

TTARA

Texas Taxpayers and Research Association

September 2011

A Work in Progress: A Review of the 2012-13 Budget

In this, the third in a series of three newsletters covering the decisions made by the 82nd Texas Legislature, the key elements of the budget are outlined. The first newsletter reviewed changes in school finance law. The second newsletter provided an overview of tax law changes.

Texas state lawmakers passed a \$172.3 billion budget for the 2012-13 Biennium (including \$85 billion in state general revenue-related funds) in a one-two punch of a regular session and a special session on school finance. The appropriations bill places a tightening belt around all functional areas of government, reflecting the lingering pain of a downturn sparked by the nation's worst recession in 75 years. In accordance with her constitutional responsibility, Texas Comptroller Susan Combs certified that the appropriations made were within her estimate of available revenues;¹ however, some unfinished business remains.

A huge question mark hangs over the funding of the state's Medicaid program—the state-federal

¹ The Comptroller by law may only consider whether the appropriations made in a particular bill are within available revenues. The law does not allow the Comptroller to consider whether the appropriations made are sufficient to meet the state's legal commitments. A supplemental appropriations bill would, however, be subject to her certification at its time of passage.

health care program for low-income Texans. Lawmakers enacted new initiatives to seek greater flexibility in managing the program, with an eye to trimming costs. If, as expected, the federal government does not consent to these initiatives, the current program in place will cost an estimated \$4 to \$5 billion more than what lawmakers appropriated.² A point of pride for many legislators was leaving a multibillion balance in the Rainy Day Fund; that celebration may prove to be premature.

Also uncertain is how public schools and junior colleges will respond to reduced levels of state funding. If schools restructure their programs and find true and meaningful budget cuts, taxpayers will be rewarded. If schools respond by making minimal cuts and ask voters to raise taxes, the legislature's "no new taxes" budget may be a pyrrhic victory. Also expected is yet another lawsuit in the seemingly never-ending battle over the constitutionality of Texas' school finance system.

And finally, lawmakers relied on a number of one-time measures—though less than in times past—to fund ongoing programs, which creates a risk of structural issues going forward.

² <http://www.texastribune.org/texas-taxes/budget/in-texas-a-businesslike-budget-after-a-fashion/>

So while the budget officially is balanced, unofficially it is a work in progress. But that is not unusual. In previous times of fiscal duress, the enacted budget has rarely been the final word. In 2003 when legislators last faced major budget difficulties, the adopted budget was more a starting point that required a substantial amount of interim “massaging,” but still without relying on any new taxes. The 2012-13 budget may prove to be a similar story.

Starting from Less than Zero

Lawmakers came to Austin last January facing the toughest fiscal challenges in modern times. The Comptroller laid the framework for the session with a bleak revenue statement: absent action by the legislature, Texas would close the books on 2011 with a \$4.3 billion deficit—the biggest in Texas history.

Texas’ revenue problems were mostly the result of a gruesome recession, but could also be attributed in part to how it had balanced its previous budget. Lawmakers in 2009 had tried to buy time by using over \$14 billion of one-time revenue to finance recurring spending programs—just under \$6 billion of cash balances and just over \$8 billion of federal stimulus money (Figure 1). It was a strategy that might have worked had the economic slump been a “normal” one, but the recession proved to be far longer and deeper. When lawmakers met in 2011, the state’s cash balances had swung to a projected deficit of over \$4 billion and the cupboard of federal stimulus funds was bare. Economically, the worst was over—state revenues were projected to grow by nearly \$5 billion in 2012-13. Unfortunately that growth would be nowhere near enough to offset the loss of one-time revenues. When the bleak revenue

Figure 1

The State’s Revenue Picture as of January 2011
General Revenue, Stimulus, and Property Tax Relief Funds

<u>Source of Revenue</u>	<u>2010-11</u>	<u>2012-13</u>	<u>Difference</u>
Cash Balances ¹	\$5.8	(\$4.3)	(\$10.1)
Federal Stimulus Funds ²	\$8.3	\$0.0	(\$8.3)
Revenues for Property Tax Relief	\$4.3	\$4.5	\$0.2
Revenue Collections	<u>\$71.6</u>	<u>\$76.4</u>	<u>\$4.8</u>
Total Revenue	\$89.9	\$76.7	(\$13.4)

Notes: ¹Includes changes in general revenue dedicated account balances. ²LBB estimates; includes supplemental funds authorized after the 2010-11 budget had passed. The amounts for 2010-11 are from the revised forecast the Comptroller provided in January 2011.

numbers were matched against the budget, lawmakers were over \$16 billion short of maintaining the existing level of state spending. The gap rose to \$27 billion by some estimates when the cost of maintaining the existing level of state services was factored in.

