Policy Report
South Carolina Policy Council
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A Review of Total State Spending, Part II: An Effective Spending Cap for South Carolina

By Simon Wong, with Dr. Jameson Taylor

In Part I of this series, we looked at state spending over the past 10 years. We found that:

- The total budget (General Fund + Other Funds + Federal Funds) increased by 44.5 percent over 10 years (FY2001 to FY2011).
- Spending increased every year except FY2010.
- The current $21.148 billion budget is the largest in state history.

As we concluded in Part I, "The Legislature has essentially proven it can't stop spending, that it is addicted to spending in both good times and bad." Thus the only way to limit state spending is an institutional control that legislators must adhere to – a constitutionally mandated spending cap.

Part I of this series posited that the best mechanism for limiting state spending is a comprehensive spending cap tied to inflation. This report reconsiders that finding and looks at several different formulas for capping governmental growth. In doing so, we discuss the pros and cons of each method and delineate five safeguards that should be integrated into an effective spending cap. At this phase in our research, we have concluded that a formula based on supply (available revenue as measured by economic productivity) rather than demand (the perceived need for governmental services) provides the best measure for limiting spending according to real economic growth. In light of this distinction, a spending cap based on inflation plus population growth is less desirable than a cap based on real gross state product (GSP), for instance. As we will demonstrate, real GSP provides a more accurate picture of the true health of the state's economy and is a better indicator for analyzing state spending levels – which, as much as possible, should be correlated against real economic conditions. That said, questions remain regarding how a spending cap measured against real GSP would prevent overspending during economic upturns.

Existing State Spending Cap is Ineffective

Technically speaking, South Carolina already has a spending cap. Article X, section 7 of the S.C. Constitution requires that:

> The General Assembly shall prescribe by law a spending limitation on appropriations for the operation of state government which shall provide that annual increases in such appropriations may not exceed the average growth rate of the economy of the State as measured by a process provided for by the law which prescribes the limitations on appropriations; provided, however, the limitation

> may be suspended for any one fiscal year by a special vote as provided in this subsection.

The state constitution thus limits budgetary spending according to economic growth, which is to say the economy provides an objective measure for making sound budgetary decisions. The tacit assumption here is that the budget should not grow during recessionary periods. In practice that has not been the case. Instead, the Legislature has overspent during boom times. When the economy has cooled, however, lawmakers have avoided making tough cuts. The result is that spending has increased with virtually no regard for the state's actual economic health.

The state constitution also does not specify the mechanism by which spending should be limited. Two basic questions are left unanswered: What is the best way to measure economic growth? And how is spending subject to the cap to be defined?

Statutory language governs the terms of the constitutionally mandated spending cap. This language can be changed at any time by revising existing state law. Thus the formula used by the state to limit spending can be changed without having to amend the constitution. The current formula (S.C. Code of Laws 11-11-410) is as follows:

> The limitation on state appropriations prescribed in subsection (A) is an amount equal to either those state appropriations authorized by the spending limit for the previous fiscal year increased by the average percentage rate of growth in state personal income for the previous three completed calendar years or nine and one-half percent of the total personal income of the State for the calendar year ending before the fiscal year under consideration, whichever is greater. As used in this section, "state personal income" means total personal income for a calendar year as determined by the Budget and Control Board or its successor based on the most recent data of the United States Department of Commerce or its successors.

The method chosen by the state Legislature to limit spending thus relies on personal income growth. This is an approximate measure of economic growth and is used by 11 other states in their spending cap formulas. For example, South Carolina, North Carolina, and Maine all use personal income as a means of limiting spending. South Carolina caps spending at 9.5 percent above personal income. North Carolina caps spending at 7 percent of personal income while Maine's formula limits spending to a 10-year average of personal income growth, or a maximum of 2.75 percent annually.

South Carolina's cap is correlated against two different measures, relying on the larger of the two to limit spending:

1) Average personal income growth as based on the last three calendar years; or
2) 9.50 percent of total personal income for the prior calendar year.

An Inaccurate Measure of the State's Economy

The formula used to set the current spending cap leaves much to be desired. According to a study on state spending limits by the Mercatus Center at George Mason University, South Carolina's current method for limiting spending is only partially effective. "Those

TELs that limit budget growth to state income growth seem to have a statistically significant impact on both state spending and state and local spending," observes the report. Whereas, "TELs that limit budgets to some share of income had no statistically significant impact on either state-only spending or on combined state and local spending." In other words, the first part of South Carolina's formula (as based on personal income growth) is theoretically sound. The second measure (as based on prior calendar year total personal income) is not.

But this is not to say that a spending cap as calculated against personal income growth is advisable. The Mercatus report finds mixed results regarding such a formula, concluding that it may serve "as an excuse for policy makers to spend up to the limit, rather than as a binding constraint on spending."

In South Carolina's case, the cap is set at such a high level (e.g., 9.5 percent of total personal income) that it is entirely ineffective. This point comes out clearly when we compare the effects of South Carolina's cap to Maine's. Since Maine implemented its 2.75 percent spending cap formula in 2005, average yearly total state spending growth has dropped by 5.58 percent (FY95-2005) – to 3.75 percent per year (FY06-2010). In particular, Maine's General Fund average yearly growth rate declined from 4.96 percent to 0.37 percent. By contrast, since implementing its spending cap in FY85-1986, South Carolina's total state spending has increased by an annual average of 5.71 percent (300.7 percent cumulatively), with General Fund spending increasing 2.74 percent annually (96.7 percent cumulatively).

