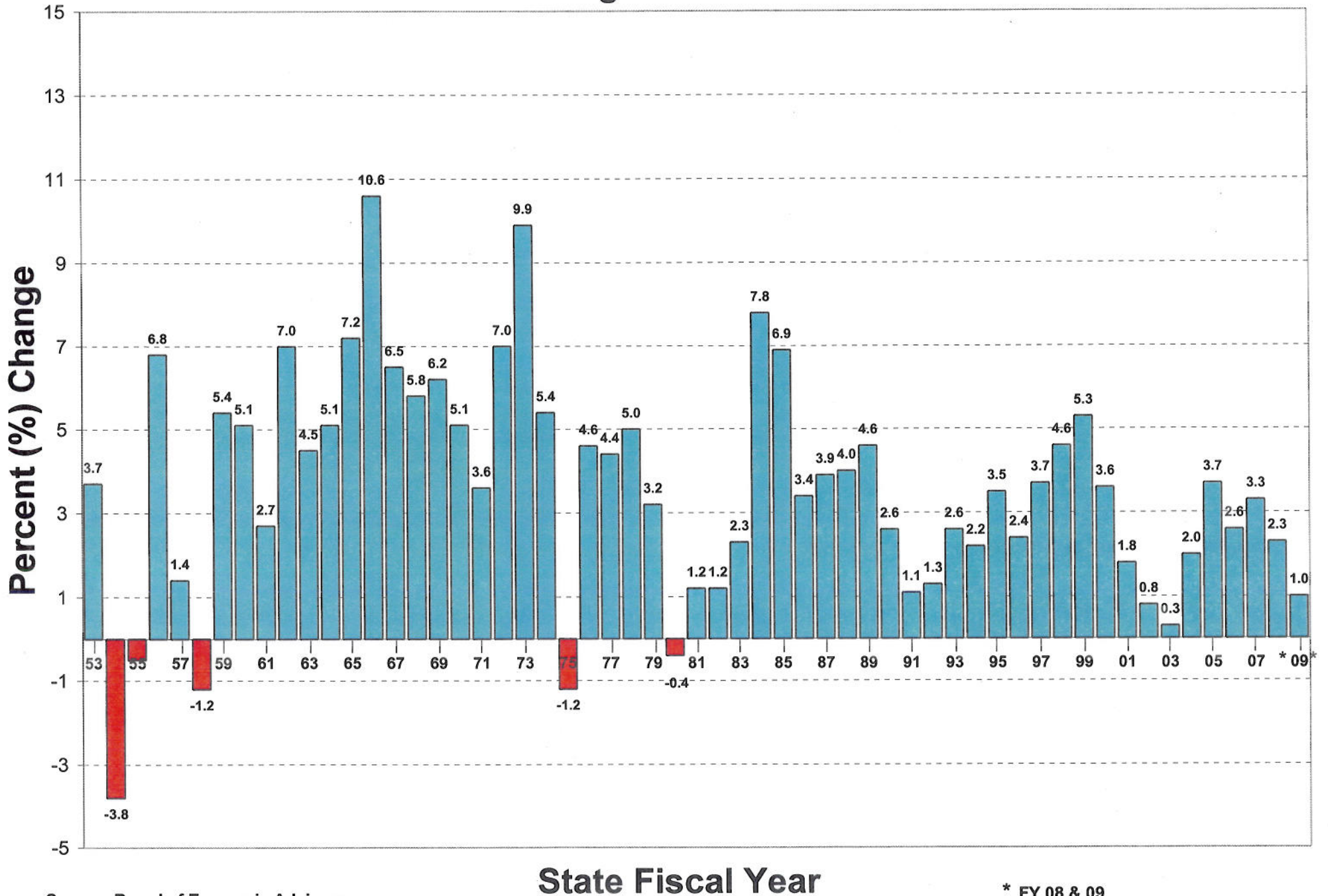
# Percent Change in South Carolina Total Personal Income