House Speaker Straus and Lt. Governor Dewhurst instructed staff at the Legislative Budget Board to prepare an initial spending draft that would balance within the Comptroller’s estimate of available revenues while also retiring the current deficit. That budget proposed deep cuts to current programs and services, but met the campaign promises of those who pledged not to raise taxes. Once lawmakers had an opportunity to review the proposed budget cuts they could then consider whether to tap available balances in the Rainy Day Fund and/or take up other proposals to raise revenues.

The initial spending draft³ was not pretty. Reflecting an overall cut of 17 percent⁴, no area

³ Figures used are from House Bill 1 as introduced. The Senate budget was generally similar to that of the House, but there were some specific differences.

⁴ In evaluating the “general revenue” budget, this analysis includes state general revenue funds plus other state funds

of the budget was spared. The proposed budget would have funded public schools at \$9.8 billion below what was required by existing state law (an overall spending cut of near 15 percent per student), eliminated many educational grants (including financial assistance to incoming college students), made deep cuts in health and human services provider payments (on top of modest reductions made in 2011), and fallen far short of meeting the expected costs of the Medicaid program.

Lawmakers' first order of business was to tackle the impending 2011 deficit. As economic conditions improved slightly, Comptroller Combs lowered her deficit projection to \$4.0 billion. Agencies and budget staff had already identified roughly a billion dollars that could be trimmed from 2011. Still, absent further legislative action, the state did not have sufficient borrowable reserves to cover its impending obligations. After some negotiation the Governor and legislators agreed to draw from the state's Rainy Day reserve to wipe out the deficit. By starting with a balance at zero instead of negative, lawmakers had a bit more wiggle room to write the 2012-13 budget.

Crafting the Final Plan

With the deficit eliminated, the House Appropriations Committee began its work by partially restoring some cuts, mostly in education and human services. When Chairman Pitts presented the committee's budget on the House floor, he counseled that there was still

