REVENUE AND THE SOUTH CAROLINA BUDGET

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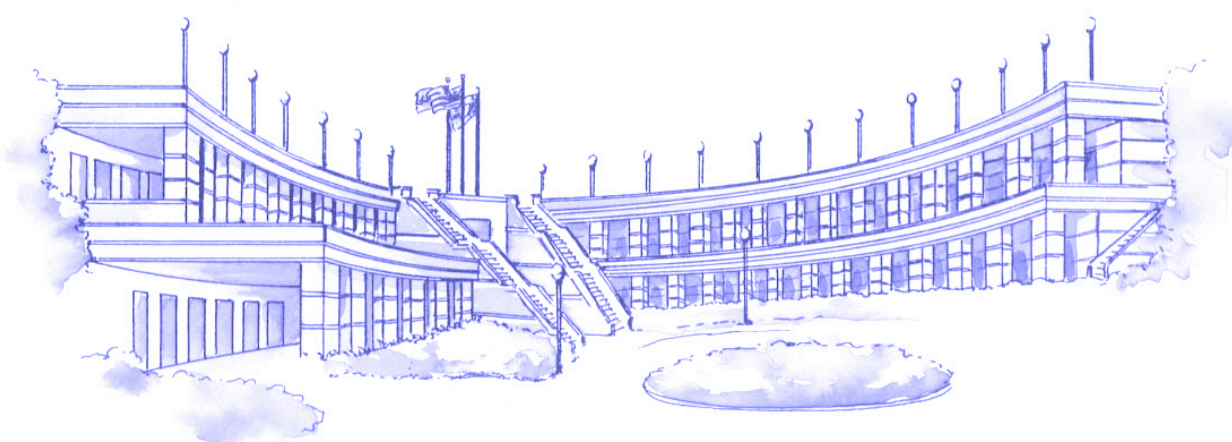

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Clemson University

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FINDINGS

- A significant part of the revenue flowing through the state's coffers is not part of the general fund, the focus of the General Assembly's annual budget deliberations. Between 1988 and 2007, the general fund share of total budgeted revenue fell from 49 percent to 32 percent. The increased share of revenue outside the general fund is due in part to earmarked and restricted federal funds and fees and charges.

- Recent actions by the General Assembly have increased the amount of revenue diverted away from the general fund. The Trust Fund for Property Tax Relief currently removes over 8 percent of the general fund. These revenue diversions have a negative effect on formula funding for other purposes, notably local governments (the Local Government Fund) and the state's two reserve funds.

- Revenue estimation is done by the Board of Economic Advisors. Errors tend to be under rather than over actual revenue, which is a conservative approach to providing the revenue basis for the state budget. Errors tend to be larger during periods of national instability in income and output.

- The revenue estimate provides the upper bound on the budget by determining how money the General Assembly can appropriate, how much "new money" is available for new or expanded programs and salary increases for state employees, and how much of the capital reserve fund may be released for current spending.

- The Budget and Control Board is responsible for monitoring budget implementation and making cuts when revenue receipts fall below expectations. Between 2001 and 2004, the Budget and Control Board made midyear cuts ranging from one percent to 8.73 percent in agency budgets. Surplus revenue can be appropriated by the General Assembly in a supplementary appropriations bill.

- While South Carolina does not have a formal and separate capital budget, the combination of capital facilities planning at the Budget and Control Board, the constitutional ceiling on debt service, and the periodic bond bill with specific projects enumerated accomplish a workable multiyear capital budgeting process.

- South Carolina was hard hit by the state fiscal crisis between 2001 and 2004, with an 11.4 percent drop in revenue in 2002 alone—the sixth largest decline among the fifty states and three times the national median. Between 2000 and 2005, the state suffered the tenth largest decline in real per capita state tax revenue.

- Like many states, South Carolina responded to the recent fiscal crisis by drawing down budget stabilization funds and cutting expenditures. South Carolina ranked sixth among the fifty states in per capita expenditure cuts during this period.

- Revenue diversification is one way to reduce fiscal instability of the kind experienced during 2000-2004. South Carolina derives a larger than average share of its revenue from just two sources, the individual income tax and the retail sales tax. Within these two taxes, the structure of each tax makes them more sensitive than average to fluctuations in state personal income.

- South Carolina, like most other states, relies on budget stabilization funds to weather fluctuations in revenue. The state has three such funds: the general reserve fund, the capital reserve fund, and the new (short-term) contingency reserve fund. Like most states, South Carolina's budget stabilization funds were inadequate to cushion a long and/or deep decline in the economy and state revenue.

- Linking spending priorities to the probability of receiving various revenues is an approach to state budgeting that has emerged from the recent experience of fiscal instability. South Carolina has not adopted this method of fiscal management.

- South Carolina's restrictions on spending growth are moderate and similar to those in place in many other states. The limit in spending growth is based on personal income growth. Thus far, the state has not approached its spending growth limit.

- Another approach to fiscal instability that has been explored is the use of spending stabilization rules. If the state had enacted a spending stabilization rule that distributed surplus revenue evenly between the general reserve fund, capital projects, and tax relief in the early 1990s, the level of spending would not have changed much but the budget cuts needed to cope with the 2001-2004 recession would have been smaller.

- The practice of annualization, or committing a large share of any increase in revenue to recurring expenditures, has contributed to the state's fiscal problems. Annualizations have not been a problem in recent years because of lack of surplus revenue, but the revenue side counterpart of enacting permanent tax reductions in response to one year's increase in revenue represents a continuing risk to budget stability.

- South Carolina's state revenue has been growing at an average rate of 5.7 percent since 1979 (1.3 percent when adjusted for inflation), which is somewhat below the national average.

- South Carolina is one of eleven states scoring high on long-term revenue risk because of such structural factors as strong tax preferences for seniors, a declining share of spending subject to the sales tax, and a mildly progressive income tax that peaks at a fairly low income level.

- Revenue demand is driven by a number of factors. The growing elderly population and the demand for state Medicaid matching funds are particularly significant. An increased college age population means pressure for more spending on higher education, while demands for better student achievement (lower dropout rates, higher test scores, better work and college preparedness) will result in more demand for spending on K-12 education.

- The long-term budget health of the state requires that legislators address the issues of revenue instability, slow revenue growth, and higher levels of funding for budget stabilization funds. Doing otherwise could result in inadequate funding for essential public programs and services.

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INTRODUCTION

It is impossible to explore the overall topic of state revenue without considering the complex relationship between revenue forecasts, actual revenue receipts, and the state budget. Revenue forecasts are essential input into formulating the state budget. Differences between forecast and actual revenue may lead to increased spending or midyear cuts in the short run, and to tax cuts or tax and fee increases over the longer term.

Revenue flowing to the general fund, which is part of the state budget, is of particular interest because it is from the state's primary sources of tax revenue: sales, income and excise taxes. The general fund is also the annual battleground of the legislative appropriations process as state agencies vie for a portion of this revenue. This report explores the relationship between revenues and the budget process, the revenue estimating process and the challenge of revenue instability, state responses to revenue shortfalls and surpluses, and prospects for long term revenue growth in South Carolina.

REVENUE AND THE BUDGET

South Carolina's state budget, which must be balanced as a constitutional requirement,[1] is a complex document. It starts with the governor's executive budget proposal, which is input into the appropriations bill that emerges from the General Assembly and is modified by any line-item vetoes by the governor that are not overridden by the House and Senate. The appropriations bill that becomes the state budget is rarely completed before June, just in time for the new fiscal year beginning July 1.

THE GENERAL FUND AND OTHER BUDGETED FUNDS

The state budget detailed in the annual appropriations act has two revenue components: the budgetary general fund and other budgeted funds. Revenue to the general fund is mostly from taxes, including sales and income taxes. The general fund supports spending on traditional state government services, such as primary, secondary, and higher education, health and human services, parks and recreation, public safety and

[1] S.C. Constitution. Article X, Section 7(a).

corrections, the governor's office and the General Assembly. Appropriations from the general fund for the current fiscal year (2006-07) were $6.1 billion. This amount reflects revenue from more than thirty-one sources and expenditures among sixty-one divisions of state government.[2]

Other budgeted funds in the appropriations act include some federal funds and state revenue from earmarked or restricted sources, such as the motor fuel user fee, department-generated revenue, and transfers from the South Carolina Education Lottery. The Department of Transportation, for example, is funded almost entirely by earmarked and restricted revenue from the motor fuel user fee, motor vehicle fees and permits, and federal funds. Other state agencies receive significant revenue from fees and charges (tuition at higher education institutions, for example) and federal funds (such as Medicaid grants administered by the Department of Health and Human Services). Appropriations of other budgeted funds for fiscal year 2007 were $13.1 billion. Total funds appropriated for 2007 came to $19.2 billion.[3]

The state budget is not a complete reflection of state finances, however. The state of South Carolina has additional programs that are conducted outside the appropriations process. These activities include the state's legally separate component entities, the most important of which are the Public Service Authority (Santee-Cooper), the State Ports Authority, the Connector 2000 Association, and the Lottery Commission. The fiduciary funds of the state employee retirement systems also are not subject to appropriation. Assets and obligations of these separate, fee-based state activities can be reviewed in the Comptroller General's annual *South Carolina Comprehensive Annual Financial Report* as well as the individual financial reports for each entity.

DATA SOURCES FOR THE BUDGET

Data on revenue flowing through the state is available from several sources. Amounts of revenue reported will differ, however, depending on whether the revenue is estimated or actual, and which funds are included in the total.

Appropriations acts. The annual appropriations acts set the state's budget; that is, how much the state intends to spend over a fiscal year and on what. Appropriations acts identify major categories of revenue flowing to the general fund and to all other budgeted funds. But this revenue is estimated. It is only what the legislature—with the advice of its economic advisors and budget staff—expects to receive over the year. What the state spends depends on actual revenue.

Financial statements. South Carolina's comprehensive annual financial report (CAFR) is prepared by the Comptroller General's Office in conjunction with the state auditor

[2] S.C. General Assembly, H. 4810, General appropriations bill for fiscal year 2006-2007, Section 70, Recapitulation.
[3] Ibid.

and an outside contracted accounting firm (South Carolina Comptroller General 2005). The CAFR reports on state government assets and liabilities as well as revenue receipts and expenditures over a fiscal year. Because the appropriations acts do not categorize revenues and expenditures in exactly the same way as is required for audit purposes, the CAFR figures do not correspond to appropriations data.

