

SPENDING & TAXES

“Fiscal policy is a major problem. While taxes are a bit below the national average, government spending and therefore debt are high. Education and social spending are far, far above average, even when federal grants — of which South Carolina perhaps receives more than its fair share — are controlled for.”

**— Freedom in the 50 States report
by the Mercatus Center**

spending and reduce taxes or cut taxes and reduce spending? ... which comes first for fiscal conservatives? Taxes and spending go hand in hand because increased revenue collections fuel the growth of government spending. Once revenue drops off, legislators call for tax increases to maintain what are now described as essential programs and services. When the economy recovers the cycle begins again, elevating spending to ever higher levels. Given these patterns, the only way to effectively reduce the size of government is to implement a tax and spending cap that requires the state to provide tax refunds when collections exceed what is necessary.

It is well established that state spending has increased rapidly over the past few years. Between FY05-2006 and FY07-2008, for instance, spending increased by \$1.1 billion. In fact, over the past five years state spending exceeded inflation, plus population growth by a cumulative 44 percent.

As far as taxes go, South Carolina ranks 38th in the country in terms of state/local tax burden, but only 47th in terms of personal income. In other words, even though the total tax burden is slightly lower (< 1%) than the

national average, South Carolina's tax rates are all the more regressive because per capita income is so low. And this doesn't even fully account for the \$7 billion in fees the state annually collects from taxpayers.

According to the Tax Foundation, South Carolina also has relatively high business taxes and sales taxes. (For more information on property taxes see the Property Rights section of this report.) At 7 percent, the state likewise has one of the highest personal income tax brackets in the country. Given that personal income brackets are indexed at only one-half of inflation, many South Carolinians are now paying taxes at the highest rate. The result is that the income tax burden for a single filer earning \$30,000 is the highest in the Southeast.



More good bills that didn't pass:

S 60: Suspends motor fuels user fee for one year, requiring savings to be passed on to retailers.

S 267: Reduces Senate pay by \$1,000 per year.

H 3124: Requires a biennial budget, rather than an annual budget. This legislation would be a good idea if the second year of the budget cycle were actually limited to updating the budget.

BEST IDEAS OF 2009



Implementing effective spending caps and increasing rainy day savings

H 3397: Limit General Fund Appropriations to 6 Percent

Status: Referred to Ways & Means Committee

This bill would limit General Fund increases to 6 percent or less, as measured by population growth, plus inflation. The proposal also creates a Spending Limit Reserve Fund that may be used to reduce taxes and fund other priorities.

► **Our take:** Limiting state spending growth to 6 percent is a start, given that annual spending increases have averaged 9 percent above inflation, plus population. Moreover, the state's current theoretical spending cap is 9.5 percent. One of the positive aspects of this proposal is that it permits excess funds to be used for temporary tax reductions. A better

South Carolina's Spending Cap

The S.C. Constitution (§ X.7) theoretically limits state spending to “the average growth rate of the economy” as measured by a formula devised by the General Assembly. Current law (§ 11-11-410) defines such growth according to state personal income — for all practical purposes at 9.5 percent of the previous year’s total personal income. Yet instead of acting as a spending limit, the law seems to be encouraging the government to grow at a pre-determined rate. Thus, state spending growth has outpaced inflation plus population by an average of 9 percent each year for the past five years. At the very least, as State Treasurer Converse Chellis has noted, “South Carolina’s current restrictions have not sufficiently limited spending growth in a way that promotes fiscal stability over the long term.”

