State of South Carolina

Office of the Governor

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June 12, 2005

The Honorable Robert W. Harrell, Jr., Speaker
South Carolina House of Representatives
508 Blatt Building
Columbia, South Carolina 29211

Dear Mr. Speaker and Members of the House:

I am vetoing in its entirety and returning without my approval H. 4810, R-432, the Fiscal Year 2006-07 General Appropriations Act ("Budget").

The big picture facts regarding the Budget are these: Not including Capital Reserve Fund, EIA, Lottery or Federal/Other Funds, it contains $1,122 million in new revenue over last year's recurring base spending total of $5,617 million, an increase of 17 percent. It spends $759 million, an increase of 13 percent over last year's recurring base spending. Even when stated in terms of the amount of increase over last year's recurring base plus non-recurring supplemental spending – a baseline which the Speaker declared on the floor last March to be the more appropriate benchmark – the Budget still represents a 10.8 percent increase in spending.

One could spend a lot of time debating whether it is appropriate to use "recurring base spending" as the baseline for determining the precise amount of growth in spending. We believe that this baseline is more appropriate since when lean years come – as they did in the early 2000s and as they inevitably will again – the only money available to fund state government's recurring needs is recurring income, and so that is used as the baseline in this veto message. However, readers who believe that less conservative "recurring base spending plus non-recurring supplemental spending" is more appropriate, then roughly 2 percent should be subtracted from our numbers. In any event, whichever baseline is used, the fundamental premise of this veto message remains unassailable: the rate increase in state government spending in the Budget is not sustainable given our state's historical economic trends.

(Note: The Speaker stated in an op-ed published in state newspaper last Sunday that the Budget increases state spending slightly more than 9 percent. This rate is incorrect since it is premised on the assumption that the $78 million used to refurbish the state's General Reserve Fund last year should be included as spending. While this replenishment was done with supplemental sources last year, the annual funding requirement of the General Reserve Fund is typically discounted from the recurring revenue estimate off-the-top like the Tax Relief Trust Fund and is therefore not viewed as a spending item. When this $78 million is properly added to last year's denominator, the growth in state spending proposed by the Budget – even using the less conservative "recurring base spending plus non-recurring supplemental spending" baseline – growth in spending increases from the slightly more than 9 percent figure cited by the Speaker to 10.8 percent.)

Throughout this legislative session, beginning with my submission of our FY 2006-07 Executive Budget and continuing in the community forums on the budget that I held all across the state last week, I have consistently advocated limiting the growth in state government spending to a rate that reasonably correlated with the people's ability to sustain it over time. Some would argue that this rate is population plus inflation, currently about 5.5 percent. Others say it should be the state's average personal income growth, now about 6 percent.

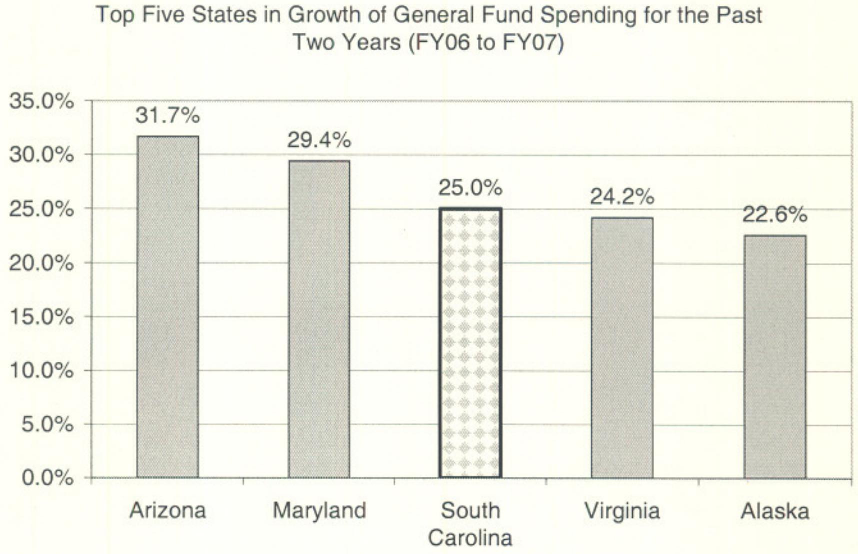
Being fiscally conservative, when we prepared our Executive Budget, we confined new state government spending to a growth factor of 5.15 percent (population plus inflation), with a handful of statistically insignificant small exemptions, over last year's recurring base. Working within that reasonable and sustainable rate of growth, we prepared a balanced state budget that, without raising taxes, restored monies that had been diverted from trust and reserve funds and provided essential services to the citizens of South Carolina in the priority areas of education, health care and social services, economic development, public safety, and natural resources. And we further proposed to return to the taxpayers all revenues collected by the state that exceeded that reasonable and sustainable rate of growth.

