TTARA

Texas Taxpayers and Research Association

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Budget Challenges Loom

Texas has now joined the vast majority of states that face some very daunting budget challenges. With the Legislature in session, the numbers have moved from speculation to reality. The Comptroller's revenue estimate has been released. House and Senate spending bills have been introduced. Governor Perry has laid out his priorities. Legislative committees are rolling up their sleeves and getting to work.

The Texas budget is a complex piece of legislation—more than 1,000 pages long and weighing over 6 pounds. It is divided into separate articles for the major functional areas of Texas government and appropriates money to over 200 state agencies and institutions of higher education from a variety of funds and revenue sources.

But as complex as the document is, two simple factors explain the state's fiscal challenges: 1) the loss of one-time money used to finance the current budget has created a structural gap for 2012-13, and 2) the nation's worst economy since the Great Depression has hammered state revenues while increasing spending demands.

As lawmakers get ready to tackle the 2012-13 budget, they'll have to deal with some leftover business from the current budget. While certified as balanced when it passed two years ago, the economy has proven to be worse than forecast, taking its toll on sales, franchise and other state tax revenues. This January, Comptroller Combs advised lawmakers that Texas faces a $4.3 billion deficit by the end of the 2011 fiscal year. That would be the largest projected deficit in the history of the state—worse than the $1 billion lawmakers faced in 1987 and the $1.8 billion in 2003.

Fortunately for lawmakers, Governor Perry, Lt. Governor Dewhurst and House Speaker Straus have already taken corrective action. At their direction, over $800 million in prospective budget cuts are already identified—savings which will be realized in legislation. And even though lawmakers will find some additional cuts, it won't be enough to close the gap, and there won't be enough money in the general revenue

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Is a Deficit Legal?

It is not illegal for Texas to run a deficit. Article 3 Section 49a of the Texas Constitution requires that a budget written by the legislature balance within the Comptroller's estimate of available revenues (a provision the legislature can "override" with a 4/5 vote), but there is no requirement that the legislature revisit a budget in the event the projected revenues do not materialize. This state of affairs has been established and clarified in a number of key opinions from past Attorneys General.

fund to pay the state's bills. Lawmakers essentially have three options for this coming August, when the current fiscal year ends: 1) allow the state to write checks it cannot honor, 2) delay paying some of the state's bills, or 3) draw from the Rainy Day Fund.

Looking ahead to 2012-13, the Comptroller's Biennial Revenue Estimate projects modest growth but the gain is overwhelmed by: 1) the loss of federal stimulus funds and 2) the state swinging from a huge cash balance to a huge cash deficit (Table 1).

The federal stimulus package proved to be the gift that kept on giving in the 2010-11 biennium. The original budget anticipated Texas would be able to use $6.4 billion of the federal largesse to fund its ongoing Medicaid and education programs. A few months after the budget passed, however, Texas qualified for an additional $500 million in federal Medicaid matching money as a result of the state's high unemployment rate. In the summer of 2010, Washington threw even more to the states by extending the Medicaid assistance for another six months—worth another $1 billion to Texas and effectively eliminating a pending shortfall in Texas' Medicaid program. But the $8 billion of federal Medicaid assistance which was such a blessing in 2010-11 is now a structural curse. The on-going programs those funds supported are still in place, but the money to pay for them is not.

Another blessing two years ago was the state's ample cash balances. Lawmakers had $2.8 billion in excess cash in the state's general revenue fund and general revenue dedicated accounts. On top of that was $3.0 billion in the Property Tax Relief Fund reserved to help fund the continuing costs of the 2006 tax relief package. That black ink has now turned red, morphing into a $4.3 billion deficit. In sum, even though the state's underlying revenues are growing by $5.5 billion, lawmakers in total have $12.6 billion less money with which to fund the state's upcoming budget.