Just as important, personal income does not provide an accurate measure of the state's economic health. In addition to income from wages, personal income includes: 1) personal dividend income; 2) personal interest income; and 3) personal current transfer receipts. These three components of personal income do not necessarily indicate an increase in the state's productivity or attractiveness as a business environment. For instance, dividend income is often derived from stocks and bonds sold in other states, or even other countries. Moreover, personal income includes government transfer payments, such as federal and state Supplemental Security Income, food stamps, direct relief, earned income tax credits, state public assistance medical care payments, federal hospital and medical insurance benefits, and adoption assistance. Thus, personal income, relative to other indicators (such as gross state product), does not specifically measure the health of South Carolina's economy. Instead, it serves as a very general proxy of the income levels of people who pay taxes in South Carolina, regardless of the source from which this income is derived. In short, personal income does not measure the value of goods and services produced by South Carolina's economy.[1]

Does Not Include the Majority of State Spending

State law also restricts the spending cap to a narrow range of expenditures that accounted for only 32.75 percent of total state appropriations in the FY10-2011 budget. The

[1]It's also worth noting that inflation is an important factor that affects personal income calculations. Growth in personal income is almost always greater than inflation. Likewise, declines in personal income are almost always greater than deflation.

spending cap does not apply to the total state budget, but only to all "nonfederal and nonuser fee revenue items." For the most part, this means the General Fund, the Highway Trust Fund, and Education Improvement Act funding. The spending cap also does not apply to local funding – for instance, county, municipal, and school district budgets.

Actual spending subject to the legal cap was about $7.3 billion in FY09-2010. Yet the theoretical spending limit for FY09-2010 was $13.501 billion. The theoretical cap was thus almost twice as high as actual spending. This is hardly a cap at all and helps explain why budgetary spending hit an all-time high in the midst of the worst economic downturn since the Great Depression.

Here, it is important to recall that the state budget is made up of three components: the General Fund, Other Funds and Federal Funds. As indicated above, the General Fund, the Highway Trust Fund and the Education Improvement Act are the only revenue sources subject to the state spending cap. This explains, in part, why the General Fund is increasingly shrinking as a share of the total budget – falling to 24 percent of the FY10-2011 budget. It may also help explain why the General Fund is subject to greater scrutiny than the Other Funds part of the budget. Yet, Other Funds revenue (derived from fines and fees) has skyrocketed, making up 37 percent of the FY10-2011 budget. Over the past 10 years, Other Funds revenue has even exceeded federal funding as a share of the state budget. For this reason, an effective spending cap must include Other Funds (fine and fee) revenue.

Similar considerations explain why an effective spending cap should also include federal funding, especially insofar as new federal programs are helping to fuel state spending. Thus, our analysis of each type of spending cap includes all three components of the budget, including federal funding. In addition, we have included a second data set that treats federal funding as a constant not subject to the cap.

A Review of Six Different Types of Spending Caps

Given that the current budget cap is completely ineffective, we want to look at several different mechanisms for limiting spending. These are as follows:

1) Inflation plus population growth (demand based)
2) Inflation only (demand based)
3) Gross state product in all industries (supply based)
4) Gross state product in private industries only (supply based)
5) Real gross state product in private industries only (supply based)
6) Real gross state product per capita in private industries only (supply based)

We will explain each metric in detail. But the following table provides a quick snapshot of our findings. Our analysis uses FY01-2002 as a baseline and projects spending out to FY2011. As stated, we apply the cap to total state spending (including federal funds).

Spending Limit Formula	Total FY2011 Budget	Growth in Budget Since FY2001
Current State Spending Cap[2]	**$27.285 billion**	**86.41%**
Gross State Product, All Industries	$21.193 billion	45.60%
Current Budget	***$21.148 billion***	***44.50%***
Gross State Product, Private Industries Only	$21.193 billion	41.40%
Inflation + Population Growth	$20.100 billion	38.40%
Inflation Only	$17.998 billion	23.90%
Real Gross State Product, Private Industries Only	$16.910 billion	15.60%
Real GSP Per Capita, Private Industries Only	$14.872 billion	1.35%

Our research indicates that five out of the six types of spending caps would have reduced spending below current levels. Note, also, that current spending is well below the theoretical spending cap currently required by state law.

Finally, we want to mention that spending cap models are sometimes validly criticized as being inaccurate because they rely too heavily on prior year data, such that fluctuations become too volatile. In light of this, we have calculated the six aforementioned scenarios using data based on an average of two prior years and an average of three prior years. The chart below illustrates the potential maximum FY2011 budget should such a smoothing average be implemented.

Method	Inflation Plus Population Growth	Inflation	Gross State Product, All Industries	Gross State Product, Private Sectors Only	Real Gross State Product, Private Sectors Only	Per Capita Real Gross State Product, Private Sectors Only
Prior Year	$20,100,443,000	$17,998,719,174	$21,192,539,698	$20,572,795,043	$16,909,735,357	$14,871,664,663
Average of Two Prior Years	$20,385,515,454	$18,122,277,432	$21,207,380,716	$20,642,385,694	$16,929,911,051	$14,891,405,494
Average of Three Prior Years	$20,672,575,977	$18,386,173,865	$21,162,850,813	$20,747,989,423	$16,898,955,080	$14,889,983,315

Method 1: Inflation Plus Population Growth

Inflation plus population growth is widely advocated as an effective spending limit formula. That said, a variety of spending cap formulas, otherwise known as Tax and Expenditure Limits (TELs), are used by many states. According to the Mercatus Center, 27 states employ some mechanism for limiting spending and/or taxes; and 16 states require a supermajority vote to increase taxes.