People may in good faith differ over the precise rate of growth in state government spending that is "reasonable and sustainable" – 5.15 percent, 5.5 percent or 6 percent, all are defensible. But absolutely no one can contend in good faith that a rate of growth of 13 percent (or 10.8 percent for that matter, if you prefer the less conservative benchmark) is anywhere close to being reasonable and sustainable. In plain terms, it makes no sense to increase state government spending at a rate that – whatever benchmark is used – is at least two times greater than the people's ability to sustain it.

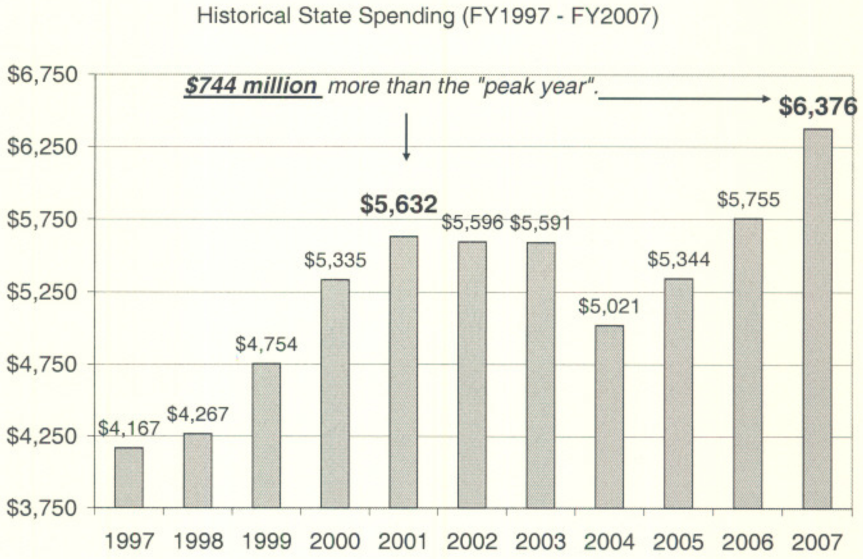
We have gone down this road before and paid the price. In 1999 and 2000, state government spending grew by 11.4 percent and 12.2 percent, respectively – an almost 25 percent increase in government spending over a two-year period. When the economy slowed, as it inevitably always does based on the business cycle, the revenues collected by the state could not keep pace with the needs of the government programs funded in the good years, and the Budget and Control board had to make painful and incredibly disruptive mid-year budget cuts.

The last point bears special emphasis: across-the-board mid-year budget cuts are extremely disruptive, resulting in the most effective state programs being cut at the same rate as the most marginal programs. Mid-year budget cuts can be compared to a jet that has already taken off and has fuel taken out of it in mid-flight. We will have failed the people of South Carolina if we head back down the road of unsustainable growth and increase the likelihood of future mid-year budget cuts – but that is precisely where the Budget takes us.

A report issued this very day by the National Association of State Budget Officers ("NASBO") underscores that fact that the Budget, without a doubt, continues to take us down that very same road. Consider the following chart published by NASBO, which shows that for the past two years, South Carolina's growth in spending has been the third fastest in the nation:



I have heard the arguments from some state legislators that "growing government by 13 percent this year simply puts us back to where we were before we had to make those midyear budget cuts." That is simply not true. The Budget is $744 million ***above*** the previous budget high-water mark that people talk of "getting back to," as is shown by the following chart.



And it is also worth noting that since that previous "high-water mark", the total state budget has increased from $15 billion to $19 billion as a result of more money from the federal government and an increase in state government fees.