In an attempt to adjust the spending cap,

the legislative leadership proposed (S 1, S 2, H 3037) amending the constitution to cap General Fund spending at the average of the previous 10 years’ annual revenue growth rates. Remaining revenue would be funneled into a Budget Stabilization Fund capped at 15 percent of the previous year’s General Fund revenue collections. This proposal, which has already emerged from the Senate Judiciary Committee with a favorable report, would essentially eliminate the state’s spending cap. This is not to say we do not support increasing payments into the state’s rainy day fund, but capping spending doesn’t really help taxpayers unless it is also tied to tax reform and reductions. A better solution is to amend the constitution to limit state spending to a formula tied to the Consumer Price Index (CPI), and then issue refunds to taxpayers when revenue goes up.

solution is to *require* that such revenue be used to reduce taxes. Instead, this legislation funnels excess tax collections into a Spending Limit Reserve Fund, which may be used by the General Assembly for a variety of purposes, such as school construction, infrastructure and natural disaster relief. In practice, though, the excess revenue can be used for anything as revenue reductions in these areas will be used to offset appropriations in other areas. Thus this legislation does not really cap spending — but only makes nonessential spending slightly more difficult. Also see S 219, H 3610

H 3533: Carnell-Felder Spending Cap

Status: Referred to Ways & Means Committee

Under the Carnell-Felder Act passed in the mid-1990s, new spending was limited to 75 percent of the increased revenue estimated by the Bureau of

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Legislation most likely to come up:

S 304 has already passed both chambers and was referred to conference committee. The House will likely take it up again in January. Over the past two years, both chambers have also flirted with passing a spending cap — whether 2010 is the year may depend on what the economy does, not to mention how voters view the General Assembly’s handling of the state budget.

Economic Advisors. The act was repealed in 1998 after the state regained its AAA credit rating.

✘ More bad bills that didn't pass:

S 32: Adds a \$1 surcharge to the sale of any security by a broker-dealer. ... This is about as smart an idea as President Obama's proposal to nearly double the capital gains tax when the stock market is down.

S 154: Increases targeted tax credit for land conservation gifts, reducing General Fund revenue by \$5.6 million.

S 304: Permits localities to use accommodations and hospitality fees as a pledge for revenue bonds, thus reducing the interest rate associated with such debt. In one way, this bill is good because it reduces borrowing costs; from another perspective, it is bad because it facilitates more spending and borrowing.

► **Our take:** Like H 3397, this legislation does not so much as provide for a state spending cap as it forces the General Assembly to be more prudent in the way it budgets, especially when there might be a deficit. The drawbacks of these two proposals highlight that what South Carolina really needs is not so much a spending cap as a tax and fee cap, combined with a spending limit that automatically mandates that excess revenue be refunded to taxpayers.

H 3396: General Reserve Fund

Status: Passed the House; referred to Senate Judiciary Committee

This joint resolution proposes amending the constitution to increase from 3 percent to 5 percent contributions made to the General Reserve Fund. The money may be used only to cover operating deficits, with withdrawals restored after three years. Also see H 3395, H 3558, H 3559

► **Our take:** Rainy day funds are a necessary means of postponing calls for tax increases when revenue collections decline during economic downturns. For this reason, we believe the state should have a robust rainy day fund. But a rainy day fund that does not provide for tax refunds is also a tempting target for legislators looking to use tax dollars on pork barrel projects they can't finance through the General Fund. Moreover, such funds indirectly facilitate the maintenance of state spending, thus undercutting the need to actually reduce the size of government. In other words, expanding rainy day contributions in itself will do little to limit the size of government, but must be part of a comprehensive tax and spending cap.

✓ Eliminating ineffective programs and agencies

H 3192: Sunset Review Commission

Status: Referred to Judiciary Committee

This bill would establish a legislative Sunset Commission, as well as a Sunset Review Division of the Legislative Audit Council, to review programs that have “outlived their usefulness.” Also see S 72, S 130

► **Our take:** A sunset commission is a great idea that is often difficult to implement in practice, owing to the politicization of the review process by special interest groups and lobbyists. Thus in 1998, South Carolina’s own sunset commission was abolished after it was found the commission’s activities cost more than they were worth. Over the course of 20 years, the commission conducted more than 100 reviews and advised sunsetting 15 programs; yet only 2 programs were eliminated.

In order not to repeat the same mistakes, the sunset commission needs to be equipped with an effective enforcement mechanism that requires the automatic elimination of underperforming agencies. Accordingly, this legislation provides for the automatic termination of any agency not specifically reauthorized and also requires that such reauthorization may not be combined with other legislative provisions.