Source: Board of Economic Advisors

\* FY 08 & 09

# Percent Change in South Carolina Total Personal Income Minus Percent Change in Consumer Price Index

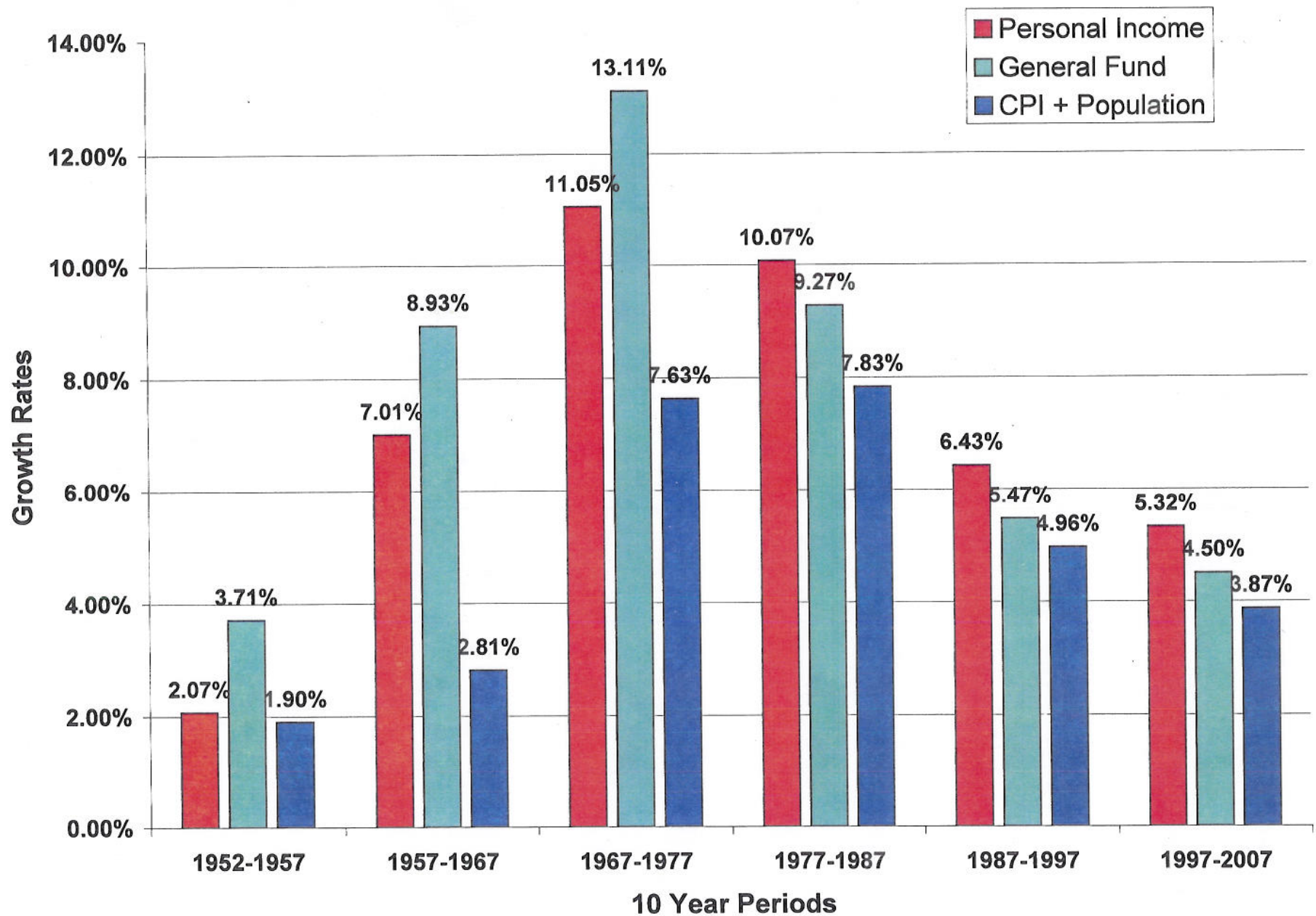


Source: Board of Economic Advisors

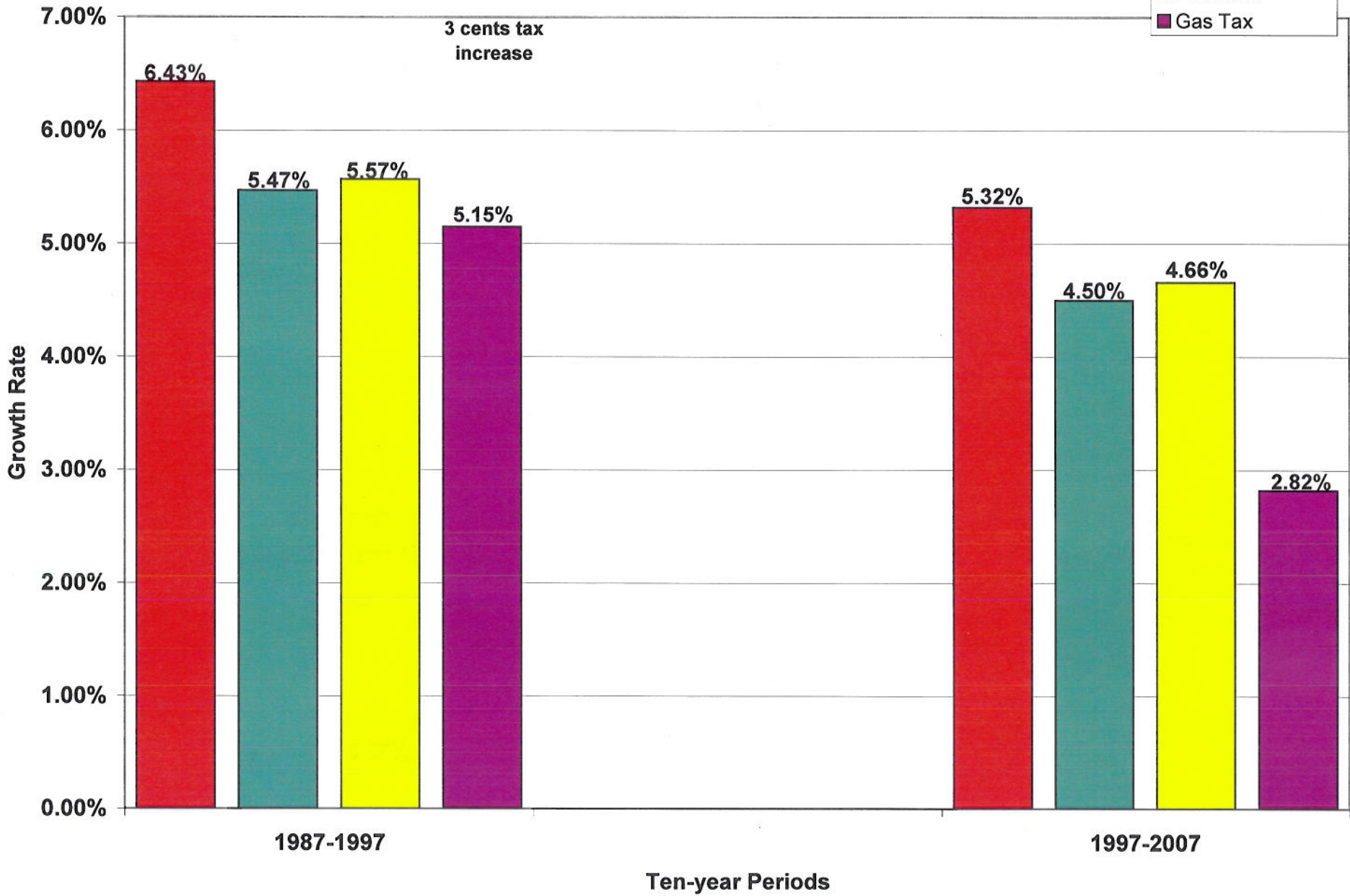