The budgetary comparison schedules in the CAFR present actual revenue received by the general fund and other budgeted funds as they are organized in the appropriations acts. The CAFR also reports on actual spending by major category. In each case, the report compares originally budgeted revenue and expenditures to actual revenue and expenditures to see how the state budget played out relative to expectations.

The CAFR also reports revenues and expenditures by the funds they are in; in other words, by how the state organizes its major pots of money for accounting purposes. The state has three types of funds: governmental, proprietary, and fiduciary. Governmental funds include the general fund, the departmental general operating fund, the Department of Transportation special revenue fund, among others. In fund accounting, the general fund is defined slightly differently than in the budget, however, so general fund revenue and expenditure totals from these two sources do not match precisely. Proprietary funds include the state's enterprise and internal service funds. Fiduciary funds are used for the state's retirement systems and are legally separate from the state's other funds.

Office of State Budget. The Office of State Budget (OSB) in the South Carolina Budget and Control Board reports on estimated and actual revenues and appropriations as well as on actual spending from the budgetary general fund and a few other select funds. OSB's annual publication, *Historical Analyses*, is an excellent source of trend data on major revenue sources flowing into the general fund, and on appropriations and expenditures by major category (South Carolina Office of State Budget 2005). Revenue, appropriations, and expenditures in this publication match those in the CAFR's budgetary comparison schedules.

Federal government. The Census Bureau collects data on annual state and local government revenues and expenditures (United States Bureau of the Census). The federal government organizes this information so that categories are comparable among states, which frequently have very dissimilar revenue systems. While these data are excellent for certain kinds of state comparisons on say, tax revenue per capita or the share of revenue coming from a specific revenue sources, they do not provide useful comparative information on state budgets.

Appropriations acts, the state's financial reports, and the OSB all are good sources of data on South Carolina's budget. The federal government's state finance data is useful for making interstate comparisons. However, it is risky to mix data from these different sources for comparison purposes at any level of detail.

REVENUE TRENDS IN THE BUDGET

The legislation to define state general fund expenditures is where state agencies and activities compete for a share of the state's main revenue sources—sales, income, and excise taxes. When these revenues are not obligated to be used for specific purposes, as they are in the general fund, the legislature can shift revenue between agencies over time in response to changing demand for state services.

Revenue to the general fund has become a smaller and smaller share of total budgeted revenue between 1988 and the present, falling from 49 percent of total revenue to around 31 percent in recent fiscal years (Table 1). This change reflects two trends in particular: certain non-general fund revenue streams have become a larger share of total budgeted revenue, and the General Assembly has diverted (formerly) general fund revenue to special funds.

Table 1. South Carolina General Fund Revenue Receipts as Share of Total Budgeted Revenue

Fiscal Year	Share of Total	Fiscal Year	Share of Total
1988	49.2%	1998	41.0%
1989	48.2%	1999	39.2%
1990	45.0%	2000	37.3%
1991	42.2%	2001	36.6%
1992	39.5%	2002	n.a.
1993	39.9%	2003	32.0%
1994	41.0%	2004	31.2%
1995	40.6%	2005	31.4%
1996	39.8%	2006	31.1%
1997	40.6%	2007	31.7%

Source: South Carolina Comptroller General 1997, 2005.
n.a. = not available

The shifting importance of various revenue sources. Since the early 1990s revenue to the general fund has grown at a slower pace than other budgeted revenue (Figure 1). The most dramatic change has been in federal and other grant revenue to the state, which is included in the budget as other budgeted funds (Table 2). The share of general governmental fund revenue coming from (mostly) federal sources increased from 23.4 percent in 1988 to 38.3 percent in 2005 (South Carolina Comptroller General 1997, 2005).[4]

The state also has increased its reliance on fees and charges over time, many of which are accounted for outside the general fund. Revenue from fees, permits, and

[4] General governmental fund revenues by source, reported in the CAFR's statistical section, include most, but not all, revenue attributed to the budget.

departmental service charges to general governmental funds rose from 4.9 percent of total governmental fund revenues in 1988 to 7.1 percent in 2005 (South Carolina Comptroller General 2005). The share of revenue from miscellaneous non-tax sources more than doubled between 1988 (3 percent of total governmental fund revenue) and 2005 (6.9 percent).

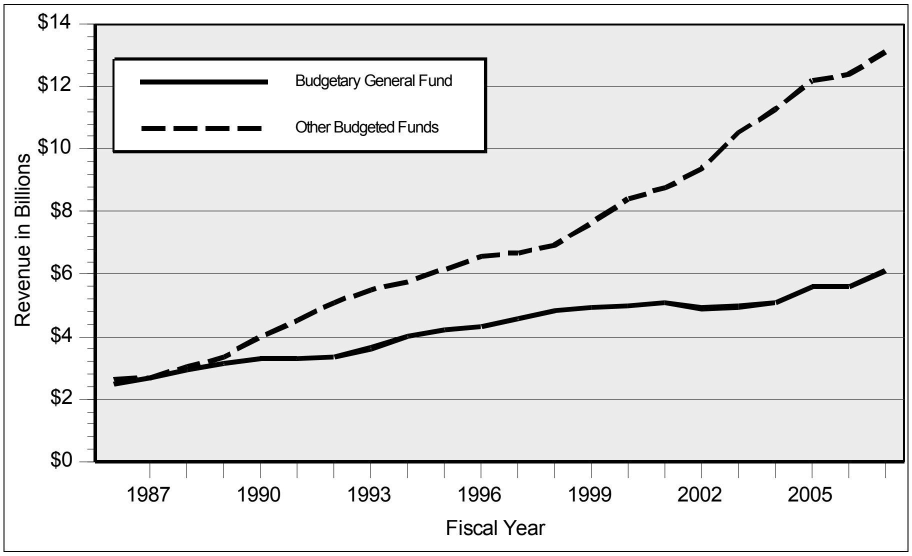

Figure 1. Revenue Receipts for the South Carolina General Fund and Other Budgeted Funds

Table 2. General Governmental Fund Revenue by Source

	Revenue (in $1,000s)		Percent of Total	
	1988	2005	1988	2005
Total revenue	$4,819,950	$15,535,867	100.0	100.0
Taxes	3,312,543	7,422,063	68.7	47.8
Individual income	1,130,898	2,765,012	23.5	17.8
Retail sales and use	1,277,447	3,225,931	26.5	20.8
Other taxes	904,198	1,431,120	18.8	9.2
Licenses, fees, permits	134,083	462,049	2.8	3.0
Interest and investment income	67,586	121,083	1.4	0.8
Federal, state, local, private grants	1,127,213	5,948,777	23.4	38.3
Departmental services	102,910	637,221	2.1	4.1
Contributions	26,125	680,867	0.5	4.4
Fines and penalties	22,777	107,197	0.5	0.7
Tobacco legal settlement	0	73,231	0.0	0.5
Other	26,713	83,379	0.6	0.5

Source: South Carolina Comptroller General 1997, 2005.

State and national economic conditions also affect revenue collections, especially from the state's major taxes. The dip in general fund revenue from 2000 to 2004 was a result of a downturn in actual revenue from a primary general fund revenue source—the individual income tax—and a slowdown in revenue growth from sales and excise taxes.[5]

[5] Additional information on the state's major revenue sources can be found in *South Carolina's State Revenue Sources,* a paper in this series.

Revenue diversion from the general fund. When general tax revenue is transferred out of the general fund it is no longer "in play" during the appropriations process and can only be used for a specified purpose. Some of the slow growth in general fund revenue reflects the increasing diversion of general tax revenue to special funds. Over time, this diversion reduces the legislature's flexibility to appropriate revenue as needed for general government services. Diversion of revenue from the general fund also has an impact on activities that are funded on a formula basis as a percentage of the general fund.

Since 1999, one of the largest diversions of revenue from the general fund has been the assignment of some state individual and corporate income tax revenue to the Trust Fund for Tax Relief (TFTR) to cover the cost of the state's four property tax relief programs: the homestead exemption for the elderly, homeowners' school property tax relief, the inventory tax reimbursement, and the manufacturers' depreciation property tax reimbursement.[6] Only the homestead exemption and the manufacturers' depreciation property tax reimbursement continue to grow. Total outlays for the other two tax relief programs are capped. Before 1999, appropriations for these property tax relief programs were made from the general fund. Appropriations for the TFTR have been around half a billion dollars in recent years (Figure 2).[7]

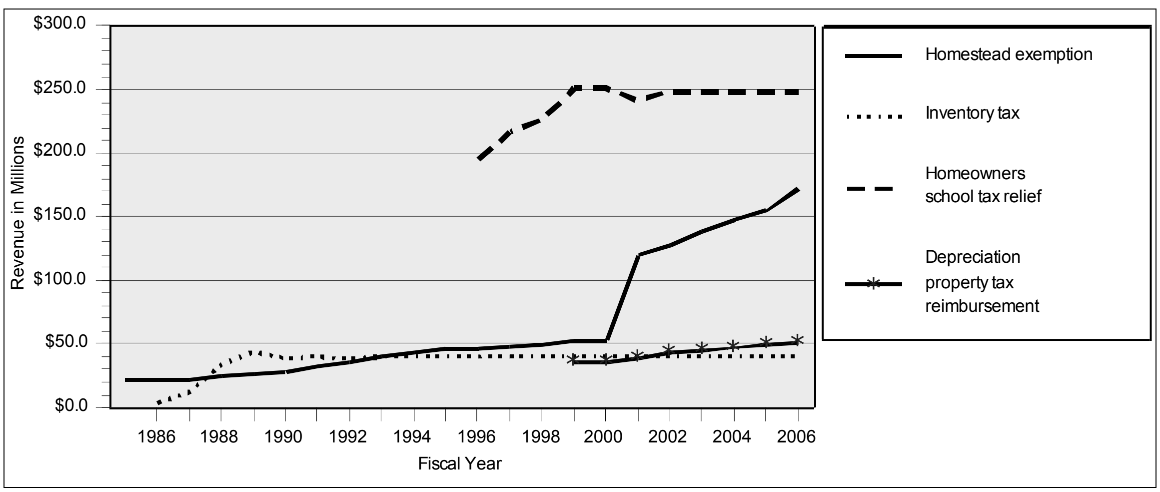

Figure 2. Revenue Transfers to Property Tax Relief Programs

Movement of close to 10 percent of general fund revenue into the TFTR has had a measurable negative impact on formula funding based on general fund revenue. Areas affected are the state's two reserve funds and state aid to local governments. The combined loss of formula funding has risen from $36 million in 2001 to an estimated $49 million in 2007 (Table 3).