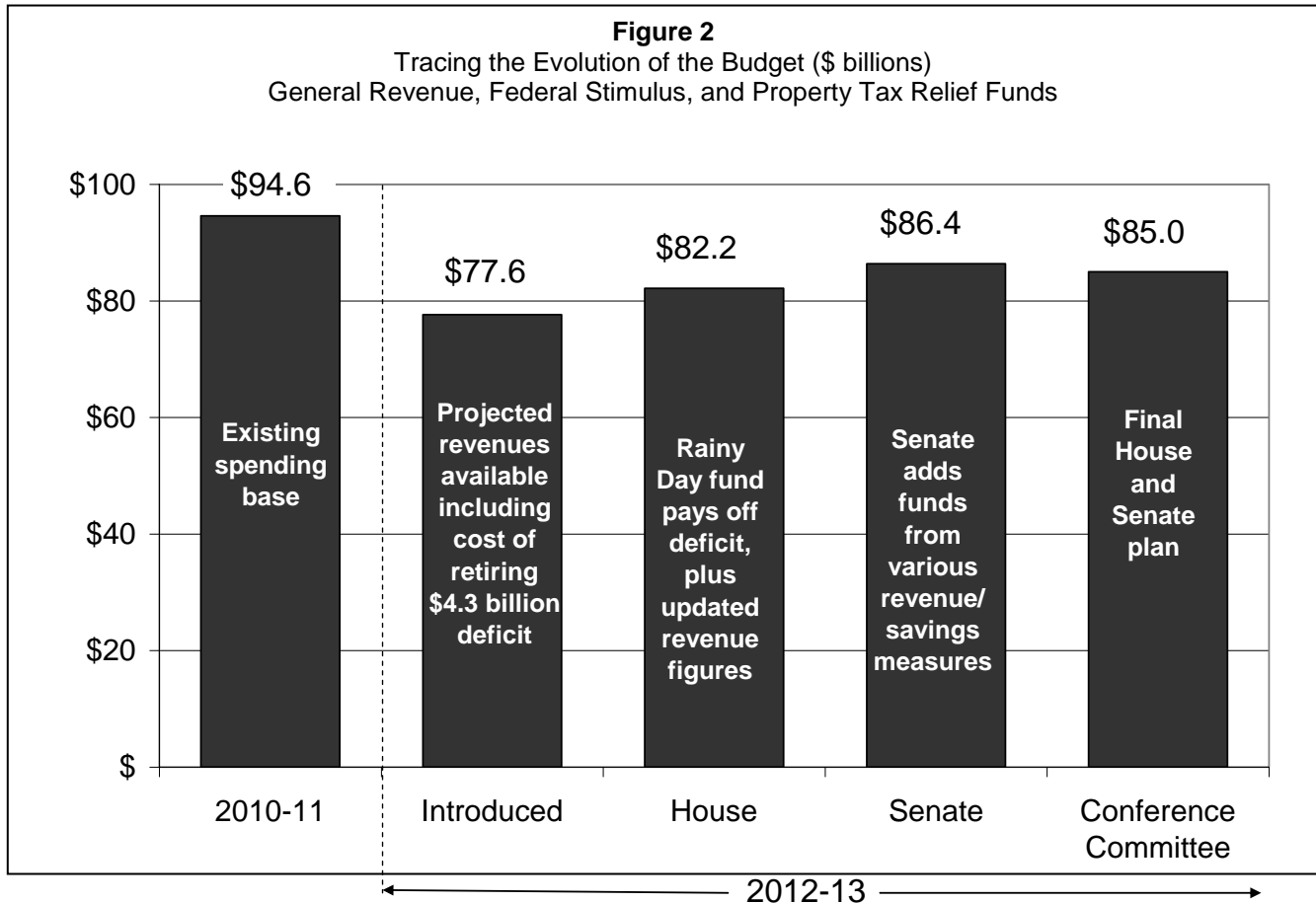
that either offset or somehow impact general revenue spending and the Comptroller's ability to certify the budget. Included are the Available School Fund, the State Textbook Fund, and the Foundation School Fund, which are typically counted as "general revenue" funds by the Comptroller and the Legislative Budget Board. Also included are: 1) the Property Tax Relief Fund (which is a part of general state aid to public schools), as well as 2) that portion of the federal stimulus funds which was used to offset state general revenue spending in 2010-11.

much work to do. He promised members he would work to identify various revenue and savings measures, allowing more of the cuts to be restored. The bill passed, 98 to 49, on what was essentially a procedural vote to move the bill to the Senate. It was clear many hoped the final bill would be less severe.

Attention then shifted to Senate Finance Committee Chair Steve Ogden. He quickly found very rough sledding on the journey to find the "sweet spot" that would garner the necessary votes for passage. Unlike the House, where a simple majority can pass legislation, Senate tradition typically requires a 2/3 vote of the membership to allow a bill to be considered. His challenge was to find an agreeable level of spending that could be paid for with revenues raised in an acceptable manner—and gain the support of 21 of 31 senators.

The Senate Finance Committee initially approved a budget that incorporated some new revenue/savings but also drew more from the Rainy Day Fund to cover prospective needs—a controversial budget strategy for many lawmakers. Support for the provision evaporated before the full Senate could consider it. Partisan considerations made a compromise that would garner the support of two-thirds of the senators unattainable. A little-used procedure was then used to skirt the 2/3 rule and bring up the budget bill and pass it on a 19 to 12 vote, reflecting the partisan make-up of the Senate.

Conferees of the House and Senate went to work to craft a final budget tallying \$172.3 billion from all state funds—down 8 percent from the previous budget. Spending from general revenue-related funds tallied \$85 billion—down 10 percent from 2010-11 spending, but well above the budget as it was introduced in January (Figure 2, next page). The cuts were deep, but not near as deep as some had feared.