\* FY 08 & 09



## SC Personal Income, General Fund, and CPI + Population Growth Rates

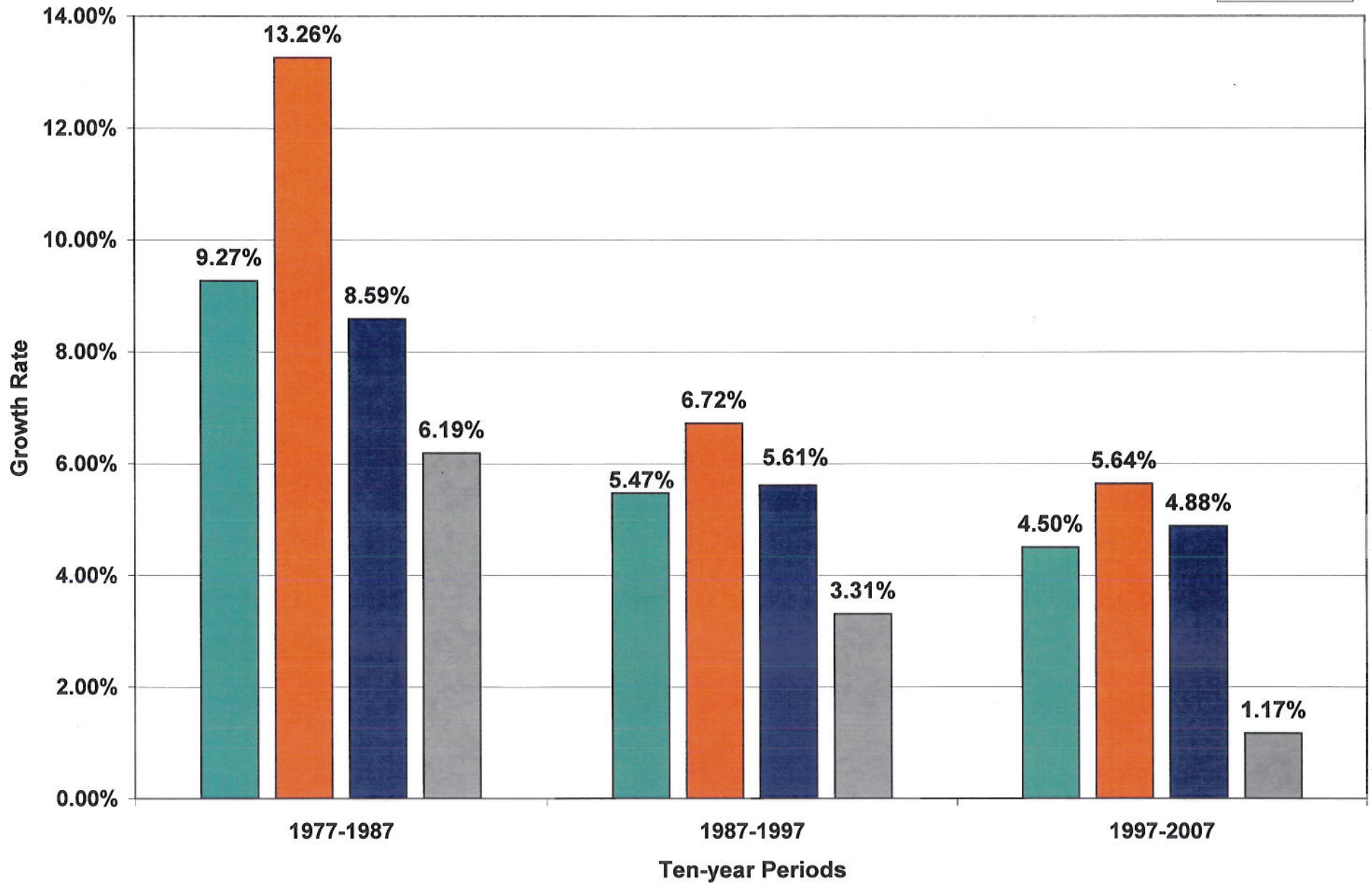