One shortcoming of this bill is that the commission does not include executive branch appointees. But that may be asking for too much given the current dominance of the legislature. Another, more serious drawback, is that the proposal reauthorizes agencies and programs for up to 12 years. More frequent reviews – perhaps, every 2 to 4 years – would be a better option.

What is the Taxation Realignment Commission (TRAC)?

Per legislation (S 12) passed this session, this 11-member commission is charged with studying the state tax code with an eye toward using the tax code to attract new businesses and residents. The first report from the commission is due March 15, 2010. This report must cover the following areas with an emphasis on “adequacy, equity and efficiency”: 1) sales and use tax exemptions or limitations; 2) state and local taxes; 3) fees, fines and other revenue sources that constitute the \$7 billion Other Funds category of the budget. In addition, the commission must examine the advantages of replacing the current tax base with a Fair Tax (essentially a statewide sales tax).

One of the primary aims of the commission is to look at the \$2.75 billion in sales tax exemptions the state currently provides. The final TRAC legislation did not include a proposal to study the 2006 property tax changes.

The final bill also does not require an up-or-down legislative vote on the commission’s recommendations. At this point, it is difficult to predict what the results of this study will be. As indicated here, the state should seriously look at abolishing corporate and personal income taxes — or at the very least lowering overall tax rates, if only by eliminating special-interest tax credits. Also see S 182, H 3146, H 3415

What is the Fair Tax?

The Fair Tax is essentially a uniform sales tax — as such, it taxes consumption, rather than income and investments. The benefit of the tax is that it makes tax collections easier and more transparent so that consumers can clearly see how much of their money is going to support the government. At the state level, proponents of the Fair Tax propose replacing South Carolina’s income, corporate and other taxes with a revenue neutral Fair Tax — set at approximately 6 percent. The rate could only be raised with a two-thirds vote from the General Assembly. A proposal (S 846) establishing a study commission on the Fair Tax passed as an amendment to the Taxation Realignment Commission bill (S 12).

this legislation should require agencies to explore the degree to which certain programs can be privatized.

S 242: Close TERI Program

Status: Referred to Finance subcommittee

This bill would close the Teacher and Employee Retention Incentive (TERI) Program to new participants.

- **Our take:** In April 2009 we issued a report explaining why TERI is a terrible idea. As we noted there, TERI constitutes an unusually generous mid-career supplement that hurts existing (unretired) employees and also increases retirement liabilities for taxpayers. In short, the program encourages

H 3640: Zero-Based Budgeting

Status: Referred to Ways & Means Committee

This bill would create a review division within the Legislative Audit Council to conduct zero-based budgeting analyses of agency budgets. Also see S 658

- **Our take:** Zero-based budgeting, as defined by this bill, entails requiring an agency to create a budget from a zero base, such that each existing program must be reviewed and justified. Agencies must use performance-based reviews in determining whether a program should be re-funded. A downside of this bill is that it requires the General Assembly to choose which programs shall be reviewed and to set the termination date for those programs. We might also add that zero-based budgeting is a tool that only works when combined with specific performance measures that show how well a program is functioning compared to similar programs in other states and in the private sector. Likewise,

state employees to retire early (at 28 years) and then return to work for the state for another five years, during which time they collect a full salary and then receive deferred retirement benefits. Given that South Carolina is already facing \$18.6 billion in unfunded retirement benefits liabilities, TERI is going to be eliminated sooner or later. Why not now?

✓ Implementing fundamental tax reform

S 378: Phase Out Corporate Income Tax *Status: Referred to Finance Committee*

This bill would phase out the state's 5 percent corporate income tax over 10 years. Also see H 3424

► **Our take:** Eliminating this tax would make South Carolina more economically competitive and thus create jobs and increase wages for hardworking families. Doing away with the corporate income tax would also pressure legislators to cease playing favorites with special-interest tax breaks. The 10-year phase-out period contemplated by this legislation, however, is too long and gives lawmakers too much time to reinstate the tax. Given that eliminating the corporate income tax will create jobs and boost the economy, the phase-out period should be accelerated.