[6] S.C. Code, §11-11-15.
[7] New state property tax relief legislation (Act 388 of 2006) that will increase the state's retail sales tax in 2007 to provide homeowner tax relief from property taxes for school operations will not affect revenue diverted to the TFTR.

Table 3. Formula Funding Decreases Caused By Revenue Transfers (in millions)

Fiscal Year	General Reserve Fund (3%)	Capital Reserve Fund (2%)	Local Government Fund (4.5%)	Total Reduction in Formula Funding
2001	$11.4	$7.6	$17.2	$36.2
2002	13.2	8.8	19.9	41.9
2003	13.8	9.2	20.8	43.8
2004	14.2	9.5	21.3	45.0
2005	14.6	9.7	21.8	46.1
2006	14.8	9.9	22.2	47.0
2007 (est.)	15.4	10.3	23.1	48.8

Source: South Carolina Office of State Budget 2005 and author's calculations.

Section 36 of Article III of the state constitution requires that the General Assembly appropriate an amount equaling 3 percent of the last year's general fund revenue for the general reserve fund and 2 percent for the capital reserve fund. Both of these funds are used to cover operating deficits of state government when they occur. The general reserve fund may only be used for this purpose. If any portion of the general reserve fund is used, it must be refunded through appropriations of general revenue over a three-year period. The capital reserve fund is available for annual appropriation after the end of a fiscal year for capital and nonrecurring spending purposes. It is refunded anew in each subsequent appropriations bill.

The first year in which the diversion of general fund revenue to the TFTR affected funding levels in the two reserve funds was fiscal year 2001, the same year in which the state was feeling the cooling effects of the recent recession on revenue collections. When actual revenue collections did not meet earlier estimates, the state cut agency budgets by one percent and drew down 60 percent of the general reserve fund and 100 percent of the capital reserve fund to cover revenue shortfalls (South Carolina Office of State Budget 2005a).

Had revenue diverted to TFTR remained in the general fund, the two reserve funds together would have been $19.1 million higher. This amount was 10 percent of the combined reserve fund drawdown in that year and was nearly 40 percent of the $48.1 million across-the-board mid-year budget cut to state agencies (Table 4).

Formula funding of state aid to subdivisions (Local Government Fund) has also been adversely affected by diversion of general fund revenue to the TFTR. The General Assembly annually appropriates 4.5 percent of the last year's general fund revenue for distribution to cities and counties.[8] In the current fiscal year, the state's cities and counties will receive an estimated $23 million less in state aid than they would have if revenue diverted to the TFTR had remained in the general fund.

[8] S.C. Code, §6-27-10 et seq.

Table 4. Effect of Revenue Transfers on Reserve Fund Withdrawals

	2001	2002	2003	2004
Formula Funding Reduction in General and Capital Reserve Funds (in millions)	$19.1	$22.1	$23.1	$23.7
Combined Reserve Fund Withdrawals to Cover Revenue Shortfall (in millions)	$186.0	$162.9	$140.4	$147.9
Funding Reduction as % of Total GRF/CRF Withdrawal	10.3%	13.5%	16.4%	16.0%
Midyear Budget Cuts to State Agencies (in millions)	$48.1	$326.5	$416.6	$43.0
Funding Reduction as % of Agency Mid-Year Budget Cuts	39.6%	6.8%	5.5%	55.1%

Source: South Carolina Office of State Budget 2005a and author's calculations.

REVENUE ESTIMATION FOR THE BUDGET

The most important single piece of information for setting a state's policy agenda is the revenue estimate (Cornia, Nelson, and Wilko 2004). The governor's executive budget and the appropriations bill are both based on the general fund revenue estimate. The revenue estimate is also the yardstick against which actual revenue receipts are measured during the fiscal year. In South Carolina, the responsibility for developing and revising those estimates as well as monitoring changes in actual revenue, falls to the Board of Economic Advisors, a division of the Budget and Control Board.

Board of Economic Advisors. The South Carolina Board of Economic Advisors (BEA) was created to prepare and review economic forecasts and general fund revenue estimates. Legislation in 1982, 1988, and 1990 established the BEA's current responsibilities and composition. Prior to that time, South Carolina had no formal process for estimating revenues (South Carolina ACIR 1991).

The BEA consists of one member appointed by the governor to serve as chairman, a member appointed by the chair of the Senate Finance Committee, a member appointed by the chair of the Ways and Means Committee of the House of Representatives, and the director of the Department of Revenue, who serves ex officio as a non-voting member. The chair of the BEA reports directly to the Budget and Control Board, which sets the state's fiscal policy.[9] Staff of the BEA work under the direction of the state's chief economist.

South Carolina is one of only twelve states in which the revenue estimation function takes place outside the state's budget office. Thirty states, however, use a council of economic advisors to provide assumptions used in the state revenue estimate and budget development (NASBO 2002a). South Carolina combines these two functions in the BEA.

The BEA issues a general fund revenue estimate in November of each year that is the basis for the governor's executive budget and the General Assembly's early work on the

[9] The Budget and Control Board has five members: the governor, the state treasurer, the comptroller general, and the committee chairmen of the Senate Finance Committee and the House Ways and Means Committee. The board appoints an executive director for the agency.

appropriations bill. A final revenue estimate for the coming fiscal year is prepared in February. Both estimates may be adjusted monthly, however, if warranted by changing economic conditions.[10]

Throughout each fiscal year, the BEA compares actual revenue collections to revenue estimates and examines shortfalls of concern. If quarterly revenue receipts overall or from certain major revenue sources are one and one-half percent or more below forecast levels, the BEA is directed to analyze the causes of the shortfall and estimate its impact on future collections relative to the budget and report this information to the governor, the Budget and Control Board, and the General Assembly. If quarterly revenue receipts are 4 percent or more below estimated revenue, the Budget and Control Board is directed to take action to avoid a year-end deficit in the state's operating budget.[11]

Challenges in Revenue Estimation. In South Carolina and the majority of states that budget on an annual basis, the last official revenue estimate is completed about four to six months before the start of the fiscal year to which it applies and covers a period about eighteen months in the future (NASBO 2002a). A lot can change in a period approaching two years.

Governors and legislators want the most accurate revenue estimate possible. Overestimates mean revenue shortfalls relative to appropriations and can lead to midyear budget cuts or tax increases, which are politically unpopular. Underestimates result in surplus revenue that may not be appropriated with the same care as revenue for the budgetary general fund.

Revenue estimating, however, is as much art as science. No model can fully anticipate changes in the economy or how those changes will affect tax bases and tax collections. Thus the only certain thing about any estimate is that it will be wrong (Stinson 2002). Revenue forecasts that seem plausible in the spring as the legislature is working on the budget may be confounded by subsequent economic events that generate considerably more or less revenue. Because tax revenue is much more volatile than measures of economic activity such as personal income or gross state product, a relatively modest shift in state economic activity can generate a much larger percentage change in revenue (Schunk 2005).

The National Association of State Budget Officers (NASBO) (1989, 1995) recommends that the process of estimating revenue begin with consensus-based national and state economic forecasts that utilize the expertise of academic and business economists while also involving the governor and legislators. Estimates should be understood to have a margin for error. Revenue needs to be monitored at regular intervals and revenue

[10] S.C. Code §11-9-810 et seq.
[11] S.C. Code §11-9-890.

estimates revised in the light of new information, particularly changes in underlying economic conditions. South Carolina's revenue estimating process conforms to these recommendations.

The national and state economic forecasts provide estimates of key economic variables such personal income and employment that affect various tax bases, such as taxable personal income and taxable retail sales. The state revenue estimate then links anticipated revenue to changes in these tax bases as well as to changes in the state and national economies that affect those tax bases. Many states purchase national economic forecasts from a national economic forecasting consultant, such as Global Insight. State economic forecasts may be purchased from an economic consulting firm or developed in-house by one or more entities, such as the state budgeting agency or a university (Forsythe 2004, Niederjohn 2004, Shkurti 1990, Stinson 2002).

South Carolina's BEA currently uses no proprietary forecasting service for the national or state economic forecast. The state had purchased economic forecasts from DRI-WEFA for a time, but dropped the contract during budget cuts earlier in the 1990s. Instead, the BEA obtains key components of national and state economic forecasts from professional contacts in other states and from the Division of Research in the Moore School of Business at the University of South Carolina (Martin 2006). The BEA uses these data to develop a two year estimate for the over thirty sources of revenue to the budgetary general fund. The BEA also estimates the amount of income tax revenue that will be transferred to the Trust Fund for Tax Relief, as well as sales tax revenue earmarked for Education Improvement Act programs (South Carolina Board of Economic Advisors 2006).

Error in the general fund revenue estimate was less than 5 percent (plus or minus) of general fund revenue collections in thirteen of the twenty-one years between 1985 and 2005, and less than 8 percent in eighteen of those years. Revenue underestimates were more common than overestimates (fourteen of twenty-one years), which is consistent with the conservative approach to revenue estimating taken by most states. When South Carolina's economy has been doing well, general fund revenue collections have run an average of $200 million above estimated revenue for that fiscal year (Figure 3). This surplus revenue is then available for appropriation after the close of the fiscal year in supplemental appropriations bills.

Larger errors in state revenue estimates occur when there is instability in the national and/or state economy. At these times, inaccuracies in the national and state economic forecasts feed into and magnify errors in the state revenue estimate. A recent study of the revenue estimating process in Wisconsin showed clear correlation between errors in forecasts of national gross domestic product, personal income, and unemployment and errors in the state revenue estimate (Niederjohn 2004).