Colorado's TABOR (Taxpayer Bill of Rights) formula, which relies on the population plus inflation metric, is regarded as the most rigorous TEL in the nation. In the midst of

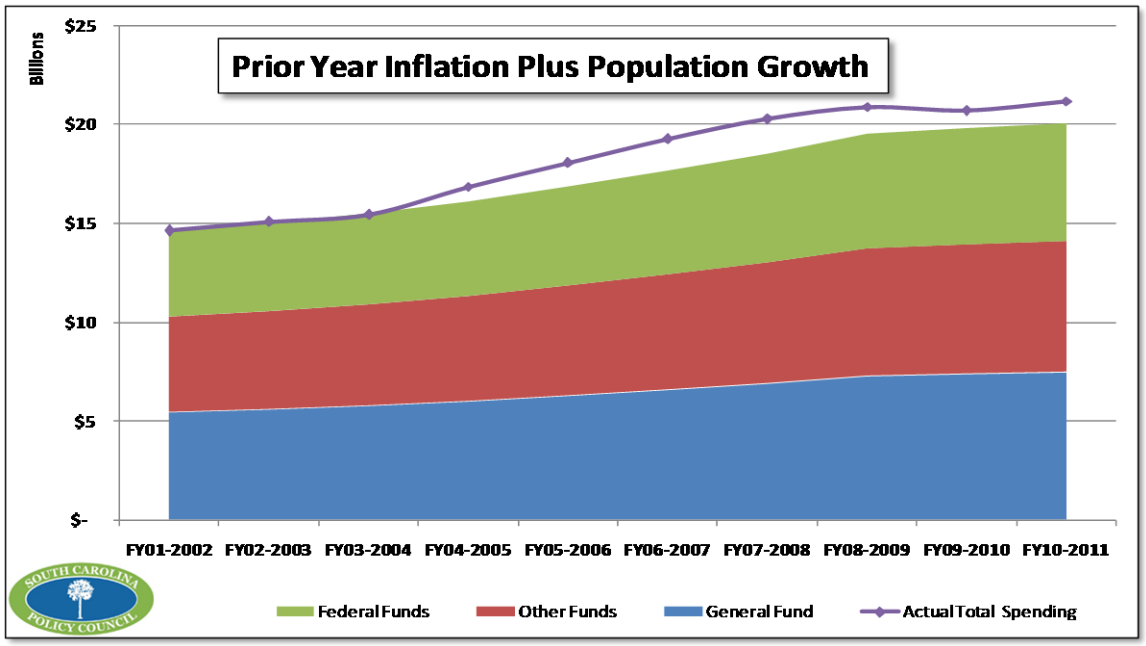
[2]This number includes two components: 1) state spending (General Fund, Highway Trust Fund, and Education Improvement Act) subject to the spending cap; and 2) actual, historical non-capped budgetary spending – that is, all remaining state spending not subject to the cap.

the recession, though, Colorado voters suspended TABOR until 2011 – raising questions as to whether population plus inflation growth is the best mechanism for limiting state spending. In 2010, legislators in South Carolina also introduced a bill (H 4232) that would have limited General Fund appropriations to population plus inflation growth. Like Colorado's TABOR, the bill included a provision to refund surplus revenue back to taxpayers.

The inflation plus population growth spending cap is a way of preserving the level of purchasing power assumed in the prior year's budget while also being able to accommodate increased demand for public services due to population growth. In other words, it is a spending limit based on the perceived need to pay for current and future governmental activities. For this reason, we identify it as a demand-based formula.

In Chart 1 below, we've capped the total budget (General Fund + Other Funds + Federal Funds) based on inflation and population growth for each prior fiscal year. The model shows that the potential maximum of the total FY2011 budget is $20.100 billion. This equates to a maximum of 38.4 percent budget growth since FY2001.

Chart 1



Method 2: Inflation Only

Although a TEL based on inflation plus population growth is a fiscally responsible idea, it is less than perfect. Spending limits based on population growth and inflation imply no efficiencies within government. In reality, an increase in total population does not mean the state must proportionally increase funding to provide the same level of operations and services. At the very least, state government should be able to capture savings from economies of scale.

What, then, about a spending cap based on inflation only? For all practical purposes, such a cap freezes spending at current levels, allowing only for an increase in spending as

measured against the Consumer Price Index (CPI). Such a cap would seem to be most useful in states, such as South Carolina, where spending is already too high and has no real correlation with the economic health of the state.

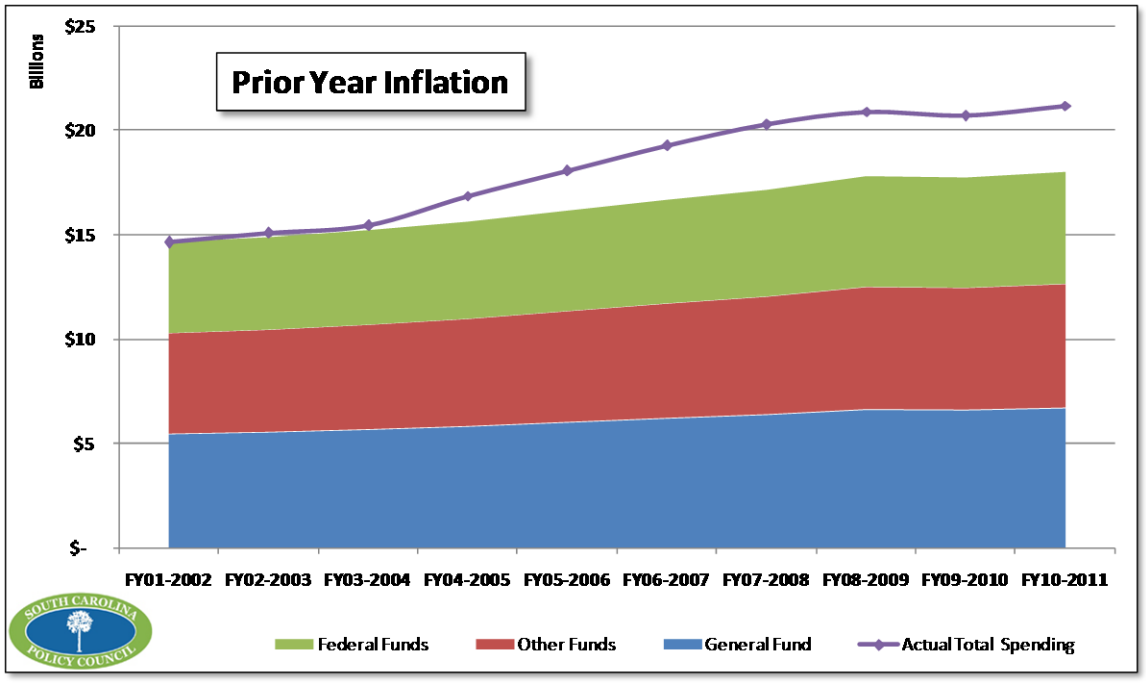
One advantage of capping spending based on inflation only is that it provides for a more stable budget. Rather than creating large ups and downs in the budget, depending on the condition of the economy, a spending cap tied to inflation would theoretically result in a smoothing effect. This is because the cap would allow for lower highs during good economic times, but higher lows during recessionary periods.