The 13 percent increase in total government spending in the Budget is especially egregious in light of an incredible new annual cost that we already know the state will have to bear beginning next year. Starting next year, the new accounting standards issued by the Government Accounting Standards Board will require all states to account for unfunded liabilities, and the state health plan has a $9 billion unfunded liability in regard to its Other Post-Employment Benefits (OPEB) program. We will have to disclose on our financial statements an additional $535 million in long term liability for the next fiscal year, and each year thereafter. The Budget spends approximately $135 million in non-recurring money on recurring needs (commonly referred to as an "annualization") and greatly hamstrings our ability to appropriately deal with that new $535 million annual liability next year.

The percentage rate of the increase in state government spending in the Budget is the best indicator of its unsustainability. But it can also be illustrated in terms of total dollars spent. The Budget contains over $400 million more in spending for FY 2006-07 than our Executive Budget, even though our budget addresses the state's core needs in education, health care and social services, economic development, public safety, and natural resources. Stated yet another way, the Budget increases spending $177 per person while our neighbor to the south, the state of Georgia, is increasing its spending by only $109 per person.

Ironically, earlier in this legislative session, before it was known the total new state revenues would be well in excess of $1 billion – an absolutely unprecedented increase in the history of South Carolina – many members of the General Assembly pledged an allegiance to the idea of government spending caps and returning surplus revenues to the private sector to stimulate economic growth. This allegiance was declared in press conferences and through support of legislation like the Taxpayer Empowerment Act. The record is clear in this regard.

On January 7, 2006, in a news story titled "Senate finance panel chief envisions rivers of red ink," it was reported that the Senate Finance Committee Chairman predicted that the full state coffers would "soon be replaced by years of deficits" and that "within three years, flat revenues will send the state's budget back into the red." The chairman was further quoted as saying the prospect of having to deal with flat revenues in the future "scared the pants off of him." The chairman concluded, according to that news story, by saying that "the looming lean times will force legislators to control spending."

Regrettably, however, as the state's economy continued to improve throughout the legislative session and the hundreds of millions of unanticipated new taxpayer dollars poured into state coffers and were certified, the commitment of many legislators to a spending limit went out the window. Forced to choose between spending the new revenues or remaining true to their pledge to limit state government spending to a reasonable and sustainable level, most chose to spend. The "looming lean times" that the Senate Finance Chairman said would "force legislators to control spending" suddenly became irrelevant in the face of the chance to spend an unprecedented amount of new money.

On the day the House first considered the budget, members of the House declared that the House had to spend all of the unexpected new revenues in order to beat the Senate to the punch – in other words, to put House members' special projects in the best position of prevailing over Senate members' special projects. This "race to spend" approach to budgeting then continued throughout the legislative session as more and more unexpected revenues became available for spending. Each time that the BEA certified additional new revenues, the House or the Senate (depending on which body was considering the budget at the time the certifications were made) ratcheted up the rate of state spending. Absolutely no effort was made to keep state spending tied to the taxpayers' ability to sustain the spending in the future.

Since my first budget veto message, I have warned the General Assembly about the dangers of wrapping-up spending items so tightly that reasonable cuts could not be made without taking significant chunks of the budget with it. In fact, I specifically warned that "[a]n unfortunate consequence of continuing to budget like this will inevitably be the veto of large items or sections that include meritorious provisions, just to address objectionable matters." Three years later, however, the General Assembly continues to budget in a manner that effectively ties my hands.

As in years past, we carefully reviewed the Budget in an attempt to identify a sufficient number of line-item cuts that, in the aggregate, would reduce overall state spending to a reasonable and sustainable level. And we came up with a list of proposed cuts toward that end, including the following:

- The $9.3 million that has been set aside this year for the Competitive Grants Program. This program was originally proposed by this administration as way of awarding grants to local projects on the basis of merit; however, it has unfortunately devolved into a process whereby money is awarded to local festivals and projects simply because it is requested, with applicants not having to provide financial details, such as budgets or estimated economic impact. Given the way the Competitive Grants Program is run, it simply is not a process that gives the taxpayers the maximum yield on their investment.

- The $7 million for the Center for Performing Arts at Francis Marion University, which is to match a $10 million grant from the Drs. Bruce and Lee Foundation. At first glance, this seemed like a proposal worth considering until we learned from the Commission on Higher Education that the planned Center is being built in downtown Florence. In essence, the spending item is identified with Francis Marion University even though the site is not even within walking distance of the campus. If the City of Florence wants to build a Performing Arts Center, the people of South Carolina should not carry the share of the local municipality to this degree.