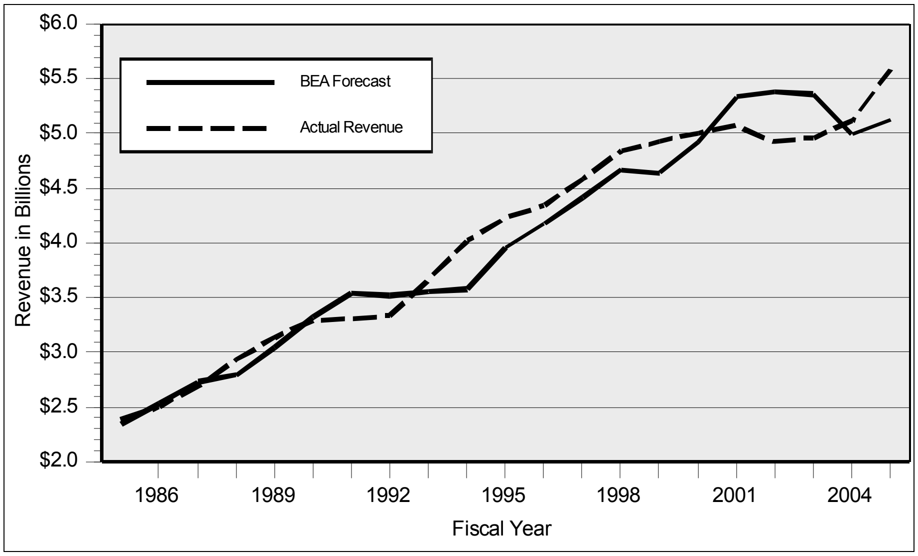

Figure 3. South Carolina Estimated vs. Actual General Fund Revenue

Over the past two decades the state has experienced two significant recessions, one in the early 1990s and one more recently between 2001 and 2004. These recessions depressed actual revenue collections below estimated revenue by an average of about $200 million a year, causing drawdown of the state's reserve funds, and in some years, mid-year agency budget cuts. The largest revenue overestimate, which was $460 million, occurred in 2002. The state's two largest revenue surpluses—$443 million in 1994 and $462 million in 2005—both occurred as the state was emerging from a recession, another phase of the business cycle when it is difficult to predict how quickly state taxes will recover.

THE SOUTH CAROLINA BUDGET PROCESS

South Carolina follows an executive budget process, whereby the governor develops and prepares a comprehensive, balanced budget proposal that is then revised and enacted into law by the General Assembly. The main source of budgetary assistance to the governor and the General Assembly is the South Carolina Budget and Control Board, created in 1950. The Budget and Control Board is chaired by the governor. The other four members are the chairs of the House Ways and Means and Senate Finance Committees, and the state treasurer and the state comptroller general, both of whom are constitutional officers elected independently of the governor. It is possible for the governor to chair a Budget and Control Board in which all the other members are from the opposite political party, although it is rare.

The Budget and Control Board has an extensive professional staff, of which the most important for budget purposes are the Office of State Budget (OSB) and the BEA, whose functions were discussed in an earlier section. The OSB is the executive budget agency for the state and provides technical support to the governor, the Budget and

Control Board, and the General Assembly in developing budget input from state agencies on the expenditure side. South Carolina's OSB is unusual because most states have an executive budget office staffed with appointees that report directly to the governor (NASBO 2002a).

The state budget is a year-round process with four stages: preparation, adoption, implementation, and review (Douglas 2002). It begins early in each fiscal year when budget guidelines are sent to state agencies. Agencies submit their requests to the governor through the OSB by law no later than November 1. The governor submits his proposed budget to the legislature within the first five days of the General Assembly session in January. The budget process ends in June with the newly enacted appropriations bill, the governor's line item vetoes, and the legislature's decision to uphold or override.

The budget takes effect July 1 of each year. On June 30 of the following year, the fiscal year ends and accountants begin a final tally of state revenue and expenditures. During the year, the South Carolina Budget and Control Board is responsible for monitoring the flow of revenue and expenditures in order to keep them as closely in line as possible within the budget that emerged from the appropriations bill.

AGENCY BUDGET PLANNING

Each year South Carolina state agencies conduct detailed internal budget planning for the coming fiscal year and more general planning for the two succeeding years. Early in the fiscal year, state agencies begin preparation of detailed budget plans for the coming fiscal year. These budget plans prioritize operating and capital budget requests by agency activity or program. Detailed justification is required for funding requests that exceed the agency's recurring base appropriation and also for requests for additional full time equivalent (FTE) employees. Requested funds are identified by their source (general fund, federal, and other budgeted funds, such as earmarked revenue from fees). Agency budget plans may be supported by goals, objectives, and performance outcomes listed in the annual accountability reports they prepare at the end of each fiscal year.[12] Budget plans are submitted to the OSB, which uses them as input into the preparation of the governor's budget proposal.

Agencies receiving one percent or more of the state's general fund appropriations for any fiscal year are also required to provide OSB with an estimate of their planned general fund expenditures for the coming three years. This information is compiled into the OSB's annual *Three Year General Fund Financial Outlook* report, which compares projected expenditures to projected revenues (South Carolina Office of State Budget 2005a).

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[12] S.C. Code 1-1-810 and 1-1-820. State agency accountability reports and current-year budget plans can be viewed on the OSB Website, http://www.budget.sc.gov/OSB-reports.phtm.

PREPARATION: THE EXECUTIVE BUDGET

The executive budget plays an important role in many state budget processes. Here a governor prioritizes his or her own policy initiatives on both the revenue side (tax cuts or increases, changes in fees) and the expenditure side (new, expanded, or discontinued programs). Thus, the executive budget sets the tone for coming legislative budget deliberations. In states with a strong executive budget process, such as New Jersey, the governor's budget proposal is an important starting point for negotiation.

South Carolina has followed an executive budget process for only ten years. Act 132 of 1993 directed the governor to prepare a state budget proposal starting with fiscal year 1995. Prior to that time, a budget proposal had been prepared and issued by the Budget and Control Board. South Carolina's executive budget process is weak, however. The General Assembly is not obligated to use the governor's proposal as a starting point and generally prepares its own budget (Douglas 2002).

ADOPTION: THE GENERAL ASSEMBLY AND THE GOVERNOR

The governor's budget proposal is submitted to the General Assembly at the start of the session in January, but is not acted on as proposed legislation. Budgetary bills must originate in the House of Representatives, where the Ways and Means Committee (twenty-five members plus professional support staff) prepares the first draft of the general appropriations bill. Sections of the proposed budget are parceled out by functional area to subcommittees, which develop recommendations for presentation to the full committee, and from there to the House. One representative in five serves on the Ways and Means Committee, so the appropriations bill that is sent to the floor has already had a great deal of input and ownership. The House usually completes its work on the general appropriations bill in March.

In the Senate, the Finance Committee of twenty-three members (half the senators) also has a professional staff to help it revise the appropriations bill received from the House. The Senate usually completes its work in May. Rarely does the appropriations bill approved by the Senate closely resemble the bill received from the House, so the two bills must go to a conference committee to iron out differences, and then back to each house for final approval. The conference committee consists of three House members appointed by the Speaker of the House and three senators, one each appointed by the chair of the Senate Finance Committee, the Senate Majority Leader, and the Senate President *Pro Tempore*.

Finally, the governor receives the general appropriations bill at the end of the legislative process in June, just prior to the start of the new fiscal year. The governor has the power to veto particular items while approving the overall bill, which is known as a line-item veto. Governors use the line-item veto for a variety of reasons, but rarely specifically because of revenue concerns. The General Assembly can override those vetoes with a two-thirds majority, and frequently does so (Douglas 2002).

State agencies and state employees will not learn until the last minute what the state of their budgets or their positions is, and even then, there is the possibility of a gubernatorial veto which may or may not be upheld. This short time frame between the end of the budget process and the beginning of the new fiscal year is a challenge to planning by state agencies.

THE ROLE OF REVENUE ESTIMATES DURING BUDGET ADOPTION

The BEA's revenue estimates serve three important purposes during the budget adoption phase. First, the revenue estimate for the coming fiscal year sets an upper bound for spending in the general appropriations bill under deliberation. Rule 5.3 of the *Rules of the House* require that at the time of introduction, any general (or supplemental) appropriations bill contain a certificate from the OSB that total appropriations do not exceed the BEA's estimated revenue for the applicable fiscal year (South Carolina General Assembly 2006). South Carolina has a constitutional limitation on annual state appropriations for general fund, school, and highway purposes. In practice, however, the revenue estimate actually determines state spending because the constitutional spending limit far exceeds the state's current revenue capacity (South Carolina Office of State Budget 2005a).

Second, the BEA's revenue estimate for the coming fiscal year identifies new money in the general fund. When positive trends in the state economy keep the general fund revenue base growing, "new money" is the term for the amount by which state general fund spending can increase. For this reason, both in the governor's budget proposal and in the General Assembly's deliberations on the appropriations bill, public and legislative attention focuses less on the size of the general fund than on the amount of new money available for appropriation. New money is the difference between last year's general fund and this year's estimated general fund, adjusted for certain mandatory spending increases or adjustments that have already been anticipated and sometimes legislated. New money can be spent on new programs, on raises for state employees, or on enhancement of existing programs, for example.

Third, the revenue estimate for the current fiscal year determines how much of the current balance in the capital reserve fund may be appropriated for discretionary uses at the end of the year, if any. When revenue shortfalls occur, the first funds used to cover any deficits are from the current year's capital reserve fund appropriation. The revenue estimate also determines whether or not the legislature may draw up a supplemental appropriations bill to use surplus revenue after the close of the fiscal year.

BUDGET IMPLEMENTATION AND REVIEW

The South Carolina Budget and Control Board and BEA monitor how closely general fund revenue receipts are tracking the revenue estimate on which the current year's general appropriations act is based. By the time of its first official revenue estimate in November, not yet halfway through the fiscal year, the BEA will have a much clearer idea of how much general fund revenue the state is likely to collect over the remainder of the fiscal year and can make a reasonable estimate of the amount of any surplus or shortfall. Increasingly, expenditure uncertainty must be factored into any budget adjustments as well.

When revenue shortfalls occur, funds from the current year's capital reserve fund appropriation are used to cover any deficits. If the capital reserve fund is exhausted, the Budget and Control Board considers using the general reserve fund and reducing the current year's general fund appropriations. During each of the four years from 2001 to 2004, state agencies took mid-year budget cuts ranging from one percent (2001 and 2004) to 8.73 percent (2003) because of revenue shortfalls resulting from the recession. The general reserve fund was also drawn down during this period (South Carolina Office of State Budget 2005a). Midyear cuts are very difficult for agencies to cope with, because staff—many of them with contracts—are the largest expenditure category for most agencies.