A disadvantage of a spending cap measured against inflation is that it presumes government should grow during inflationary periods. As indicated above, this assumption is shared by all demand-based spending caps, which generally assume that moderate government spending growth is desirable under normal conditions. In reality, however, inflationary periods that reduce economic productivity may require additional cuts in governmental spending. Moreover, increased public spending could even be a factor in driving up prices, exacerbating inflation levels for all consumers.

No state currently relies on a formula based on inflation growth alone to limit spending; however, several states use inflation as a primary indicator, among others. Lawmakers in New York are also apparently considering a spending limit based on a three-year average of the U.S. inflation rate.

Using the inflation-only formula, the potential maximum of the total FY2011 budget would be $17.998 billion, or 23.90 percent growth since FY2001. Spending is significantly lower than the current FY2011 budget of $21.148 billion (44.5 percent growth since FY2001).

Chart 2



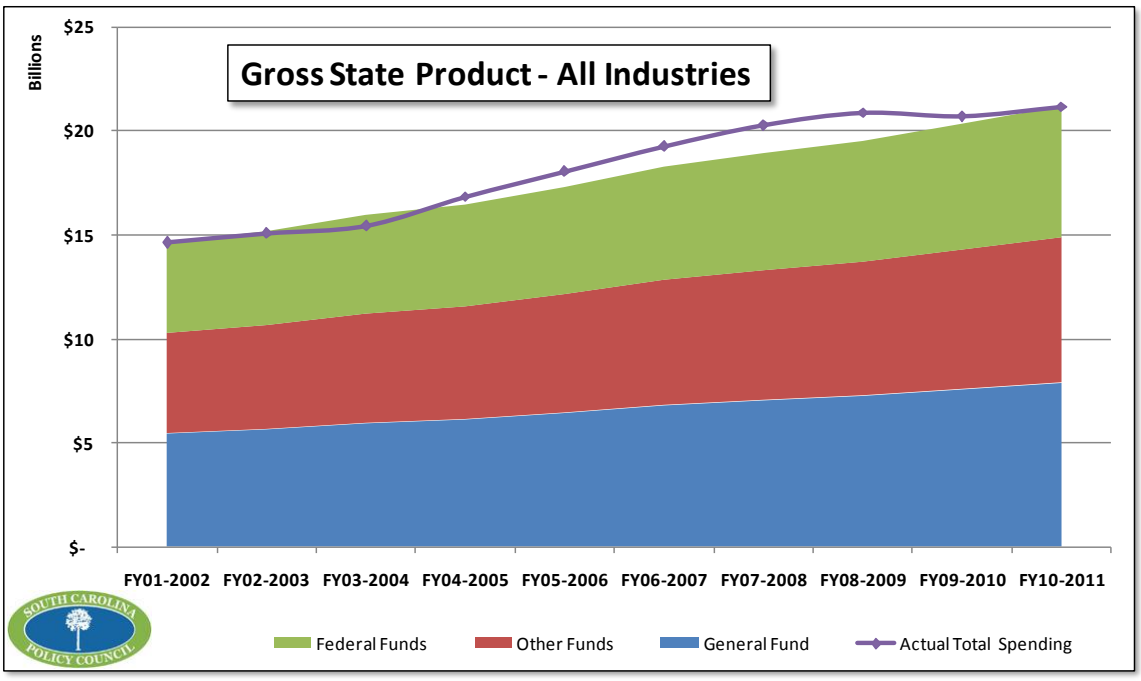
Method 3: Gross State Product, All Industries (Private Industries Plus Governmental Industries)

Gross state product (GSP), also referred to as state gross domestic product (GDP), provides another objective metric that can be used to cap state spending. This method has generated some interest among South Carolina lawmakers. In 2008, for instance, a bill (S 1162) was introduced that would have required the existing budget cap to be measured against U.S. real GDP instead of personal income.

Gross state product, as opposed to U.S. GDP, provides a more accurate picture of South Carolina's economy. More to the point, GSP indicates the degree to which current resources can accommodate state spending. Unlike inflation and/or population growth measurements, which rely on the demand for state services, GSP measures the value of the goods and services produced in South Carolina each year. Broadly speaking, these goods and services are the tax base from which state revenue is derived. A spending cap tied to GSP thus ensures that government growth will be limited by a finite supply of revenue, as opposed to what can easily become seemingly infinite demands on state resources.

Gross state product, however, can be measured in different ways – namely, as including private sector and public sector activities, or exclusively private sector goods and services. For the purposes of this formula, we employ a comprehensive definition that includes both the private sector and public sector. Under this spending cap, the maximum budget for FY2011 would have been $21.193 billion. This equates to a maximum of 45.6 percent budget growth since FY2001.

Chart 3



Method 4: Gross State Product, Private Industries Only
The alternative way to measure gross state product is to use only the value of private sector goods and services. This is a better measure of economic health because private sector activities are the only real source of state (and federal) tax revenue.