The Search for Additional Dollars

While the House had been working on identifying additional revenue/savings items, most initiatives would be cobbled together by Senator Robert Duncan in Senate Bill 1811. This general “fiscal matters” bill would become critical in the waning days of the session as it became a vehicle for needed provisions in other bills that had failed as the session clock wound down (such as the rewrite of the school finance formulas). The bill died in a last minute filibuster in the Senate, but became law as Senate Bill 1 in an immediate special session, and was a key part of the overall plan to finance the budget.

Among the various revenue/savings items lawmakers considered at one time, but eventually discarded were: suspending the back-

to-school sales tax holiday, repealing certain natural gas tax investment credits, cutting the sales tax collection discounts, repealing the hotel tax permanent resident discount, and eliminating the insurance tax credit for mandated examination fees. Consideration of increasing tax rates never gained any traction and was never seriously discussed. Also among the rejected was a proposal to require a partial prepayment of the franchise tax.

Lawmakers did, however, agree on proposals to defer some payments while speeding up other collections, making certain technical changes in the Tax Code, and extending the small business franchise tax exemption (Figure 3, next page). A more detailed review of revenue-related legislation is available in TTARA’s July newsletter: *Tax Wrap-Up for the 82nd*.

Figure 3

Key Revenue and Cost Savings Measures
Used to Balance the 2012-13 Texas Budget
(\$ Billions)

Comptroller revenue estimate revisions	\$1.5
HB 4: Net budget cuts to 2011	\$0.6
HB 275: Rainy Day Fund withdrawal	\$3.2
SB 1: Defer state school aid payment	\$2.3
HB 257: Unclaimed property “speed-up”	\$0.3
SB 1: Tax “Speed-ups”	\$0.3
SB 1: Delay fuels tax transfers	\$0.4
SB 1: Sales for resale revisions	\$0.2
SB 1: Franchise tax small business exemption	(\$0.2)
SB 1: Other revenue provisions	\$0.2

Note: This is a list of key revenue/savings measures, but is not comprehensive. Senate Bill (SB) 1 passed in the special session. All other bills passed in the regular session. In addition to the items listed above, SB 1 included a change in the school finance formulas that was assumed in the appropriations bill.

The Final (for now) Budget: Cuts but no Calamity

As is traditional in Texas, the 2012-13 discretionary budget is very focused on a few key priority areas—education, health and human services, and public safety (Figure 4). The proverbial “other” category accounts for only 5 percent of the dollars spent.

Public Education. Lawmakers made cuts to state aid for public schools, but the cuts were nowhere as deep as originally proposed in January, reflecting the priority lawmakers place on public schools. During the session, budget writers added over \$5 billion back for schools, though the final bill still fell \$4 billion below what existing state formulas required.

Under Texas law, the state and local school districts share the responsibility of paying for public schools. Texas law lays out a series of

Figure 4

Assessing the 2012-13 Texas Budget
\$ Billions of General Revenue-Related Funds

Category	2010-11 <u>Biennium</u>	2012-13 <u>Biennium</u> ^a	Dollar <u>Difference</u>	Percent <u>Difference</u>
Public Education	\$41.6	38.3 ^b	(\$3.4)	(8.1%)
Health & Human Services	\$26.1	22.7 ^c	(\$3.4)	(13.0%)
Higher Education	\$13.3	11.8	(\$1.5)	(11.5%)
Public Safety/Criminal Justice	\$8.6	\$8.1	(\$0.5)	(6.1%)
Other Budget Areas	<u>\$4.9</u>	<u>\$4.2</u>	<u>(\$0.8)</u>	<u>(15.3%)</u>
Total, All Categories	\$94.6	\$85.0	(\$9.6)	(10.1%)

Notes: Numbers may not add due to rounding. ^a Article 9 of HB1 includes various provisions making funding changes to other parts of the budget bill. The amount shown here for each budget category assigns the changes made in Article 9 to the appropriate functional area. ^b Does not include \$2.3 billion of state aid due under current formulas that will be paid in September of 2013. If this deferred payment is included, the dollar difference for public education compared to the 2010-11 Budget would be a net drop of \$1.0 billion and a percentage reduction of 3.6%. ^c Reflects actual appropriations in HB 1 and does not include anticipated supplemental appropriation of \$4.8 billion. If this amount is included, the net dollar difference for health and human services compared to the 2010-11 Budget is \$1.4 billion and a percentage *increase* of 5 percent.