If a surplus is likely, the General Assembly can and usually does make supplementary appropriations. In recent years, supplemental appropriations have ranged from a low of $44 million in 2002 to a high of $327 million in 1997 (South Carolina Office of State Budget 2005a). In each year that there is no operating deficit, the General Assembly is allowed to appropriate the capital reserve fund for spending in the coming year.[13]

CAPITAL BUDGETING

Planning and budgeting for long term infrastructure needs is a critical component of the state budget process. In most states, capital expenditures are defined as the purchase of land and buildings, and facility construction, renovation, major repair, and demolition. Minimum spending for inclusion in most states' capital budgets ranges from $25,000 to $100,000 (NASBO 1999). Because of the large dollar amounts required, capital projects are usually financed by issuing debt. Within the revenue perspective of this report, however, capital budgeting is somewhat less important than the operating budget. In South Carolina, general fund revenue is appropriated for debt service on general obligation bonds and for the capital reserve fund, which is used for direct capital outlays when it is not needed for budget stabilization. State agency appropriations from the general fund may be used for smaller capital outlays and the future operating costs of new facilities.

[13] S.C. Constitution, Article III, Section 36.

While some states have separate budgets and/or appropriations bills for capital projects, South Carolina does not. The Budget and Control Board has a Capital Budgeting Unit within the OSB with planning, budgeting, and oversight responsibility for permanent state capital improvement projects. Each year, all state agencies that provide and maintain physical facilities are required to prepare a five-year *Comprehensive Permanent Improvement Plan* (CPIP) and submit it to the Capital Budgeting Unit. Higher education institutions including the state's technical colleges first must submit their plans for review and priority ranking to the Commission on Higher Education.[14] The Capital Budgeting Unit also monitors expenditures on capital projects under construction. South Carolina follows the recommended practice of projecting three years' worth of operating expenses for new facilities for inclusion in the operating budget (NASBO 1999).

The Joint Bond Review Committee reviews and approves each CPIP and establishes funding priorities for approved capital projects. The committee also monitors the state's outstanding debt from general obligation and institution bonds and recommends future bond issues as needed to support the statewide CPIP. The Joint Bond Review Committee has ten members. Five members are appointed by the chair of the Senate Finance Committee, with three from the committee and two from the Senate membership at large. Five members are also appointed by the chair of the House Ways and Means Committee, with three from the committee and two from the House membership at large. The Joint Bond Review Committee reports to the General Assembly and the Budget and Control Board.[15]

General fund revenue is used to pay for only two types of capital spending in South Carolina. First, after every year in which it is not needed to cover a revenue shortfall/operating deficit, the capital reserve fund is appropriated for spending on capital projects and other nonrecurring purposes. In recent years, the capital reserve fund has been around $100 million (South Carolina Office of State Budget 2005a).

Some of the state's capital projects are included in a periodic bond bill that authorizes the issuance of general obligation bonds and specifies the projects that the proceeds of the bond issue will be used to finance. The Office of the State Treasurer issues bonds up to the authorized limit as needed to match capital spending needs. The most recent capital improvement bond bill passed by the General Assembly was in 2000 in the amount of $137 million (South Carolina Office of State Budget 2005a).

Most states, including South Carolina, have some kind of limitation either on the amount of debt service (principal plus interest) that can be paid on general obligation bonds or the amount of general obligation debt that can be authorized (NASBO 1999). Article X of the state constitution sets a ceiling on the annual general obligation debt service that

[14] S.C. Code §2-47-55.
[15] S.C. Code §2-47-10 et seq.

the General Assembly can obligate itself to pay. That ceiling is 5 percent of general fund revenue collected in the previous year, which was raised to 6 percent by legislation in 2002 and 2004.[16] The additional one percent is not available for general capital projects. Instead it is split between debt service on infrastructure for economic development and research infrastructure at higher education institutions.[17] The state also issues general obligation bonds for higher education institutions and highway bonds for transportation projects, but debt service on these bonds is paid with earmarked revenues from outside the general fund and does not count toward the 6 percent limitation.

In July 2005, Standard & Poor's downgraded the credit rating on the state's general obligation bonds to AA+ from their coveted AAA status, citing slow economic growth and high unemployment following the recent recession plus the weak funding status in the state's general reserve fund after the recession (Standard and Poor's 2005). A good credit rating is important because it means a lower interest rate and thus lower debt service cost for a given level of capital outlay.

REVENUE INSTABILITY AND THE RECESSION: THE FISCAL CRISIS

Even the most carefully planned budget is susceptible to revenue instability as state and national economies move through the business cycle. State revenue is inherently volatile, often with larger swings than the ups and downs of economic activity as measured in personal income, production, and jobs. Table 5 compares annual growth in South Carolina's general fund revenue to the state's gross domestic product and personal income from 1997 to 2005. Note the contrast between the drop in revenue in 2002 and the modest increases in gross domestic product and personal income in the same year.

Table 5. South Carolina Economic and Revenue Trend Comparisons

	Gross Domestic Product		State Personal Income		General Fund Revenue	
Year	$ in Millions	% Change	$ in Millions	% Change	$ in Millions	% Change
1997	$97,397		$81,004		$4,588	
1998	102,945	5.7%	86,854	7.2%	4,846	5.6%
1999	108,663	5.6%	91,716	5.6%	4,931	1.8%
2000	112,514	3.5%	98,270	7.1%	5,007	1.5%
2001	117,296	4.3%	101,468	3.3%	5,080	1.5%
2002	121,582	3.7%	104,046	2.5%	4,930	-3.0%
2003	127,459	4.8%	107,247	3.1%	4,968	0.8%
2004	131,492	3.2%	113,668	6.0%	5,116	3.0%
2005	140,019	6.5%	120,043	5.6%	5,591	9.3%

Note: Gross domestic product and personal income by calendar year; general fund revenue by fiscal year.
Source: U.S. Bureau of Economic Analysis, South Carolina Office of State Budget 2005a.

[16] The General Assembly may pass legislation to raise (or lower) the ceiling on general obligation debt service to not more than 7 percent (or less than 4 percent). A two-thirds vote of the membership of both Houses is required.
[17] S.C. Code §11-41-10 et seq. and §11-51-10 et seq.

The recent recession hit state budgets particularly hard. Between fiscal years 2002 and 2004, total state revenues across the nation fell about $200 billion short of the amount needed to fund services at budgeted levels (Kalambokidis and Reschovsky 2005; McNichol 2004). The recession that started in 2001 was mild, but the early revenue declines associated with the recession were far worse than predicted by economic indicators (Maag and Merriman 2003). According to Giertz and Giertz (2004), this downturn in state revenues was the most severe in fifty years.[18] Fiscal year 2002 was the only budget year since World War II in which state revenues actually fell in current dollars (not adjusted for inflation). This situation is much worse than usual state budget crisis that arises when revenue fails to keep up with inflation.

The state fiscal crisis was caused by a number of factors. A stock market bubble had resulted in a sharp rise in capital gains, resulting in a spike in taxable personal income. The stock market bubble and realized capital gains also indirectly spurred consumption, which fueled growth in revenue from sales taxes as well (Dye 2004). This unusually strong revenue growth in the two top state tax revenue sources, individual income tax and retail sales tax, lead states to make long term spending commitments that were difficult to continue when revenue growth slowed in response to the recession and the end of the stock market bubble (Boyd 2003, NASBO 2004). In addition, tax cuts in many states enacted during the boom years of the 1990s were being implemented over successive years, adding to the recessionary revenue loss (Zahradnik, Lav and NcNichol 2005). The sixteen states (South Carolina not included) that had made the largest cuts in taxes during the 1990s had larger budget shortfalls, deeper spending cuts, sharper tax increases, and had more loss in credit rating than other states during 2002-2004 (Zahradnik 2005b).

Changes in federal policies also contributed to the recent state fiscal crisis. Some of the federal tax cuts enacted in 2001, 2002, and 2003 impacted state tax revenues because of linkages between the federal and state codes. Expanding internet and catalog commerce without Congressional action to lift the moratorium on internet taxation or to enact legislation authorizing states to collect taxes on catalog sales is another costly federal policy. Federal mandates in election reform, education of disabled children, and the No Child Left Behind law were under funded by an estimated $73 billion, and prescription costs for low-income elderly and disabled individuals with both Medicare and Medicaid contributed another $28 billion in state and local spending demands over this three-year period. The impact of federal policies on South Carolina in combined revenue loss and increased spending obligation was estimated at $2 billion over three years (Lav and Brecher 2004).

South Carolina was hit hard by the fiscal crisis. The state's 11.4 percent decline in 2002 inflation-adjusted revenue from all sources was the sixth largest decline in the nation

[18] Local government revenue tends to be less cyclical because of reliance on the property tax as a major revenue source.

and over three times the decline for the median state. Boyd (2006c) reports that South Carolina had the tenth largest decline in real per capita state tax revenue (-6.7 percent) over the entire period from 2000 to 2005. But the state's financial position has strengthened over the past two years. Strong general fund revenue growth in fiscal year 2005 was enough to make budgeting for 2006 a less painful process for legislators than it had been in the previous several years. General fund revenue receipts in 2005 were $462 million above the BEA's estimate for the year (South Carolina Office of State Budget 2005a). This surplus of actual revenues over estimated and appropriated revenues, plus a smaller one in the previous year, allowed the state to continue to refund the general reserve fund and repay loans from other trust funds that it had used to close operating deficits during fiscal years 2001, 2002, and 2003.

RESPONSES TO REVENUE SHORTFALLS

States responded in a variety of ways to the recent state revenue crisis. Between fiscal years 2002 and 2004, legislators chose to cut spending more often than raising revenue through increases in taxes or fees. Spending cuts eliminated 42 percent of the approximately $200 billion state budget gap nationwide. Increases in taxes and fees covered another 14 percent, and budget stabilization funds and general fund balances financed about 10 percent. Other stopgap measures accounted for the remaining 34 percent, including borrowing, some federal fiscal relief ($20 billion in 2003), the tobacco settlement, and payment date shifts (McNichol 2004). In the recession in the early 1990s there was more equal use of revenue increases and spending cuts (Maag and Merriman 2003, Boyd 2006c).