House Speaker Straus instructed Appropriations Committee Chair, Jim Pitts, to prepare a 2012-13 budget for the legislature to work from that balanced within available revenues—without relying on higher taxes and without drawing from the Rainy Day Fund. This budget bill has been introduced as House Bill 1 (Table 1). While it totals $156.4 billion of spending from all state funds, it is the state's general revenue funds that comprise roughly half the budget over which the legislature has the most discretion.[1] While the bill balances, it is by some estimates as much as

[1] Less discretionary funds include state highway moneys, which are constitutionally dedicated to be spent one way or another on the state's highway system, federal funds which are restricted for certain programs, and other dedicated moneys. "Discretionary" funds here include the state's general revenue fund and any related fund which acts as a general revenue offset, including the Available School, Textbook, and Property Tax Relief Funds. Any shortfall in these funds automatically draws from general revenue, and any excess in these funds reduces general revenue spending. The LBB and Comptroller typically do not include the Property Tax Relief Fund as a general revenue-related fund, even though it operates in the same manner as all other general revenue-related funds.

Table 1
Texas State Finances As Currently Proposed in House Bill 1

	2010-11	2012-13	Difference	Percent Change
Beginning Balances[1]	$5.8	($4.3)	($10.0)	-174%
Federal Stimulus Funds[2]	$8.0	$0.0	($8.0)	-100%
Current Net Revenues[3]	$75.8	$81.3	$5.5	7%
Total Revenues	$89.6	$77.0	($12.6)	-14%
Public Education	$42.0	$35.3	($6.8)	-16%
Health & Human Services	$25.7	$20.0	($5.6)	-22%
Higher Education	$13.1	$11.0	($2.0)	-16%
Prisons & Safety	$8.6	$7.5	($1.2)	-14%
Other	$4.4	$4.1	($0.4)	-8%
Total Spending	$93.8	$77.8	($16.0)	-17%
Total	($4.3)	($0.8)[4]	n.a.	n.a.

Notes:
Numbers may not add due to rounding. Funds shown are general revenue and those funds directly impacting general revenues. It includes the property tax relief fund plus federal stimulus moneys received that were used to offset general revenue spending.
[1] Includes $3 billion in balances in the Property Tax Relief Fund and changes in balances of general revenue dedicated accounts.
[2] Includes $6.4 billion of funds specifically appropriated, plus $1.5 billion in funds Texas qualified for after the legislature adjourned.
[3] Includes $300 million of funds from actions of the School Land Board after the Comptroller had already released her estimate.
[4] An estimated $800 million from a bill cutting 2011 appropriations will eliminate this shortfall.

$27 billion below the amount of general revenues it would take to maintain the "current level of state services." Senate Finance Committee Chair Steve Ogden prepared the Senate version under similar instructions from the Lt. Governor, though Senate Bill 1 spends somewhat more overall than the House Bill (Table 2).

Four areas dominate the Texas budget—Public Education, Health and Human Services, Higher Education and Public Safety. The proverbial "All Other" category is only five percent of general revenue spending.

Public Education. The amount of state funding for public schools is determined by mathematical formulas written into state law based largely on school districts' property wealth, tax rates, and number of students. The level of state funding proposed in HB 1 is $9.8 billion below what current formulas would require (the Senate, $9.3 billion). Taking both state aid and local property taxes into account, HB 1 would reduce per student funding from roughly $9,200 per student in 2010 to $7,850 by 2013—a 15 percent reduction. In anticipation of these cuts, many school districts are conducting a very public discussion of ways in which they would respond to the lower level of funding—a difficult, but healthy, process. However, in order to validate any level of

Table 2
Comparing the Draft House and Senate Bills
($ billions)

	House	Senate	Difference
Public Education	$35.3	36.1	($0.8)
Health & Human Services	$20.0	19.0	$1.0
Higher Education	$11.0	11.5	($0.5)
Prisons & Safety	$7.5	7.7	($0.2)
Other	$4.1	$4.1	0.0
Total Spending	$77.8	$78.3	($0.5)

Notes: Funds shown are general revenue and those funds directly impacting general revenues—the property tax relief fund plus federal stimulus moneys received that were used to offset general revenue spending. Numbers may not add due to rounding.

funding below what current law would require, lawmakers will have to pass a bill rewriting the school finance formulas. In previous revamps, this task was made easier by increasing overall funding for public schools while providing "hold harmless" provisions to ensure that no district lost money. *Roughly 3/4 of Texas school districts currently benefit from these provisions.* Eliminating these revenue protections would reduce the state's costs by $5.5 billion and would provide greater equity in our school finance system, but certain districts would see very dramatic reductions in state aid. Until formula revisions are adopted, the exact impacts to individual school districts are speculative at best and subject to a wide margin of error.