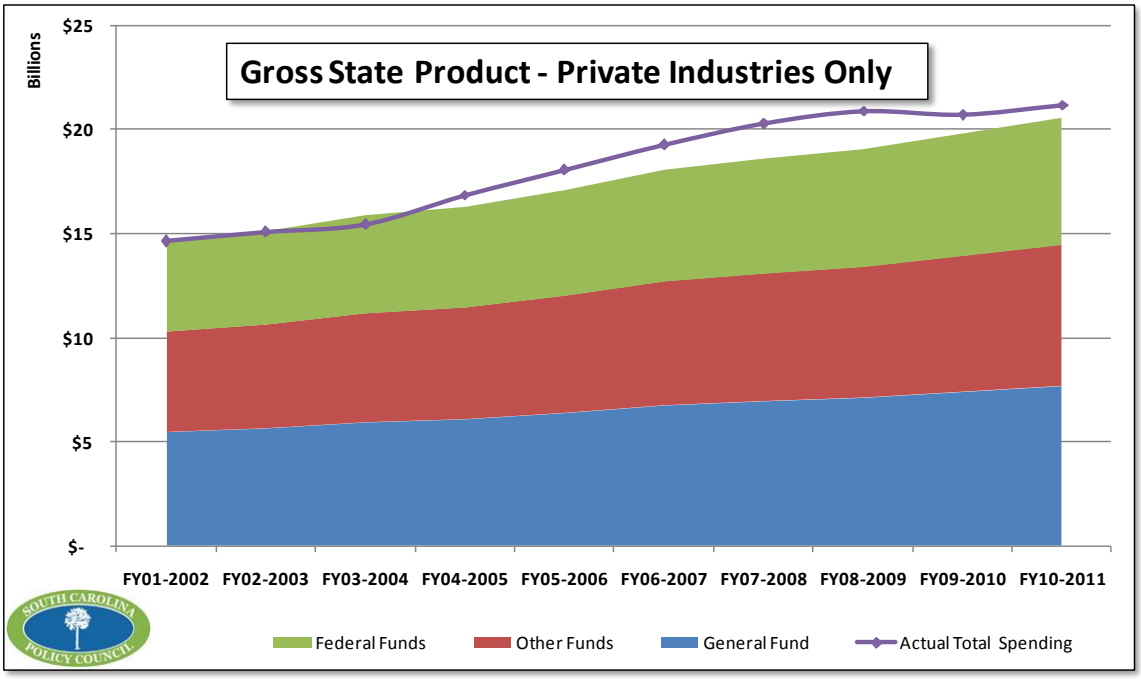
As indicated in the table above, a GSP spending cap that includes both the private and public sectors is the only method that results in maximum allowable spending that exceeds current spending levels. (Again, though, current spending is far below the current legal cap.)

When we look more closely at private sector and public sector GSP, we find that public sector GSP growth outpaced the private sector in 8 out of 11 years from FY1998 to FY2008 (latest data available). Governmental sector GSP grew 87.96 percent ($15.174 billion to $27.068 billion) from FY1998 to FY2008. During the same period, private sector GSP grew 55.8 percent ($87.771 billion to $129.316 billion).

A spending cap based on private sector GSP alone provides a better mechanism for measuring government growth against real economic growth. Indeed, including public sector GSP in any spending cap would only invite more spending as existing governmental spending pushes the maximum cap higher and higher.

A TEL utilizing private sector GSP would have resulted in a maximum FY2011 budget of $20.572 billion, which translates into budgetary growth of 41.4 percent since FY2001.

Chart 4



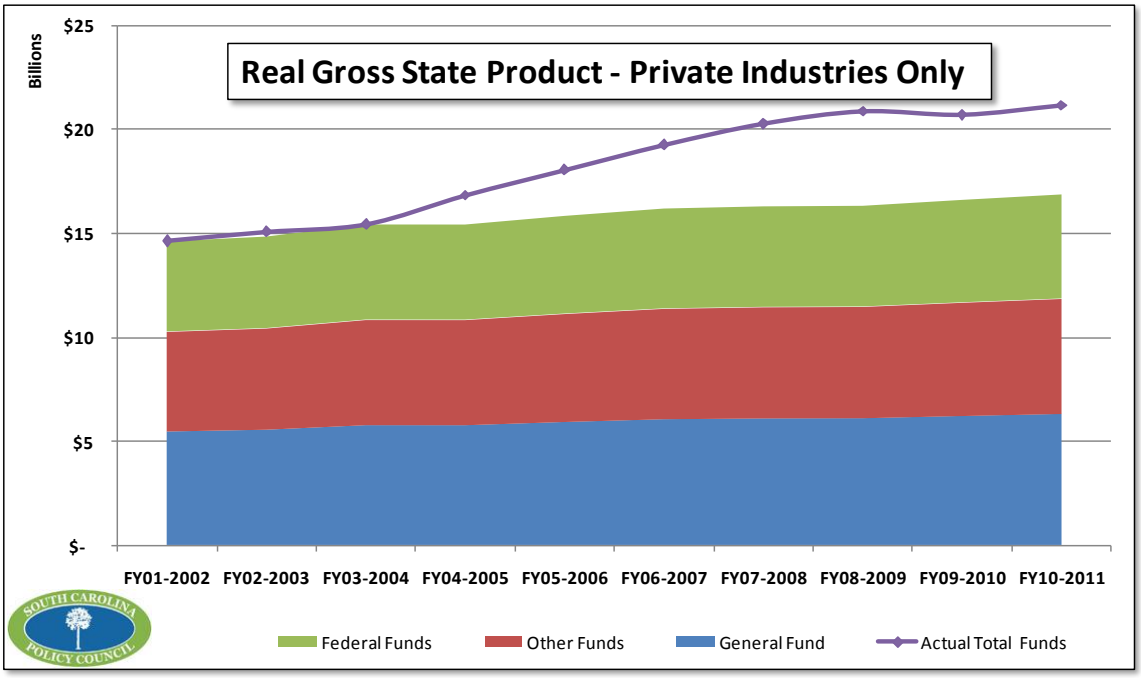
Method 5: Real Gross State Product, Private Industries Only
One problem with using private sector GSP is that it does not control for inflation. For reasons explained above, inflation should not be the primary driver of state budget

growth. Rather, inflation should be used as one among several measures that can be used to objectively evaluate governmental spending levels.