South Carolina was among the many states that cut spending across-the-board to help reduce budget gaps during fiscal years 2002, 2003, and 2004 (South Carolina Office of State Budget 2005a, NASBO 2004 and earlier reports). State agencies were cut between one percent and 8.73 percent of their general fund appropriations to help reduce the operating deficit. Over all government spending categories, South Carolina ranked sixth highest among the fifty states in the percentage decline in real (inflation-adjusted) per capita state expenditures between 2002 and 2003 (Boyd 2005a).[19]

Cuts in state budgets across the country fell across most spending categories. Boyd (2006c) examined the change in real per capita state government expenditures between 2002 and 2004. Although spending per capita on education increased slightly in inflation-adjusted terms over this two year period, the increase in per capita spending on K-12 education was far lower than it had been in the 1990s and the increase in per capita spending on higher education was due to tuition increases rather than state aid. On a *per pupil* basis, however, K-12 education did not fare well during the recent fiscal crisis.

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[19] Includes all state general government spending, except for medical vendor payments and capital.

In thirty-seven states school districts had less inflation-adjusted revenue from the state *per pupil* in 2004 than they did in 2002 (Kalambokidis and Reschovsky 2005).

Every state has certain kinds of expenditures that cannot be cut very much, which make the spending cuts in discretionary categories more severe. Boyd (2006c) observed that the only major functional area outside of education to show real per capita spending growth between 2002 and 2004 was payments to medical vendors (mostly Medicaid), which grew 16.5 percent.

There is only one way for states to reduce revenue instability in advance of a crisis—diversify the state tax system to increase its reliance on more stable revenue sources. There are, however, a number of ways that states can reduce the impact of revenue instability on state budgets once it happens, as it inevitably will. The most important of these strategies is maintenance and use of budget stabilization funds. States can also minimize the impact of revenue instability by linking spending priorities to the likelihood of revenue receipts during budgeting, by judicious use of surplus revenue, and by stabilizing spending over the entire business cycle. Finally, states employ a number of one-time fixes to deal with revenue shortfalls.

REVENUE DIVERSIFICATION

Revenue volatility can be reduced by diversification of revenue sources, just as the volatility of an investment portfolio can be reduced by including assets with different characteristics (Dye 2004, Garrett 2006, Schunk and Porča 2005). There is no set formula to reduce state revenue volatility, however, because state tax bases and tax structures are different. But economists and tax analysts agree on some basic observations about the tax mix.

State taxes ranked from the least stable to the most stable are: corporate income tax, individual income tax, retail sales tax, and excise taxes. Revenue from the corporate income tax is highly variable because corporate profits are highly cyclical and are the most volatile component of personal income. In South Carolina and many other states, however, corporate income taxes generate only a small percentage of total tax revenue.

Revenue from the individual income tax is closely linked to changes in wages and salaries as well as to changes in the stock market affecting taxable capital gains (Schunk 2005, Dye 2004). Variability in individual income increases with income level. Because more progressive state income tax codes rely more heavily on income from higher tax brackets, these states will experience more volatility in tax revenue. Research suggests that a flatter income tax structure can reduce revenue volatility (Sobel and Wagner 2003).

Revenue from the retail sales tax is less volatile than revenue from the individual income tax, in part because some taxable goods are regular expenditures that are hard to reduce or eliminate, even during economic downturns. Removing food from the sales tax base increases the variability of sales tax revenue to a level similar to that of the individual income tax, however (Sobel and Wagner 2003). Excise taxes yield the most stable revenues of the major state taxes. But because these taxes are levied on a per unit basis, they are susceptible to decline in revenue yield over time unless the rate is indexed to inflation or periodically adjusted upward. Fees and charges, which make up a large part of nontax state revenue, also are important revenue sources that can add to state revenue volatility (Schunk and Porča 2005).

South Carolina relies somewhat more heavily on revenue from the individual income tax and the retail sales tax than the average state. The state received 76.4 percent of its tax revenue from general retail sales and individual income taxes in 2005, compared to a national average of 66.8 percent (United States Census Bureau 2005). Within these two major taxes, the structure of each tax can make it more or less vulnerable to cyclical fluctuations, as measured by the short-run elasticity of the tax with respect to changes in personal income (percentage change in revenue in response to a one percent change in personal income). The short-run elasticity in the 1990s of South Carolina's individual income tax (1.466) and retail sales tax (1.718) were both well above the national averages of 1.092 and .967, contributing to the severity of the decline in revenue in 2001-2003 (Sobel and Wagner 2003). Based on more recent revenue data, the South Carolina BEA is using elasticities of 0.92 for the sales tax and 1.1 for the individual income tax in its current revenue estimates (South Carolina Office of State Budget 2005b).

Continued monitoring of these two important state taxes in relations to changes in the economy and tax policy will help revenue estimators better predict their behavior. For example, the volatility of revenue from the retail sales tax may increase in response to the lower (3 percent) tax rate on unprepared food, which took effect in October 2006. In addition, another report in this series documents that growth in revenue from the state retail sales tax is not keeping up with personal income growth in South Carolina (Schunk 2005).

The state's above average dependence on sales and individual income taxes also means that the state relies very little on both corporate income tax and excise taxes. The small contribution of corporate income taxes to total tax revenue moderates revenue variability, but increased use of excise taxes would add some stability to the revenue mix. South Carolina ranks low on excise taxes per capita or as a percent of income, and is particularly low in taxes on motor fuel and tobacco products (Porča, Ulbrich and Saltzman 2005, Ulbrich and Saltzman 2006).

BUDGET STABILIZATION ("RAINY DAY") FUNDS

Forty-eight states, including South Carolina, have some type of budget stabilization or "rainy day" fund that can be used to cushion the state general fund budget from short-term fluctuations in revenue (NASBO 2004).

National trends. Rainy day funds are maintained separately from the general fund although they are usually funded with general tax revenue. Rainy day funds are often the first line of defense against budget shortfalls and help states avoid midyear budget cuts. Budget stabilization funds make a state a more attractive borrower as well, because they are a factor in a state's bond rating. States also draw on unappropriated balances carried forward from prior years' general fund and other funds to help balance the budget. Fund balances generally increase during the expansive phase of the business cycle. But rainy day funds and other fund balances can be quickly exhausted in a multi-year downturn, as they were in many states in 2002, 2003, and 2004 (McNichol 2004).

States entered the recession with larger than usual reserves, averaging 10.4 percent of annual expenditures. Balances in these funds dropped from $49 billion nationwide at the end of fiscal year 2000 to only $18 billion at the end of fiscal year 2005, when they were already being replenished. Over this same period, the number of states with reserves of 5 percent or more of spending dropped from 39 to 13 (Zahradnik 2005a). Many states, including South Carolina, had capped the amount to be put into budget stabilization funds at levels that were inadequate for a deep and/or prolonged downturn in state revenue.

South Carolina's budget stabilization funds. South Carolina has three reserve funds to provide a cushion against revenue shortfalls: the general reserve fund, the capital reserve fund, and the new contingency reserve fund.

The general reserve fund is the state's primary rainy day fund. The general reserve fund balance must equal 3 percent of general fund revenue of the latest completed fiscal year—a figure that has been reduced twice from 5 percent and then 4 percent in the 1980s. Funds can be withdrawn from the general reserve fund only to cover general fund operating deficits, but an amount at least equal to one percent of the general fund must be put back each year until the fund is back to 3 percent. During the recent state fiscal crisis, the general reserve fund was reduced by more than half during fiscal year 2001 and was fully depleted in 2002. Appropriations for fiscal year 2006 restored the general reserve fund to its full funding level of $153 million (South Carolina Office of State Budget 2005a).

The capital reserve fund receives a recurring appropriation of 2 percent of general fund revenue of the most recently completed fiscal year. This fund, too, can be tapped to cover revenue shortfalls, and must be used prior to the general reserve fund. Unlike the general reserve fund, however, the capital reserve fund has another function in the state budget. In years in which there is no operating deficit in the general fund, the capital reserve fund is intended to pay for capital improvements either in cash or in debt service. The capital reserve fund was fully appropriated to cover operating deficits in the general fund in 2001, 2002, 2003, and 2004 (South Carolina Office of State Budget 2005a).

The contingency reserve fund was established in a proviso to the general appropriations act for fiscal year 2007.[20] It is used to hold any surplus general fund revenues from the most recently completed fiscal year. The contingency reserve fund is the first to be used to replenish the general reserve fund if it falls below its full funding level. Any remaining funds may then be used for capital purchases (including school buses) and state expenses resulting from natural or other disasters. Amounts in the contingency reserve fund may be appropriated only after the start of the next session of the General Assembly in January following the close of a fiscal year. Holding the fund through this period ensures that this surplus revenue is available for disaster relief after a hurricane, should one hit the South Carolina coast during the summer or fall.

The contingency reserve fund is a temporary provision, however, and is not a constraint on or directive to the General Assembly in the same way as the constitutional provisions governing the general reserve fund and the capital reserve fund.

Improving the adequacy of budget stabilization funds. Before the current fiscal crisis, states tended to consider an adequate funding level for budget stabilization funds (including unreserved fund balances) to be in the amount of 5 percent of the general fund. In the wake of large state revenue shortfalls and dwindling rainy day funds in 2002, the Government Finance Officers Association has recommended that states and other general purpose governments hold funds of between 5 percent and 15 percent of the general fund, *at a minimum,* in rainy day funds or as unreserved fund balances. Alternatively, this goal could be set to require at least one to two months of general fund operating expenditures (Government Finance Officers Association 2002).

Many states, including South Carolina, have placed limits on the size of their budget stabilization funds. Thirty-five states have caps of 10 percent or less (Zahradnik 2005a). South Carolina's constitutionally required reserve funds together equal 5 percent of general fund revenue, the lowest amount that the Government Finance Officers Association considers sufficient. The new contingency reserve fund will help refund the general reserve fund after it has been tapped, but its ability to do so depends on the year-to-year availability of surplus revenue that may not be forthcoming in a multiyear recession. Although the capital reserve fund is the first fund tapped to cover an operating deficit, it must be refunded out of current appropriations each fiscal year and thus competes with other state programs.

[20] S.C. General Assembly. 2006-07 General appropriations bill (H. 4810). Part 1B, Section 73.15.

To better weather future recessions, South Carolina would benefit from a higher level of funding in the general reserve fund by returning to the prior 5 percent of general fund revenue, if not higher. Setting the exact amount by which to increase the general reserve fund should be done after examining various factors, including the duration and size of revenue shortfalls in earlier recessions, the average level of the state's unreserved general fund balance in nonrecession years that would be available to cushion a revenue shortfall, and the state's rules regarding agency carry forward of unused appropriations, which can also cushion revenue shortfalls (NASBO 2004). Requiring that appropriations of some or all of a given year's surplus revenue be used to build up the general reserve fund to a new, higher level would ensure that establishing the new funding level does not compete with other state general fund appropriations. At a higher funding level, the general reserve fund's short three year refunding timeline may need to be re-examined as well.