# SC Personal Income, General Fund, Gasoline Tax, and Educational Improvement Act Fund Growth Rates

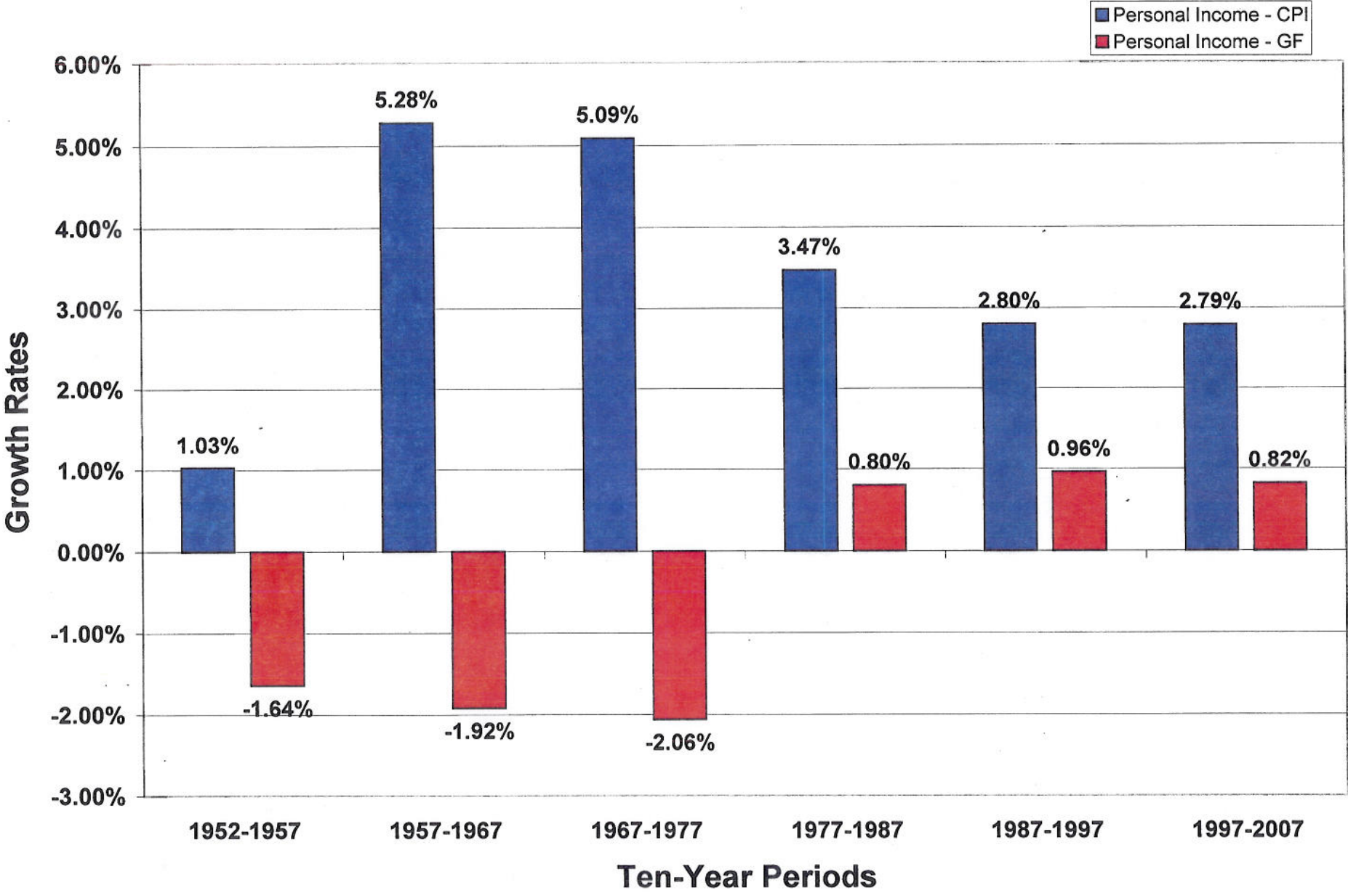