S 145: Taxpayer Inflation Protection Act *Status: Referred to Finance Committee*



The S.C. Fair Tax movement seeks to replace all state taxes with a uniform sales tax. Supporters claim this would simplify the tax code and allow for more transparency.

Other bills that passed:

S 360: Removes a stipulation that the 1 percent capital project sales and use tax be used to collect a limited amount of money — in effect, setting the stage for such taxes to continue indefinitely. The law exempts from the tax unprepared foods obtained with food stamps (became law without governor's signature).

H 3635: Institutes an annual \$10 fishing license fee for recreational saltwater angling, along with other fees, including a \$150-\$300 fee to operate a saltwater public fishing pier or a charter fishing vessel (became law without governor's signature).

BUDGET TALK

This year's budget was the second-largest in state history, with total spending increasing by \$730 million over last year's final budget. The final budget, however, is not the same budget passed back in June 2008. This is because FY08-2009 appropriations were reduced as economic forecasts were revised downward. Here is a timeline:

June 2008:

The FY08-2009 budget (HB 4800) was enacted.

\$6.74 billion General Fund

\$20.86 billion Total

July-August 2008:

The Budget & Control Board implemented a 3 percent across-the-board cut (\$187.1 million).

October 2008:

The General Assembly passed HB 5300, cutting \$621.1 million from the budget.

\$6.11 billion General Fund

\$20.32 billion Total

December 2008:

The Budget & Control Board implemented a 7 percent across-the-board cut (\$383.4 million).

\$5.86 billion General Fund

\$20.07 billion Total

March-May 2009:

The House passed a \$5.81 (\$21.24 total) billion budget that included \$883 million in federal stimulus money. A week later, however, the Budget & Control Board mandated a 2 percent across-the-board cut (\$102 million), thus requiring the Senate to revise the House's numbers.

Final FY08-2009 Budget:

\$5.76 billion General Fund

\$19.97 billion Total

FY09-2010 Budget:

\$5.71 billion General Fund

\$20.70 billion Total

To recap:

- The FY09-2010 budget is \$730 million more than the final FY08-2009 budget and only \$50 million less in terms of General Fund appropriations. That's a 1 percent cut.
- As ratified, the FY08-2009 budget raised General Fund spending by \$13 million over the previous (FY07-2008) year and total spending by \$592 million. This is in addition to a \$1.1 billion increase in General Fund spending between FY05-2006 and FY07-2008.
- Thus, while it is true that the final FY08-2009 budget cut spending by \$1 billion, even this "bare bones" budget still constitutes a total spending increase of more than \$140 million over three years.

This bill would conform the state tax code to IRS norms by automatically adjusting tax brackets at 100 percent of inflation — a reform that would save low-income taxpayers at least \$5.5 million a year.

► **Our take:** South Carolina’s current approach of indexing tax brackets at half of inflation constitutes a built-in tax hike for low-income earners. Consider that when the state instituted an income tax in 1959, a majority of taxpayers fell into the second-lowest bracket. Today, the top bracket of 7 percent applies to anyone earning more than \$13,350 — only \$2,500 more than federal poverty level. The result is that many low-and-middle-income families are being taxed at one of the highest rates in the country. This problem should be addressed, not only by fully indexing the brackets for inflation, but recalibrating the tax brackets altogether.

H 3017: Supermajority Vote to Raise Taxes
Status: Referred to Judiciary Committee

This joint resolution proposes amending the constitution to require that any bill that creates or raises taxes must be approved by a two-thirds vote. Also see H 3016

► **Our take:** Of course, this idea only really works if a recorded vote is required to raise taxes. At the very least, recorded votes should also be required on all measures that have a fiscal impact.

Government Growth Far Outpaces Household Income

- For fiscal years 2007 (13%) and 2008 (20%) alone, state spending exceeded population growth, plus inflation, by a cumulative 33 percent. Over the past five years (FY2005-FY2009), total state spending increased by 24 percent, with General Fund appropriations rising by 29 percent.
- Between FY04-2005 and FY06-2007, state spending exceeded inflation, plus population growth, by 5.5 percent a year. During the same period, median household income declined by 0.3 percent — meaning that the relative growth in state spending outpaced household income growth by 20 to 1.
- Spending by cities, counties and school districts has grown at nearly 8 percent every year since 1997.
- Average millage shot up from 277 in 1997 to 357 in 2005. The following year, the property tax reform capped millage increases at inflation, plus population growth.
- Despite property tax relief in 2006, local governments continue to increase revenue collections from licenses, fees and charges, which have increased 14 percent annually.