- The $1 million for streetscape improvements and upgrades for the City of Columbia. This item was included in the Budget by the Senate to enhance the appearance of North Main Street in the City of Columbia. While there is merit in improving this entranceway into Columbia, this is the primary responsibility of the City of Columbia, not the state.

- The $1 million for the Calhoun County Library to replace an existing county library. While there is merit in improving the state's county libraries, this is the primary responsibility of the county, not the state.

However, given the difficulty in getting at a number of spending items in the Budget, we eventually realized that we could not responsibly make line-item cuts to reach that goal – that it was impossible for me to responsibly implement via line-item vetoes the $400 million in spending reductions that would be necessary to bring state government spending to a sustainable level – to a level that does not create the almost certain prospect of mid-year budget cuts in the future. In order to responsibly reduce spending to accomplish that end, it is necessary to: 1) reduce the rate of increase in certain areas of spending – areas that are simply too important to the public good to be eliminated outright by me in a line-item veto; and 2) eliminate special interest spending that is cleverly rolled-up and included with core area spending. Here are but a few examples of such spending in the Budget:

- <u>DHHS: Pharmaceutical Reimbursement Rate $3,300,000</u>
  We proposed moving to a pharmaceutical reimbursement rate closer to the Southeastern average. With these savings rolled up within the existing Pharmaceutical Services line at the Department of Health & Human Services (a line which currently has around $50 million on it), it makes it particularly difficult to extract the amount of these savings.

- DHEC: TERI Savings $1,873,454
  We proposed this Department of Health & Environmental Control cost savings within our budget; unfortunately, only TERI Savings for the cabinet agencies were adopted. With these savings rolled up within existing Personal Service and Employer Contributions lines at this agency, it makes it particularly difficult to extract the amount of these savings.

- Mental Health: TERI Savings $1,930,576
  We proposed this Mental Health cost savings within our budget; unfortunately, only TERI Savings for the cabinet agencies were adopted. With these savings rolled up within existing Personal Service and Employer Contributions lines at this agency, it makes it particularly difficult to extract the amount of these savings.

- Disabilities & Special Needs: TERI Savings $956,930
  We proposed this Disabilities & Special Needs cost savings within our budget; unfortunately, only TERI Savings for the cabinet agencies were adopted. With these savings rolled up within existing Personal Service and Employer Contributions lines at this agency, it makes it particularly difficult to extract the amount of these savings.

- Higher Education: TERI Savings $11,646,021
  We proposed these college and university savings within our budget; unfortunately, only TERI Savings for the cabinet agencies were adopted. With these savings rolled up within existing Personal Service and Employer Contributions lines at the College and Universities, it makes it particularly difficult to extract the amount of these savings.

- K-12 Education: TERI Savings $830,000
  We proposed these education savings within our budget; unfortunately, only TERI Savings for the cabinet agencies were adopted. With these savings rolled up within existing Personal Service and Employer Contributions lines at the K-12 educational agencies, it makes it particularly difficult to extract the amount of these savings.

- Revenue: Compliance and Technology Service Savings $3,000,000
  We proposed these Department of Revenue savings within our budget that are related to the increased enforcement collections. With these savings rolled up within existing Other Operating Expenditures lines at the Department of Revenue, it makes it particularly difficult to extract the amount of these savings.

- All agencies: Travel Savings $726,365

We proposed these savings within the budgets of agencies related to increased management of agency travel. By increasing this management, savings are anticipated. With these savings rolled up within existing Other Operating Expenditures lines at agencies, it makes it particularly difficult to extract the amount of these savings.

- <u>Budget & Control Board – Employee Benefits $52,597,344</u>
  Our budget funded a 3 percent employee pay plan increase that with exemptions totaled $30,433,871. With these savings rolled up within the existing Employee Pay Plan line at the Budget & Control Board, extracting $22 million to achieve the employee pay plan proposal put forth in our budget is not possible through the veto of the actual line.

- <u>Budget & Control Board – Employee Benefits $30,503,922</u>
  Our budget sought to cover premium increases for those employees that did not use tobacco products - a practice that many businesses nationwide are now employing and that would save the state $1 million annually. The Conference Committee budget covers all premium increases. With these savings rolled up within the existing Health Insurance – Employer Contributions line at the Budget & Control Board, extracting $1 million to achieve the employee health plan proposal put forth in our budget is not possible through the veto of the actual line.