Accordingly, apparent GSP growth generated by inflation should not be treated as real economic growth. An increase in the Consumer Price Index due to appreciation of the U.S. dollar does not definitively indicate a change in real productivity. For this reason, it is prudent to measure GSP in real terms. In other words, the TEL formula should be limited to the value of private economic output adjusted for inflation.

Under this method, the maximum spending limit for FY2011 is $16.910 billion. Had a TEL based on real GSP been implemented in FY2001, budgetary growth would have been limited to 15.60 percent over the past 10 years.

Chart 5



Method 6: Real Gross State Product Per Capita, Private Industries Only
As compelling as a TEL based on real gross state product may be, we want to adjust this formula by adding an additional metric. The challenge we face is that even private sector real GSP does not completely capture real economic growth.

Thus, we want to reintroduce a factor that accounts for state population – namely, real economic output per capita. In doing so, we arrive at a spending limit that measures real economic productivity, but also accounts for inflation plus population.

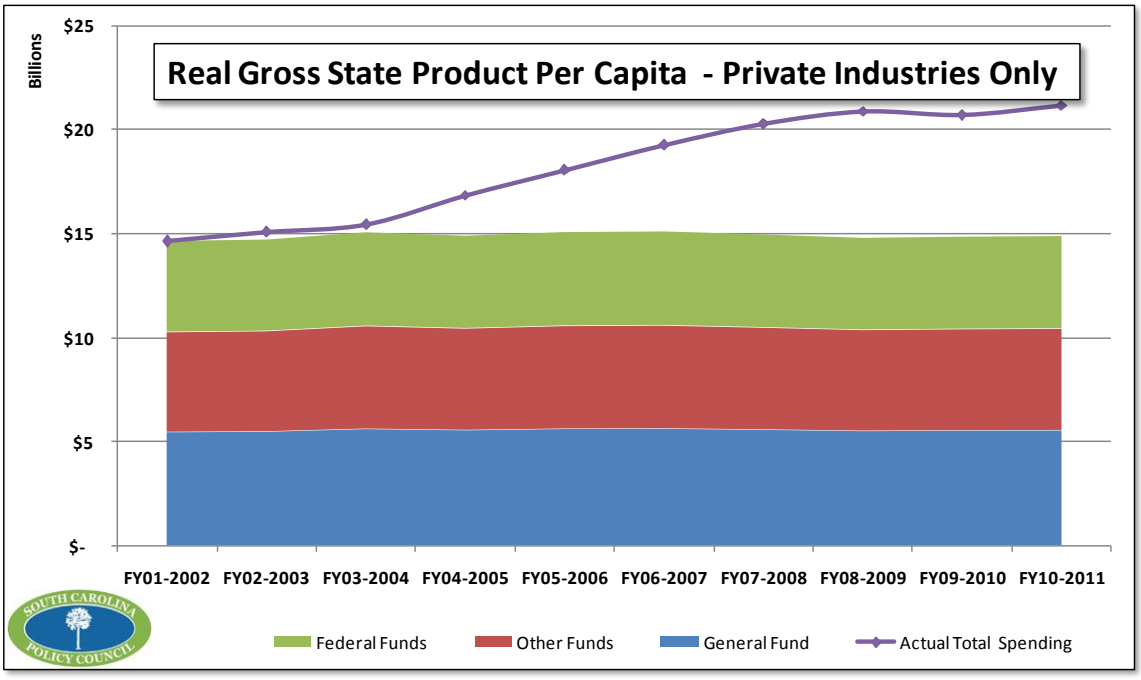
One advantage of using real GSP per capita to measure economic productivity is that it captures a wide range of economic activities and benchmarks. For instance, real GSP per capita can account for specific labor and demographic trends that impact productivity – new workers relocating to South Carolina, new graduates entering the work force, or alternatively, losses in productivity from retirees leaving the workforce. In addition, a

spending cap based on real productivity would provide an incentive for lawmakers to implement policies that increase economic productivity for the state as a whole (for instance, broad based tax cuts).

A disadvantage of using real GSP per capita to limit spending is that it theoretically allows for significant governmental spending growth when the economy is doing well. We address this concern in more detail below.

As measured by real GSP per capita, the maximum potential budget for FY2011 is $14.872 billion. The result is a 10-year spending increase of 1.35 percent, assuming South Carolina had implemented this budget cap formula in FY2001.

Chart 6



Needless to say, a 10-year spending increase of 1.35 percent seems unrealistic, if not draconian. Remember, though, that this spending cap is tied to real economic growth. If the proposed budget under this model reflects little growth it is because South Carolina's economy has stagnated over the past 10 years.

The following benchmarks place the reality of South Carolinas's poor economic performance in context:

- South Carolina ranks 38th out of 50 states in terms of real GSP growth for all industries from FY2000 to FY2009 – only 11.05 percent in 10 years. By contrast, the national average is 14.91 percent.
- In terms of real GSP growth for private industries only, South Carolina ranks 42nd out of 50 states – only 7.58 percent in 10 years. The national average is 13.23 percent.

- Private sector employment has declined 4.18 percent (64,200) from an annual average of 1.536 million workers in 2000 to 1.472 million workers in 2009.
- In terms of growth of real Gross Operating Surplus (GOS), a measure of the state's cash-flow based on a metric commonly used in the private sector, South Carolina ranks 43rd out of 50 states: only 9.89 percent for all industries from FY1999 to FY2008. The national average is 25.80 percent.
- In terms of growth of real GOS in private industries only, South Carolina ranks 45th out of 50 states at 8.01 percent from FY1999 to FY2008. The national average is 26.02 percent.[3]

By comparison, real GSP growth in private industries for the Texas state economy was 23.76 percent over the past 10 years. During the same period, private sector employment grew 7.9 percent, from 7.870 million workers in 2000 to 8.491 million workers in 2009. Likewise, Louisiana and Florida enjoyed growth in real GSP for private industries of 28.72 percent and 22.00 percent, respectively.