✓ **Bringing transparency to the state's debt**

H 3386: Bond Referendums on General Election Day
Status: Referred to Ways & Means Committee

This bill would require bond referendums be held on general election days.

► **Our take:** This legislation would insure more citizens participate in the process of approving bond debt. From a fiscal perspective, the results could be mixed because in-

creased participation may not necessarily imply more informed voters. That being said, transparency regarding the bond approval process requires such referendums be held at predictable times. An even better idea is to require “truth in lending” language on bond referendum ballots. Such language would detail how much new bond debt, including interest, will cost taxpayers and indicate that bonds are essentially loans that must be paid back — by taxpayers.

S 147: General Obligation Bond Responsibility Act
Status: Referred to Finance Committee

This bill would require the General Assembly authorize general obligation bonds only in odd-numbered years and only via a bill or joint resolution specifically permitting a bond authorization.

► **Our take:** This bill would bring more accountability and transparency to the bond issuing process by treating general obligation bonds

Thousands of South Carolinians converged on the Statehouse in April to protest excessive spending by government. During the past five years, state spending has increased by 24 percent.

in the same manner as state capital improvement bonds. In addition, any proposal to issue new bond debt would require certification from the State Treasurer to insure that the debt does not exceed constitutional limits (§ X.13.6.c) capping bond debt at 5 percent of general revenue from the preceding fiscal year.

One reason such legislation is necessary is that even many observers of state politics don't have a clear idea of how large the state's debt is. For the record, the S.C. Comptroller General's Office places South Carolina's debt at \$8.2 billion. This figure does not include debt taken on by governmental component units, such as the State Ports Authority or the Public Service Authority. It also does not include \$18.6 billion in unfunded state retiree benefits.

Want to learn more?

See our February 2009 report revealing the state budget is \$21 billion — not \$7 billion as commonly reported.

WORST IDEAS OF 2009

Increasing taxes and fees

S 483: Local Option Tourism Fee

Status: Ratified by General Assembly; became law without governor's signature

This legislation gives counties the option of mandating a 1 percent sales and use tax with proceeds used to fund tourism promotion and property tax relief.

► **Our take:** Sales taxes in South Carolina are already higher than the national median of 5.4 percent, with sales and use taxes reaching 8 percent in some counties. As for tourism promotion, taxpayers should not be forced to subsidize advertising costs for any industry. Likewise, whatever



property tax rollbacks are granted by this bill are sure to be temporary. Finally, this bill should be considered in relation to H 3335, which permits certain counties to use up to 50 percent of local accommodations and hospitality taxes on operating expenses.

S 314: Increase Traffic Tickets by \$5

Status: Referred to Judiciary subcommittee

This bill would impose an additional \$5 surcharge on all misdemeanor traffic offenses.

Legislation allowing counties to impose an additional tourism sales tax will make destinations such as the Grand Strand more expensive and less attractive to potential visitors.

► **Our take:** Traffic tickets may not be the worst form of government intrusion, but they are among the most annoying. Revenue collected from this fee increase would go to the State Treasurer and on to the S.C. Criminal Justice Academy, meaning the money wouldn't even be available to fund essential services and wouldn't be subject to direct legislative oversight. In addition, increasing taxes and fees is simply another way for lawmakers to avoid prioritizing spending and making targeted cuts.

H 3209: Expand Grocery Tax

Status: Referred to Ways & Means Committee

This bill would eliminate the sales tax exemption for unprepared food items obtained with USDA food coupons.

► **Our take:** Groceries should not be taxed at all. Raising taxes on low-income families that receive WIC benefits doesn't make a lot of sense. Also see S 360, H 3011