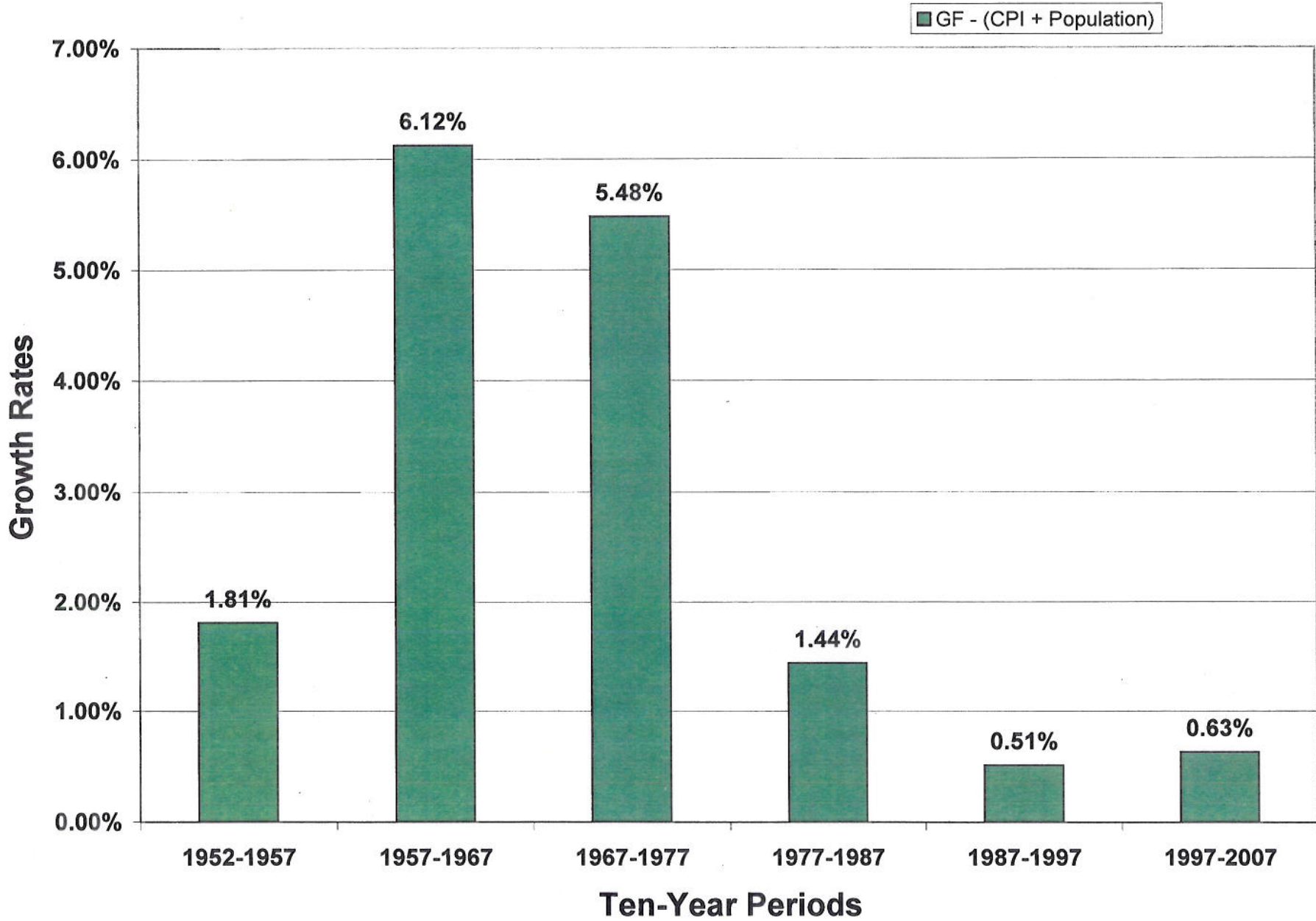
# SC General Fund, Personal Income Tax, Sales Tax, and Other Growth Rates