As the experience of other states indicates, a spending cap based on real GSP growth could allow for fairly robust governmental spending growth. But just as public sector spending should not necessarily increase because of population growth or inflation, it also should not necessarily increase because of real gains in economic productivity. On the one hand, it should be acknowledged that private sector growth often generates demand for additional governmental services – sewerage, roads, public safety, etc. On the other, a productive economy reduces the need for taxpayer subsidized welfare and health care benefits. Whether or not these various trends offset one another is not essential. The most important consideration here is how to limit new spending to core services.

Before we discuss this issue, we want to revisit a question left unstated throughout this paper. Is government spending good for the economy? Ironically, many spending caps seem to be based on the notion that government growth is a good thing – that government, somehow, has a right to grow at the same pace as the private sector. The tacit assumption is that the private sector needs the government and that the private sector and public sector should work together to promote economic growth.

Our approach is the opposite. Government growth, beyond a minimal level, is detrimental to the economy. This minimal level comprises those core services necessary to a stable economy – for instance, providing for the public safety, adjudicating legal claims through the court system, and so on.

Of course, the purpose of this paper is not to enter into a discussion regarding the scope of limited government. We want only to point out that, at bottom, every budgetary decision must be informed by these basic questions: What is the proper role of government? What does government exist to do? How can government make the citizens of South Carolina more free?

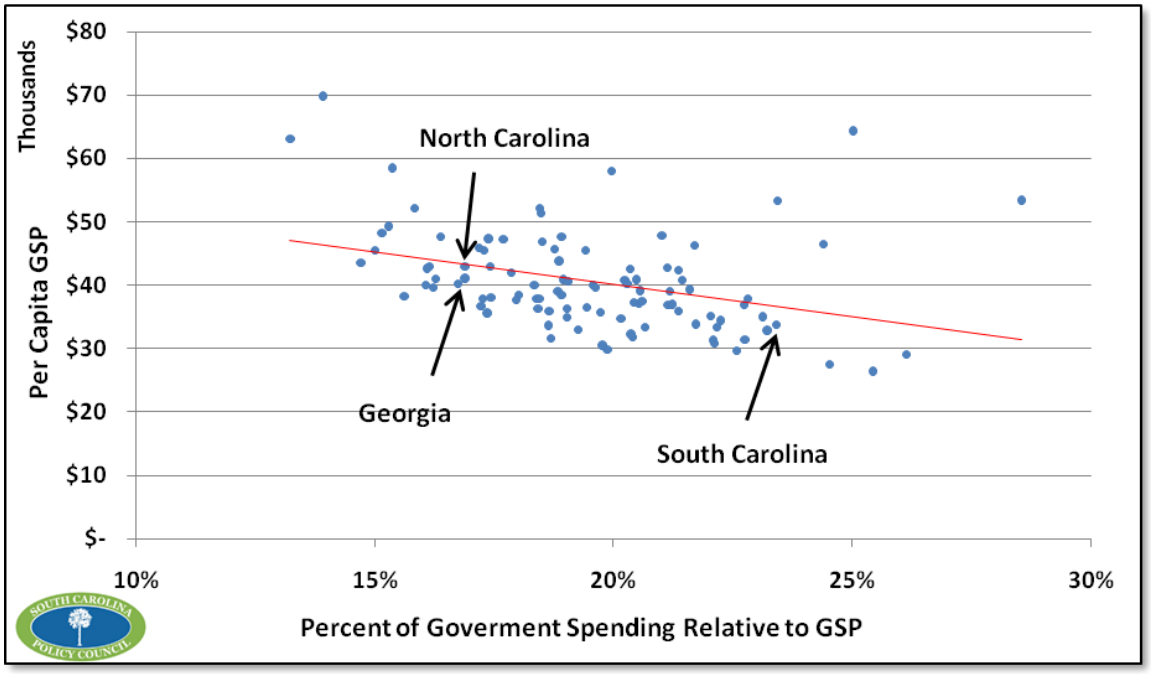
[3]Data derived from U.S. Bureau of Economic Analysis and Bureau of Labor Statistics. The calculations are adjusted using the Consumer Price Index (CPI).

We would argue that the proper role of government is not to plan South Carolina's economy. This theoretical conclusion is buttressed by sound economic data – as presented in our recent economic text, *Unleashing Capitalism*. Thus, in spite of appropriating more than $2.5 billion in economic incentives from FY99-2000 to FY07-2008, lawmakers can point to little real growth in economic productivity.

Moreover, as based on data from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, a negative correlation can be established between the percentage of government spending relative to GSP and GSP per capita. What this suggests is that a state that has higher governmental spending relative to GSP generally has lower productivity per person. The implication is that the larger government is relative to the private sector, the lower the quality of life and standard of living for individual citizens.

As can be seen in the scatter plot below, South Carolina suffers from high governmental spending, but low GSP per capita.[4] This correlation suggests high governmental spending in a low-income state like ours is doing more harm than good.

Chart 7



By contrast, had an effective spending cap been enacted 10 years ago, lawmakers would have been forced to streamline governmental activities and cut spending – reforms that would have promoted real private sector job growth.

Federal Funds as Uncontrollable Variable

As indicated, the spending caps discussed above apply to total spending, including Federal Funds. It might be argued that the state has little control over such funding. But as recent debates over whether the state should accept federal stimulus funding

[4]Derived from *Freedom in the 50 States: Index of Personal and Economic Freedom* by the Mercatus Center, using 2004 and 2006 data.

demonstrated, this is not true. Many federal pots of money are discretionary. At the same time, much of this money comes with strings attached that obligate state funds.

Still, a state spending cap could exclude federal funding and remain effective (though, this is not the case with Other Funds revenue). The table below shows the maximum potential FY2011 budget if we removed federal funds from the state spending cap and allowed such funding to grow at its historical rate from FY2001 to FY2011.