mathematical formulas to determine the amount of state aid each district receives. The formulas are based on each school district's number and type of students, the characteristics of the district, the taxable value of local property, and the tax rates levied. To make the budget work, legislators this session rewrote the formulas to fit within available revenues. That move will likely spark yet another in Texas' seemingly never-ending litigation over school finance. (A more detailed look at legislator's deliberations on school finance is available in TTARA's July newsletter: *The New Normal for School Districts?*)

Since the legal process takes considerable time, it is unlikely any lawsuit filed in the coming months would be finally decided prior to January 2013, when the next legislature meets. Still, to reach a resolution of a major dispute, lawmakers may feel pressured to react to any information at issue in the lawsuit, and some further rewrite of the school finance formulas in 2013 is almost assured.

Higher Education. Just as unprecedented as the cuts to public education were those to higher education funding—also at a time of growing enrollment for most institutions. Among the controversies caused by the budget as introduced was the lack of financial aid funding for any new incoming students. These funds were restored, albeit at a reduced level. Ultimately overall funding for institutions of higher education was cut by roughly 10 percent.

Health and Human Services (mostly Medicaid). The most daunting challenge within the budget is Medicaid—a program that accounts for 85 percent of all Health and Human Services spending. Medicaid is a shared program between the state and federal government that provides health care for low-income families and individuals (focusing primarily on needy children and the elderly).

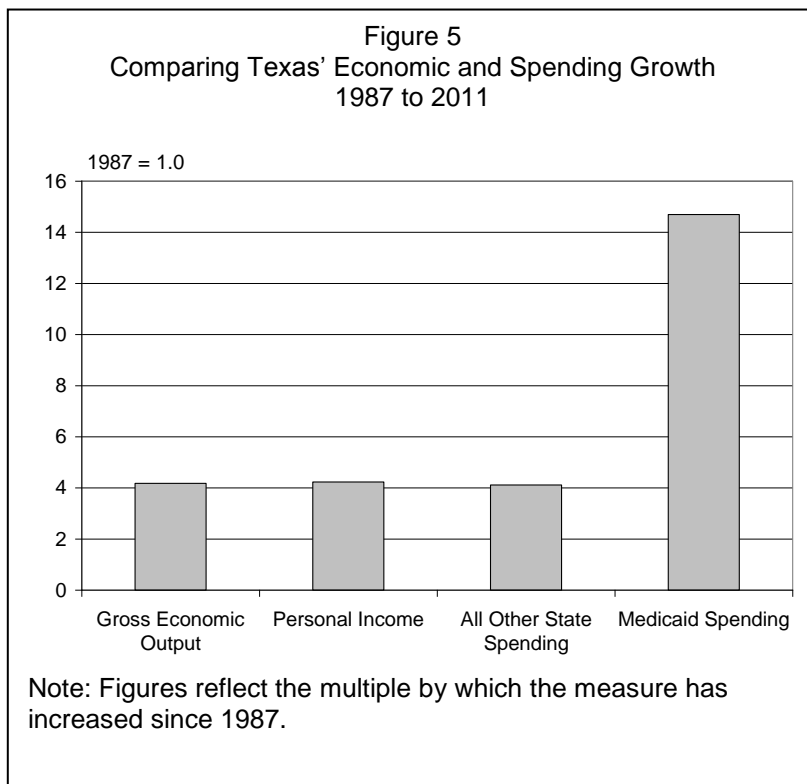
States participate at their option. If they opt in, as all 50 states do, the federal government pays for a substantial portion of the program (about 58 percent in Texas). That comes with a catch, though. States must provide certain minimum standards of care for people meeting specified income criteria. States may exceed the federal standards, but they may not go below them. States do have the authority to decide the amount they will pay health care providers for their services, but those providers are free to make their own decision as to whether those rates are sufficient for them to accept Medicaid patients (only about one in three Texas doctors does so).