LINKING SPENDING PRIORITIES TO REVENUE LIKELIHOOD

Cornia, Nelson, and Wilko (2004) propose that state policymakers link spending priorities to the probability that the state will receive certain amounts of revenue. Revenue estimates are usually prepared as point estimates; that is, as a specific dollar amount. But revenue estimates can be more properly viewed as probability distributions. In a stable or expanding state economy, for example, the probability would be quite high that the state would receive at least the same amount of revenue as it did in the previous year. However, the higher the anticipated increase beyond that level, the less likely it is that this will occur.

In theory, the state budget process can be revamped to link the risk and uncertainty of revenue estimation to various expenditures. For example, critical state spending obligations could be matched with revenue that has a high probability of receipt, and lower priority spending could be associated with lower probability revenue. Budgets constructed in this fashion are essentially preplanned to deal with shortfalls and surpluses, with foundation spending receiving the first revenue dollars and discretionary spending the later revenue dollars only after they have been received. This sort of budget planning reduces or eliminates the need for across-the-board budget cuts and agency rebudgeting when shortfalls occur. It also makes clear to policymakers the risk associated with committing revenue with a lower probability of receipt to permanent tax cuts or long term program expansion, for example.

Cornia, Nelson, and Wilko (2004) recommend that states proceed with caution in restructuring the state budget process to incorporate revenue probabilities, despite the benefits of this approach. Doing so would be a major undertaking in most states including South Carolina and would disrupt long-standing policies and organizational structures. But incorporating more explicit statements of uncertainty into the revenue estimate would help remind policymakers of the link between revenue and spending during budget deliberations (NASBO 2002b).

OTHER STRATEGIES

Each state is different in terms of its economy, revenue structure, and constitutional or statutory restrictions about how it can respond to an unexpected change in revenue. The standard strategies of rainy day funds and rules limiting the growth of spending in boom years were inadequate to cope with the magnitude of the drop in state revenues between 2001 and 2004. More drastic measures were required, including increases in taxes and fees and deliberate cutbacks in expenditures. Many of these measures were short-term. Among the many strategies adopted by other states to balance the state budget during the recent state fiscal crisis were (NASBO 2004, NASBO 2002b):

- Contingent tax increases and rebates triggered by specific fiscal conditions;
- Contingent expenditures authorized only if fiscal conditions permit;
- Borrowing or postponing expenditures into the next fiscal year (a very short-term strategy);
- Asset sales or use of non-recurring funds;
- Transfer of funds from various special funds to the general fund;
- Targeted cuts in programs, layoffs, furloughs, early retirement incentives, and hiring freezes;
- Privatization and contracting out;
- Reduced aid to local governments;
- Increased use of fees and charges;
- Broadening tax bases and/or raising tax rates;
- Tax amnesty programs and enhanced penalties and fines.

THE ROLE OF SPENDING IN CRISIS RESPONSE

Since the 1970s a number of states have placed some restraints on the growth of government. Appropriately structured restraints can help to stabilize spending over the budget cycle.

TAX AND EXPENDITURE LIMITATIONS

Thirty states had some type of tax or expenditure limitation, or TEL, in place in 2005 to limit growth in tax revenue or growth in spending or both. Some are statutory, others constitutional. Most states, including South Carolina, have spending limits rather than tax/revenue limits. A few states—Colorado, Missouri, and Washington—require voter approval for tax increases (all taxes in Colorado, over a certain amount in the other two states). Most of these limitations were enacted in the late 1970s or the early 1990s (National Conference of State Legislatures 2006).

Colorado's TEL, better known as TABOR (or Taxpayers' Bill of Rights), is the most restrictive in the nation. It created a crisis in state funding during the recent recession because of the effects of permanent tax cuts enacted during the boom years of the late

1990s combined with a later voter-approved constitutional amendment that requires annual spending increases in K-12 education. In addition, TABOR has prevented state spending levels from returning to pre-recession levels by requiring that all spending growth be limited to a population plus inflation formula based on the last completed year. TABOR also prevented Colorado from establishing a rainy day fund by requiring that all revenue above that allowed by the formula be refunded to residents (Frates 2005). In November 2005 Colorado voters relaxed TABOR by approving a referendum that allows the state to keep all revenue collected over the next five years, instead of requiring any revenue collected over the limit to be refunded to taxpayers (Zelenski 2005).

South Carolina's expenditure limitation is fairly typical, a constitutional and statutory restriction on the growth of appropriations that was enacted in 1980 and revised in 1984. It is based on the average rate of growth in state personal income, or alternatively, 9.5 percent of the previous year's state personal income. Spending limitations based on personal income tie spending to trends in the state economy and allow it to respond to local conditions. TELs that restrict growth in revenue or spending to a formula based on population and inflation, however, keep inflation-adjusted spending per state resident at a constant level over time, which greatly limits government's ability to respond to changing spending demands. South Carolina's state revenue estimate effectively limits appropriations because current spending levels are well below those allowed by law. South Carolina also has a restriction on the number of full time equivalent state employees in relation to population. As with spending, the state is well below its allowed limit for state employment (South Carolina Office of State Budget 2005a).

Studies of the impact of TELs on state budgets and economies reveal substantial drawbacks, especially with strict TELs such as Colorado's TABOR (Brome and Saas 2006, National Conference of State Legislatures 2006). For example, states with strict limits on revenue collections faced higher borrowing costs because of uncertainty about the ability of governments to raise revenue for debt service. On the other hand, states with strict spending limits rather than revenue limits experienced lower borrowing costs. As Brome and Saas (2006) point out, "no one can guarantee . . . that public officials will meet TEL requirements by maximizing efficiency first and then cutting service levels if necessary."

TELs that restrict growth in revenue or spending to a formula based on population and inflation run the risk of being unable to keep up with expenditure demands (Brome and Saas 2006). The consumer price index (CPI) is based on average household purchases, not government purchases. The costs of medical care and education, both major components of state general fund spending, have been growing at about twice the rate of the CPI. In addition, growth in overall state population may be an inaccurate representation of population growth in the various groups more heavily dependent on state services: elderly (health care), children (K-12 education), and young adults (higher education, prisons). Nationwide, the elderly population is estimated to grow at twice the rate of the overall population over the coming forty years (Bradley, Johnson, and Lav 2005).

At least one study found that the more restrictive TELs may have reduced both the efficiency and the equity of the state and local public sector. Equity has been particularly affected in a negative way by increased use of fees in response to limits on tax and budgetary growth (Mullins and Joyce 2001). Finally, if the purpose of a TEL is to strengthen the private sector or promote economic development, Colorado's experience does not support that contention. McGuire and Reuben (2006) found little evidence that TABOR affected growth in Colorado's per capita personal income or employment, the two primary measures of the strength of the state economy.

SPENDING STABILIZATION RULES

One way to stabilize state budgets relative to revenue is to adopt a spending stabilization rule. A stabilization rule is designed to even out spending over the business cycle rather than to simply limit the growth in state expenditures. Schunk and Woodward's (2005) research demonstrates how the recent state fiscal crisis could have been moderated by use of a simple spending rule. They simulated state general fund spending using a stabilization rule with the following characteristics: real (inflation-adjusted) spending per capita was held constant and any surplus revenue was distributed evenly between the state's rainy day fund, one-time capital spending, and temporary tax relief. A slightly modified spending rule allowed real per capita spending to increase by one percent a year.

Schunk and Woodward analyzed how state general fund spending would have differed from actual spending under their spending rule. They examined annual state general fund spending between 1992-93 and 2003-04 to cover the highs and lows of the business cycle. Allowing real per capita spending to grow at a rate of one percent a year over this period yielded aggregate state spending nationwide only 2.9 percent lower than actual spending in 2003-04 but resulted in steady spending growth along with regular funding of capital expenditures, rainy day funds, and temporary tax relief during the period. The authors' simulation of South Carolina's general fund expenditures under the same budget stabilization rule showed that the state would have been spending nearly the same in 2003-04 as it actually did, but would have had to cut spending by 2.7 percent in only one year, 2001-02. The budget cut in that year would have been less than one-third the amount of the cut that actually happened (9 percent).

Schunk and Woodward point out that spending stabilization rules work differently than TELs because they focus on spending stability rather than simply spending restraint. Like TELs, spending stabilization rules limit spending growth to some measure of growth in the state economy and demand for public services. But unlike TELs, spending stabilization rules also explicitly restrict the use of surplus revenue to building rainy day funds for budget stabilization and other nonrecurring uses.

South Carolina's recent establishment of the contingency reserve fund emphasizes proper use of surplus revenue in budget stabilization. However, funding for the general reserve fund, the state's rainy day fund, remains below recommended levels of 5 to 15 percent of the general fund. Allowing appropriations from the new contingency reserve fund to build up the general reserve fund (rather than simply refunding it to its current level of 3 percent) would help stabilize the budget in a future revenue downturn.

THE MIXED BLESSING OF SURPLUS REVENUE

Revenue shortfalls are not the only challenge presented during the budget cycle. An equally difficult challenge facing any state legislature is to develop an appropriate process to deal with surplus revenue in the general fund. While a revenue surplus in the current year is a welcome event, unwise use of surplus funds can lead to budget problems down the road.

The riskiest use of surplus revenue is to allocate it to an expenditure item that will be recurring, so that it adds to the budget in subsequent years. Examples of such recurring items are creating new positions, increasing salaries and/or fringe benefits for state employees, or authorizing construction of new facilities that will require recurring maintenance and utility expenditures. The use of nonrecurring funds for recurring purposes creates a future year budget reality called annualization, which established an obligation in the same vein as increased spending obligations for mandatory programs, such as the homestead property tax exemption and the state match for Medicaid. The practice of annualization is particularly problematic when the General Assembly uses surplus revenue to fund some recurring item for the remainder of the fiscal year, knowing that it must then be added into the budget for a full fiscal year beginning in July.[21]

In South Carolina, annualizations were commonplace during the economic boom in the late 1990s when surplus revenue was plentiful. Lanier and Saltzman (2001) analyzed the contents of supplemental appropriations acts and appropriations from the capital reserve fund over the four year period from 1997-98 through 2000-01. They found that an average of about 75 percent of these appropriations were for ongoing programs even though this revenue was restricted by law for use on nonrecurring expenditures. When state revenue growth slowed as the nation entered the recent recession, new and expanded programs funded with surplus revenue competed for funding with long-established programs, exacerbating the state's fiscal crisis.