But while the General Assembly has the power to revise the Budget in those ways, I do not. That is one reason why I have decided to veto it in its entirety.

But there is another, more practical reason for this decision. The now-Majority Leader in the House had this to say about legislators' inclination to override the numerous line-item vetoes that I delivered on last year's budget: "It's very hard for members to vote against particular projects in their districts. For instance, it would be hard for me to vote in favor of (keeping) Charles Towne Landing in the budget and not supporting (an override) when a project came up in another member's district." He also bluntly said that I had made a strategic mistake by handing down so many vetoes: "When you put that many vetoes into a bill we create natural constituencies against complying with them."

Other members of the House and the Senate have told me the same thing – even legislators who I know to be fiscal conservatives. When even conservative members of the legislature say they cannot sustain my budget vetoes in a multiple line-item veto context because of the "natural constituencies against complying with them," then common sense says I should try a different approach. And that different approach is this: one single veto of the Budget in its entirety so that the question facing the members of the General Assembly is simply whether we grow state government spending by 13 percent (or 10.8 percent, if the less conservative approach is their preference). Shouldn't we make a decision on whether the rate of government spending should be reasonably correlated with the people's ability to sustain it – and not about the relative merits of hundreds of special projects, each with their "natural constituencies?"

And so with this single veto of the Budget in its entirety, I put the following question to the members of the General Assembly: knowing that the Budget is $744 million above the previous budget high-water mark and that increases in state government spending in 1999 and 2000 by 11.4 percent and 12.2 percent, respectively, led to painful mid-year budget cuts in later years, are you willing to increase state government spending at a rate that no reasonable person can argue is sustainable? I respectfully submit that no responsible legislator could answer this question in the affirmative.

If either the House or the Senate sustains my veto of the entire Budget, then I would ask those bodies to immediately pass another *Sine Die* resolution for the purpose of passing a new budget that limits the increase in spending to a reasonable and sustainable rate. I would also specifically ask that the House and the Senate address the following:

- Adopt tax relief as called for within our FY 2006-07 Executive Budget and specified in the Appropriations Bill, H.4810 to provide for a 2 cent reduction in the sales tax on food amounting to $77 million from FY 2006-07 in forecasted recurring revenue.

- Adopt property tax relief as called for within our FY 2006-07 Executive Budget and codified in H.4449 to provide $34 million from FY 2006-07 forecasted recurring revenue to mitigate the fiscal impact associated with implementing H.4449.

- Adopt tax relief as called for within our FY 2006-07 Executive Budget and specified in the Appropriations Bill, H.4810 to provide $7 million in alternative fuel and fuel efficiency tax incentives from FY 2005-06 forecasted increased enforcement collections.

- Adopt a reserve fund method to address the state's most pressing needs as described in Proviso 73.15 of the Appropriations Bill. With the General Assembly not appropriating $56 million of the FY 2005-06 forecasted surplus funds, this fund would receive that amount for state needs.

- Use $174 million from FY 2005-06 forecasted surplus funds used to repay the trust and reserve funds borrowed from during the recent economic downturn.

- Increase funding for disaster preparedness by $7 million.

To those who say that revising the Budget so that it complies with a reasonable and sustainable spending cap is impractical, I say this: we did it in our Executive Budget. I admit that working within a self-imposed cap, as opposed to simply spending whatever is available to be spent, involves making difficult choices. Often those choices upset sometimes very politically powerful people, but to avoid doing real harm in the long run to the taxpayers at large and constituencies served by government by mid-year budget cuts in the future, it is necessary.

Consider the upside: working within a reasonable and sustainable spending cap, it is possible this year for us to have a balanced state budget that, without raising taxes, restores monies to trust funds, provides for the Conference Committee tax plans, provides the Conference Committee Contingency Reserve Fund, and provides essential services in the priority areas of education, health care and social services, economic development, public safety, and natural resources – and this still leaves enough money to dedicate $410 million to set aside in preparation for the $500 million annual cost due for the state health plan. If the decision was instead made to rebate further monies to the taxpayers it could result in as much as a $400 per family rebate.

For these reasons, I am vetoing in its entirety and returning H. 4810, R. 432, the FY 2006-07 General Appropriations Act, without my signature.

Sincerely,

Mark Sanford