Texas' Medicaid costs are exploding, creating a structural state budget gap that will only get worse as new mandates become effective with the implementation of national health care reform. Since 1987, driven in part by the effects of growing federally-mandated coverage, and by high medical inflation, Texas state costs for Medicaid have increased by an astounding factor of 15—i.e. the state spends 15 times more on Medicaid today than it did in 1987 (Figure 5). In comparison, Texas' gross economic output and personal income have increased a bit more than four fold, as has all other state spending.

While high profile court cases drove increases in state spending for both public education and for prisons, all of the relative growth in the Texas budget over the past 25 years can be attributed to one program—Medicaid.

There is no question the program provides a wide array of valuable services to a population in need; however, in effect the federal government is setting the state's spending priorities and thereby crowding out other parts of the budget.

Lawmakers have attempted to gain some flexibility with the passage of Senate Bill 7 by Nelson in the special session. This bill provides some direct cost savings by extending the state's



managed care system to certain South Texas counties and by also providing other administrative and program savings. Additionally, it authorizes Texas to participate in an interstate health care compact. The compact would give participating states the flexibility to design a program more suited to their needs, and would receive federal Medicaid support through a block grant. The prospect of Congress initiating such a compact is, however, remote.

In order to make the budget numbers work, lawmakers discounted the projections of budget staff, and set the Medicaid appropriation in 2013, the second year of the biennial budget, at a level \$4 to \$5 billion below the state's cost obligations. This was a decision of political necessity—a bill that cut that amount from other parts of the budget likely could not pass, nor could one that raised that amount in additional new revenues. The strategy has little risk as long as sufficient balances are available in the

Rainy Day Fund when needed to cover the shortfall (at \$6.5 billion, they should be more than sufficient, although that will leave little room for any other demands).

The Path Ahead

For now, the budget is legally and technically balanced. However, four major challenges will confront lawmakers as they build from this point:

1. Current Medicaid costs,
2. Future Medicaid costs,
3. School finance, and
4. Replacing one-time money spent in the 2012-13 budget.

The 2012-13 Medicaid shortfall will have to be addressed by lawmakers, at the absolute latest when they convene in 2013. While some additional revenues may materialize as the economy improves, the risks of a dreaded “double dip” recession are increasing, and the Comptroller rightfully should remain cautious in her estimates. The bulk of the projected shortfall will have to be covered by balances in the Rainy Day Fund. Even so, the shortfall will present some challenges, particularly next summer as the state must determine the appropriate size of its issuance of tax anticipation notes for the 2013 state fiscal year.

Medicaid will present further challenges for the upcoming 2014-15 budget as lawmakers may be forced to produce another \$2 billion to pay for a new federal mandate associated with national health care reform—costs that will continue to accelerate over the next several budgets.

School finance may demand more dollars if the state is to “buy” its way out of the next round of

litigation, or stave off new rounds of budget cuts or local property tax increases.

And finally, Texas faces a short term structural imbalance because of the use of one-time money—Rainy Day Fund balances, accelerated tax payments, deferred spending—to pay for recurring spending needs. Unless the economy rebounds, lawmakers may be forced to either make further cuts in the 2014-15 budget, or raise new revenues.

Still, any forecast is subject to a wide margin of error, and it is way too early for panic. Texas' revenue system has demonstrated tremendous strength and resiliency in recent years. In 2003, lawmakers confronted severe fiscal challenges

and balanced the budget through a combination of budget cuts, draining the Rainy Day Fund, and a hodge-podge of one-time fiscal measures. Over the next six years, the economy and state revenues rebounded strongly, allowing budget writers to restore most of the spending cuts, undo the one-time fiscal measures, cut taxes, and build a record \$9 billion plus balance in the Rainy Day Fund.

As the national economy continues to struggle, Texas' current rebound is not likely to be as robust in 2011 and onward. Even so, the budget is sort of like a football game—the only score that counts is what's on the board when the final whistle blows. Right now, the first quarter has barely begun.

TTARA

Texas Taxpayers and Research Association
400 West 15th Street, Suite 400
Austin, Texas 78701