# SC Personal Income Minus CPI and Personal Income Minus General Fund

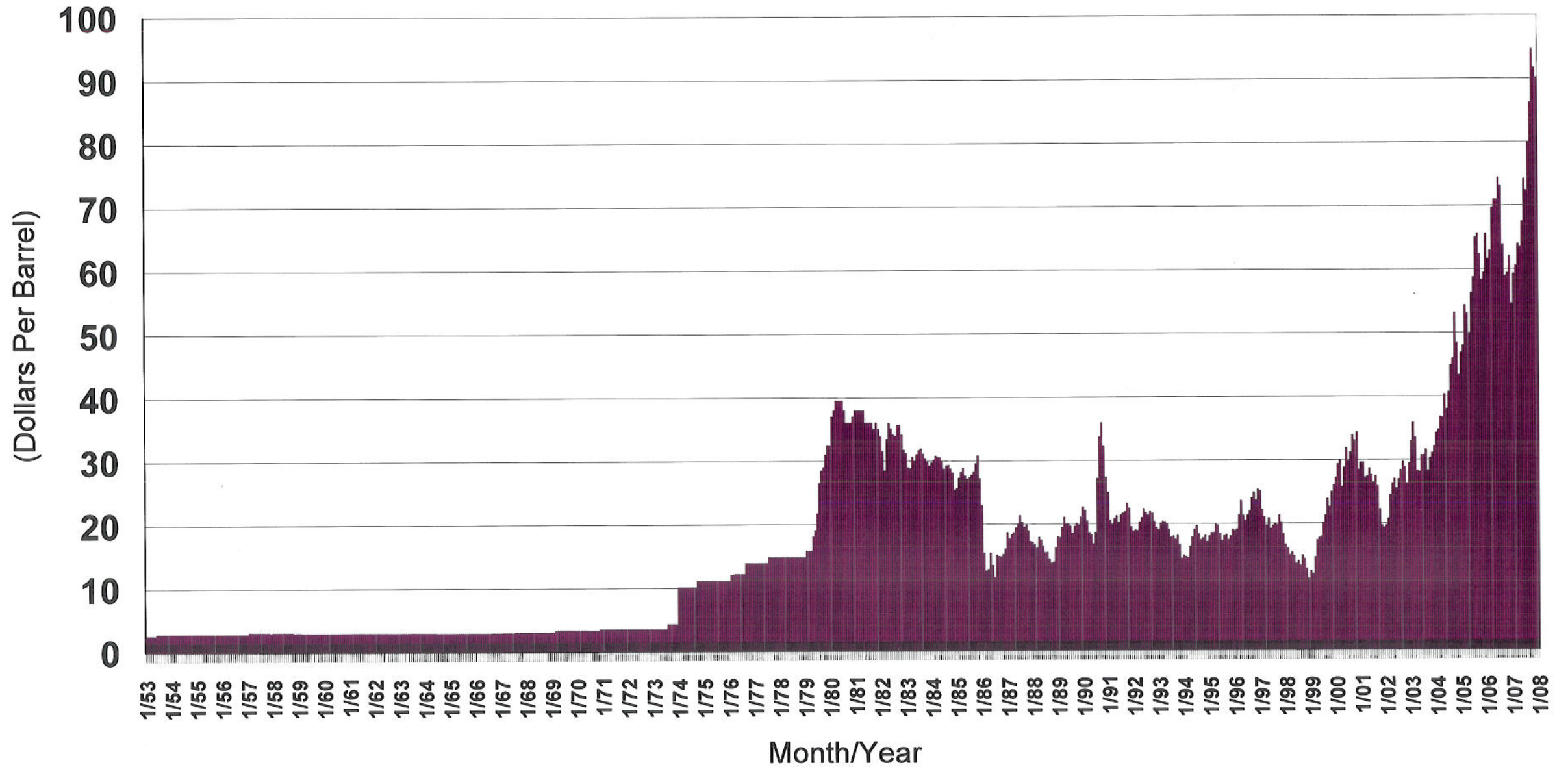


# General Fund Growth- (CPI + Population)



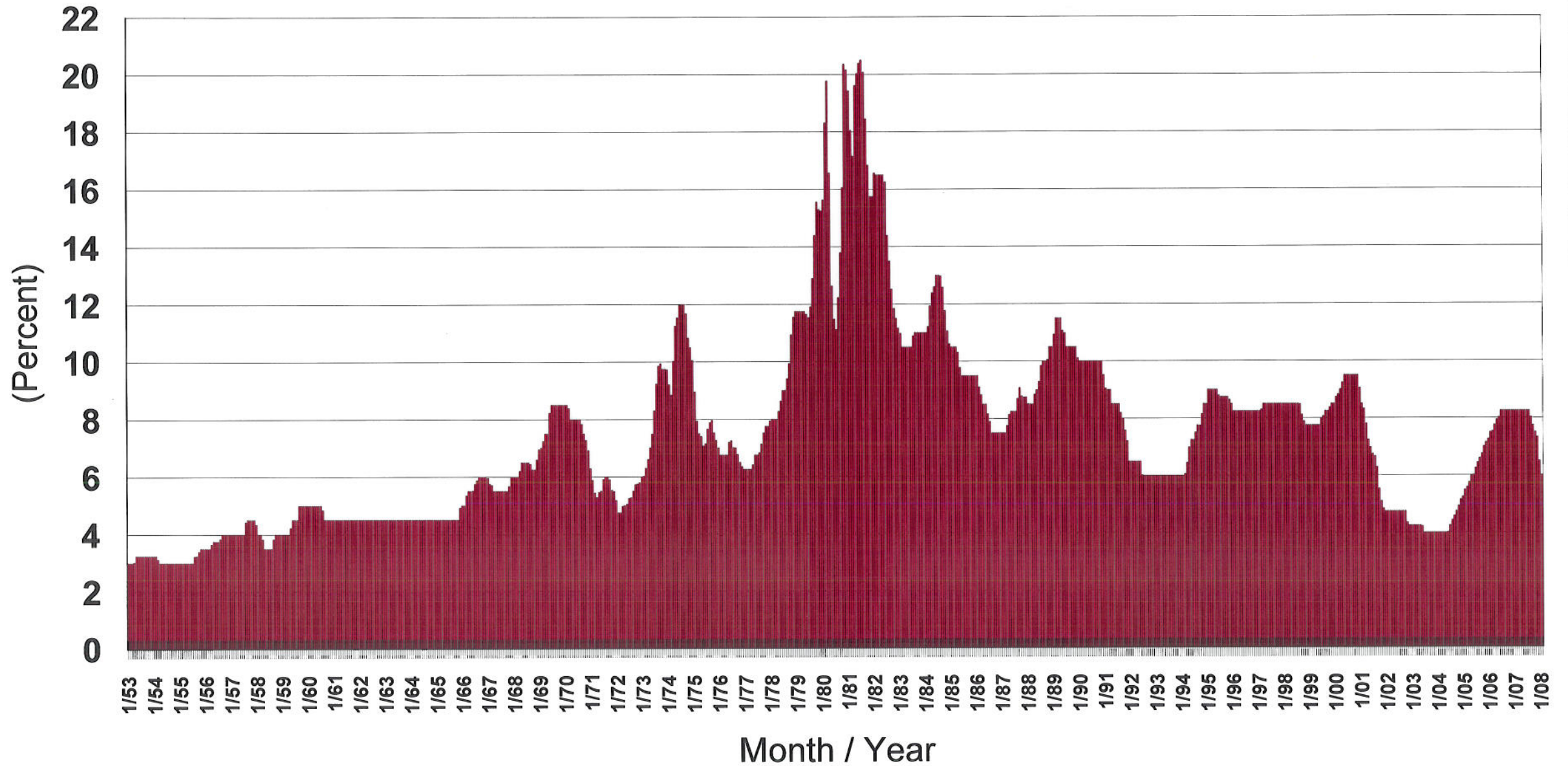


# Spot Crude Oil Prices (1953 to 2008)





# Prime Rate of Interest (1953 to 2008)



## SC Spending Limit Components, 1952-2007

Period	Personal Income	General Fund	CPI + Population	Personal Income - CPI	Personal Income - GF	GF - (CPI + Population)
1	2	3	4	5	6	7
1952-1957	2.07%	3.71%	1.90%	1.03%	-1.64%	1.81%
1957-1967	7.01%	8.93%	2.81%	5.28%	-1.92%	6.12%
1967-1977	11.05%	13.11%	7.63%	5.09%	-2.06%	5.48%
1977-1987	10.07%	9.27%	7.83%	3.47%	0.80%	1.44%
1987-1997	6.43%	5.47%	4.96%	2.80%	0.96%	0.51%
1997-2007	5.32%	4.50%	3.87%	2.79%	0.82%	0.63%