Method	Inflation Plus Population Growth	Inflation	Gross State Product, All Industries	Gross State Product, Private Sectors Only	Real Gross State Product, Private Sectors Only	Real Gross State Product Per Capita, Private Sectors Only
Prior Year	$22,381,005,100	$20,905,328,772	$23,147,795,306	$22,712,656,062	$20,140,724,204	$18,709,740,437
Average of Two Prior Years	$22,581,162,070	$20,992,082,319	$23,158,215,581	$22,761,517,513	$20,154,890,096	$18,723,601,001
Average of Three Prior Years	$22,782,714,916	$21,177,371,040	$23,126,949,948	$22,728,479,949	$20,133,155,084	$18,722,602,451

Designing an Effective Spending Cap

A spending cap can be an effective mechanism for limiting state spending and, in turn, holding down taxes. Yet, as the discussion above indicates, a spending cap is not a magic formula that will solve all of the state's budgetary problems. What a cap will do is force lawmakers to prioritize. That said, a spending cap cannot set these priorities. It must be complemented by other good budgeting practices (such as strategic budgeting and sunset review efforts) that can help lawmakers make targeted cuts while preserving core services.

Looking at six different spending cap formulas, we have concluded that a TEL based on real GSP per capita provides the most accurate correlation between real economic growth and budgetary growth. Again, though, this does not mean the state budget should automatically increase because the state's economy is booming. Additional analysis is needed to determine how best to formulate a spending cap for South Carolina that provides for necessary increases in core funding while also limiting spending on non-core functions, such as economic development. In this regard, the following questions need to be addressed:

1) Should spending be limited to a percentage of real GSP per capita growth – for instance, 50 percent? Assuming (as based on a strategic budgeting model) that, at worst, 50 percent of current state spending is allocated to core services, with the remainder being discretionary?
2) How can the formula – real GSP per capita growth – best account for the tipping point at which private sector growth would be served by increased governmental

spending? And likewise the point at which the private sector would be hurt by new spending?

3) Should the formula allow all government spending to grow at the same rate (it would seem not)? Or should only core services be allowed to grow as based on real GSP per capita?
4) How can the formula best account for inflation? – for instance, by utilizing the Consumer Price Index? Or the Producer Price Index?
5) How can a revenue cap complement a spending cap, so as to limit new spending when real GSP increases?

All this is to say that an effective TEL does not operate within a vacuum. For this reason, it is important to realize that, no matter how accurate the model, even the best TEL will be insufficient if it does not include various safeguards. We recommend the following:

1. *A spending cap must be comprehensive*. A spending cap that does not include all sources of revenue will allow lawmakers to use revenue from other sources (fines and fees, for instance) to offset cuts required by the TEL. New Jersey, for instance, has a poorly designed spending cap that only applied to about 15 percent of total spending (including federal funding) for FY10-2011. The result, observes the Mercatus Center, is that "the state has experienced structural deficits regularly over the past 20 years." By contrast, Colorado has a well-designed budget cap that included about 73 percent of total state spending (including federal funding) for FY10-2011. A comprehensive TEL would include all sources of state revenue, including federal funds. Going one step further, all governmental entities should be subject to a spending cap, including county, municipal and school district budgets. In other words, the budget cap should include 100 percent of state and local governmental spending.

2. *A spending cap must be accompanied by a revenue cap*. Theoretically, a spending cap would seem to make a revenue cap redundant. But, in practice, a revenue cap is a safeguard that makes it all the more difficult for lawmakers to evade a spending cap by shifting tax dollars from one pot to another. Implementing this cap would require that every source of revenue, such as general tax revenue and revenue from fines/fees, be capped at a specific level correlated to the state's spending cap. For instance, revenue collected from fines and fees might be capped at $5 billion, with any surplus revenue being automatically refunded to taxpayers. Such a cap would also help prevent the problem of overspending during boom times.

3. *A spending cap must refund surplus revenue to taxpayers*. As indicated, surplus revenue generated by a state spending cap should be refunded to taxpayers. The alternative is to deposit such savings into reserve funds that are inevitably targeted once revenue declines. But a spending cap that allows surplus revenue to be eventually spent is not a spending cap at all. Colorado, Florida, Massachusetts, Michigan, Missouri, Oklahoma and Oregon already impose revenue caps that require surplus revenue to be returned to taxpayers.

4. *A spending cap must be tied to real economic growth and not subject to political manipulation*. This report identifies several ways to measure economic productivity, concluding that real GSP per capita provides the best approximation of the state's economic health. One advantage of this method is that it is fairly straightforward and would not need to be adjusted upward to allow for additional spending; although, as we suggest above, it could be modified so as to hold spending below increases in real GSP. Whatever mechanism is used, the aim should be to prevent spending growth from exceeding real economic growth. At the same time, existing spending (and debt) should be evaluated in light of the state's current economic health.

5. *A spending cap must include off-balance spending, such as pension and other post-retirement benefits*. The TELs discussed above explicitly apply to direct spending. This means the state's off-balance spending accounts, such as pension plans and post-retirement benefits, are not explicitly capped. As we discuss in our recent report on South Carolina's pension system, the state's retirement plan is saddled with a $12 billion unfunded liability and another $9 billion in unfunded post-retirement healthcare benefits. Any discussion of a state spending cap, and state spending, generally, must account for these obligations and should seek to cap future spending on retiree benefits.

As indicated in *Unleashing Capitalism*, governmental policies, such as tax rates and business regulations, affect economic outcomes. In turn, economic outcomes should inform government spending. This is another way of saying that state budget growth should be a reflection of South Carolina's economic performance. The reason this is not the case is because lawmakers have repeatedly shifted the burden of new government spending to future taxpayers. New debt is used to pay for current programs. Higher taxes are used to cover current and future deficits that are a consequence of years of overspending. The best way to end this cycle – and help create a prosperous future for South Carolina's children – is to implement an effective and comprehensive spending cap.

To learn more, contact the Research Department of the S.C. Policy Council at 803-779-5022.

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