[21] Young, Richard, "Fiscal crisis: An overview of recent states' actions," *Public Policy and Practice,* May 2004.

Since the recession, South Carolina has reduced its practice of annualization in appropriations of surplus revenue. The lack of significant revenue surpluses available for discretionary spending in the last few years made annualization more difficult. State legislators also reaffirmed their commitment to limiting use of surplus revenue to nonrecurring expenditures in recent legislation. However, there is still a temptation to use surplus revenue as a rationale for permanent tax reductions, which has an effect on the revenue side equivalent to expenditure annualization.

EXPECTATIONS FOR THE FUTURE: LONG TERM REVENUE GROWTH

Like many other states, South Carolina has been on a budgetary rollercoaster over the last three decades, with periods of rapidly growing revenue resulting in surpluses followed by periods of declining revenue and shortfalls. Long term revenue forecasting is even more challenging than the twice a year revenue estimates developed by the BEA, because so many factors can change.

REVENUE GROWTH 1979-2007

The National Association of State Budget Officers reports that the average increase in the size of state general funds from fiscal years 1979 to 2007 was 6.4 percent per year—only 2 percent per year when adjusted for inflation. That growth rate is very close to the average annual growth of real per capita income of 1.9 percent over the period 1979 to 2005 (NGA/NASBO 2006). Revenue credited to South Carolina's general fund grew at a slower rate of 5.4 percent a year over the same period, or 1.3 percent per year when adjusted for inflation. When revenue diverted to the trust fund for tax relief is included in this total, revenue growth is slightly higher at 5.7 percent a year, but still below the national average (South Carolina Office of State Budget 2005a).

South Carolina was not the only state to experience fiscal distress in recent years. Many states reduced their spending in one or more of the fiscal years between 2001 and 2004 in response to disappointing revenue increases or sometimes actual revenue declines.[22] For fiscal years 2003 and 2004, the average increases in state spending were 0.6 percent and 0.2 percent, respectively, compared to 8.3 percent in 2001 and 7.2 percent in 2000. Many states reduced agency budgets and funded positions and drew on fund balances and budget stabilization funds in response to revenue shortfalls (Young 2004).

Beginning in the latter part of fiscal year 2004, state revenue rebounded sharply, enabling states to recover some of the ground lost in the preceding fiscal years. In the last two fiscal years (2005 and 2006), the national picture and the South Carolina budget situation have both generally been brighter. In 2005, the average inflation-adjusted

[22] See, for example, reports and policy briefs on state revenue and expenditure trends at the Nelson A. Rockefeller Institute of Government's Fiscal Studies Program (http://rfs.rockinst.org/) and the National Association of State Budget Officers (http://www.nasbo.org/publications.php).

increase in state general fund revenue was 3.1 percent, and 4.2 percent in 2006. Revenue in 2006 exceeded estimates in 37 states as well (NGA/NASBO 2006).

RISK FACTORS FOR SOUTH CAROLINA

While the current budgetary situation has improved, there are clouds on the horizon. The Center on Budget and Policy Priorities rates South Carolina at high risk for revenue shortfalls in future years (Lav, McNichol and Zahradnik 2005). The center identifies ten risk factors that threaten the growth of a state's revenue over time. South Carolina is one of eleven states that scored high on all ten risk factors, which are:

- Declining percent of sales subject to sales tax (down 13.4 percent from 1990 to 2003, compared to a national average of 8 percent);
- Declining corporate income taxes as a share of total taxes (down 6.6 percent 1979-2002, compared to U.S. average decline of 5.5 percent);
- Above average risk of loss due to e-commerce (estimated $252 to $395 million a year);
- Exceptionally high income tax preference to seniors (see the paper, *South Carolina's State Revenue Sources,* in this series);
- Low progressivity on income tax compared to other states because top bracket takes effect at a fairly low income level (see the paper, *South Carolina's State Revenue Sources,* in this series);
- Spending pressures from a growing number of elderly, disabled persons, and special needs pupils;
- Individual income tax cuts enacted 1994-2000 that reduced potential growth in income tax revenue;
- Constitutional spending growth limit (see below);
- Link to the federal phase-out of the estate tax, costing South Carolina an estimated $49.5 million a year (see the paper, *South Carolina's State Revenue Sources,* in this series); and
- Rated as high risk in other national studies.

South Carolina's long-term revenue risk is reflected in the difference between short-run (cyclical) and long-term elasticity of state tax revenue with respect to changes in or growth of state personal income. The short run elasticity over the period 1965-2002 was estimated at 1.898 while the long-term elasticity was .953, suggesting that tax revenues will not quite keep pace with the growth of state personal income. Most of the elasticity problem is in the sales tax, for which long-run elasticity is estimated at only .748, slightly below the national median (Dye and Merriman 2004).

ISSUES DRIVING REVENUE DEMAND

The need for revenue is driven by a number of factors. These include: population growth and age distribution, federal programs (especially those requiring a state match), state earmarks, past annualizations of new or expanded programs, normal growth in existing state services to accommodate population growth and inflation, utility costs, and infrastructure needs (which are reflected at least partly in debt service). The revenue available to meet those expenditure demands is determined primarily by the tax structure and changes in the economy, although other factors such as population also influence revenue. In particular, an aging population means that more people will qualify for the particularly generous income tax breaks available to persons over age sixty-five in South Carolina, which will slow the growth of income tax revenue (McNichol 2006a).

Specific areas of pressure on state budgets in the next few years include Medicaid, elementary and secondary education, and higher education. Medicaid has surpassed all other areas of state government spending including elementary and secondary education as a result of rising general health care costs, growth in enrollment of high costs disabled populations, and expansion to cover more low-income children and pregnant women. As the population ages, the high cost segment of the Medicaid population, those over age sixty-five, is going to increase by 8.5 percent between 2005 and 2010 while the under-sixty-five population grows only by 3.8 percent. In 2004, Medicaid accounted for 17.6 percent of total general fund appropriations, up from 12 percent a decade earlier (Perez 2005).

The school age population is growing relatively slowly or declining in most states, but there are pressures to increase spending per pupil to meet higher graduation and learning standards, court challenges to school financing systems, and rising costs of special-needs children. The college population is expected to grow faster than the elementary and secondary population, and colleges that have been battered by state higher education spending cuts in recent years will be looking to restore that support (Boyd 2005b).

Since 1977, there has been a steady decline nationwide in the percent of state revenue devoted to higher education from 6.7 percent to 4.5 percent in 2000, just prior to the recent budget cuts (Kane and Orzag 2002). Further cuts in higher education funding have put upward pressure on tuition, which in South Carolina has been only partially mitigated by the availability of lottery-funded scholarships. A backlog of highway and other infrastructure needs and continued issues of prison overcrowding will add to other sources of spending pressure for South Carolina. There also are continuing concerns about possible future need to shore up the financial health of the state retirement system, a problem that also affects many other states (Eckstrom 2006, Giertz 2003, Boyd 2006b).

Declining federal aid and changes in the federal tax system that affect state taxes are another source of continuing budgetary pressure. Federal grants to state and local governments account for about 30 percent of state government revenue. Proposals are on the table to cut grants and to cap domestic discretionary spending. Grants to state and local government are about 17 percent of the federal budget, so they are at risk in any federal budget-cutting (Boyd 2006a). Efforts to reduce federal Medicaid costs are more mixed, with some costs being passed on to the states and others resulting in reduced spending at both levels (NGA/NASBO 2006). Changes in the federal income and estate tax system have already had an impact on those states that are linked to those federal taxes and did not choose to delink (McNichol 2006b).

Conclusion

The experience of 2002-2004 was a wakeup call not only for South Carolina but also for many states to the challenges of both revenue instability and long-term risk factors threatening state budgets on both the revenue and expenditure side. While South Carolina has a fairly solid institutional structure in place for forecasting revenue, preparing and monitoring budgets, and planning for capital improvements, the budget crisis of 2002-2004 took a heavy toll on state services and led to increases in fees in many areas as the accumulated rainy day funds proved inadequate to the task of filling the budget gap.

Despite the lack of direct access to proprietary forecasting services, South Carolina's revenue estimation is generally quite accurate—within 5 percent of actual revenue 60 percent of the time in the last twenty-one years and within 8 percent of actual revenue 83 percent of the time. However, even good revenue estimation cannot prevent the kind of cyclical variability that has led to the shortfalls and surpluses in budgetary revenue over the last decade. The General Assembly has learned from past experience about the hazards of using surplus revenue for recurring expenditures, but a period of several years of surpluses could easily undo that learning with either more spending annualizations or more permanent tax cuts. The increasing diversion of general fund revenues to earmarked special funds is also a long-term concern. These diversions reduce the flexibility of the General Assembly in responding to fluctuations in revenue.

South Carolina's general reserve fund and capital reserve fund provided an initial cushion for the recession of 2001-2004, but were quickly exhausted. Experience in other states as well as South Carolina suggests that most state budget stabilization fund levels are too low to weather a prolonged recession. The contingency reserve fund created in 2006 to hold surplus funds in reserve (primarily for refunding the general reserve fund or to cover other short-term emergencies, such as natural disasters) until the General Assembly reconvenes in January, but does not address the larger problem of budget stabilization. Rules that use a portion of surplus revenue in any given year for building the general reserve fund to a higher level would be a positive addition to the tools available to address cyclical revenue instability in South Carolina.

While South Carolina does not have a formally distinct capital budget, unlike a number of other states, there are processes and procedures in place that accomplish many of the goals of multiyear capital budgeting and infrastructure planning. The OSB's Capital Budgeting Unit and the Joint Bond Review Committee provide planning, review, priority-setting and oversight of the state's capital projects. Some capital projects are funded out of general fund revenue through appropriations of the capital reserve fund or surplus revenue, while others are funded through periodic bond bills. Adoption of a formal capital budget could, however, make this process a more transparent one.

Longer term, the state's tax structure lends itself both to cyclical instability and to long-term revenue shortfalls should revenue fail to keep pace with the growth of personal income. Spending demands from many sources (especially Medicaid) will continue to require revenue increases in coming years.

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