The House budget also eliminates $1.8 billion in state funding for certain non-formula public school programs (incentive funding for teacher excellence and student performance, pre-kindergarten, communities in schools, and technology); the Senate would leave $400 million for these programs at the education commissioner's discretion.

Contributions to the Teacher Retirement System's pension fund are budgeted at $3.1 billion, about $900 million below the level required to meet the recommended actuarial targets for the fund. That does not create immediate problems for the fund, as some states are experiencing, but contributions in future years will ultimately need to be increased.

Health and Human Services. Roughly 85 percent of the state's Health and Human Services budget is Medicaid—the federal/state social safety net program providing medical care for lower income Texans. Over 3 million of the state's 25.1 million people are enrolled in Medicaid; 75 percent are children, the bulk of the remainder are aged and disabled, including 55,000 Texans in nursing homes. In general, the state does not provide the services directly, but pays others to provide them. Medicaid is a federal program; states may opt to participate (all 50 states currently do). Each state manages its own program, but it must meet certain minimum standards of eligibility and services in order to qualify for federal matching aid. For every $1 the program costs, Texas pays about 42 cents with the federal government financing the remainder. The House and Senate budgets both cut current reimbursement rates to providers (doctors, hospitals, etc.) by 10 percent, saving roughly $1.6 billion in state funds (and foregoing $2.2 billion in federal funds)., but these cuts are controversial. Even more problematic is the fact that the proposed House budget falls roughly $6 billion below the level of state funding required to comply with current standards of eligibility and care (the Senate, $7 billion). As a result of the federal health care reform act, states have little flexibility to reduce services, as Texas did in 2003 when it last faced severe budget challenges. Texas, as will many other states wrestling with budget woes, will have to obtain some type of relief from Washington, either in the form of additional federal aid or through new flexibility to make program cuts. If no relief is offered, the state will be obligated to provide services it cannot currently afford.

Higher Education. The House budget proposes a 10 percent reduction in basic funding to higher education (the Senate, 5 percent), along with much deeper cuts in "special items" unique to each institution. The House also proposes ending state funding for four junior colleges and limiting financial aid to current students. Group insurance contributions for higher education employees are reduced as more of the costs are shifted to employees. State funding for junior college employee insurance is even more substantially reduced.

Public Safety and Corrections. The House and Senate Budgets reduce spending for public safety and criminal justice by $1.2 billion compared to the current budget. This proposed amount is about $1.6 billion below the amount contained in agency budget requests.

The state is not without a number of tools that can be used to close the budget gap. The state's Rainy Day Fund, created after the budget woes of the late 1980s when the oil and the real estate markets simultaneously crashed, is projected to have a record $9.4 billion balance by the end of 2013.[2] In addition, lawmakers can employ a number of one-time budget tricks they have used previously—such as delaying certain payments and transfers. But, overreliance on the Rainy Day Fund or on one-time measures places the state at risk of simply pushing its budget challenges two years down the road.

All in all, the state's budget picture is the bleakest in recent memory, and the work of the House Appropriations Committee and the Senate Finance Committee will be difficult. The budget will clearly be much leaner than Texans have grown accustomed to. However, as past history has proven time and time again, eventually the rain clouds will part, and Texas will experience substantial revenue growth. As the economy rebounds, many of the budget cuts made today can be reexamined, if appropriate.

Remembering 2006: Property Tax Relief

It has become popular to blame much of the state's budget woes on a "structural deficit" supposedly created in 2006 when the legislature enacted a package of bills to reduce school property taxes. Those property tax cuts were financed in part by a reformed franchise tax that has failed to meet the revenue projections of former Comptroller Strayhorn, a fact that has sparked substantial misinformation about the intent and structure of the original package. Some have even referred to the package as the franchise tax/property tax swap.

No such thing was ever intended.

[2] Three-fourths of oil and gas severance tax revenues in excess of 1987 collections are deposited into the Rainy Day fund, as well as one-half of any unencumbered general revenue balances.

A clear understanding of the intent and design of the package can be determined by examining the original fiscal notes on the legislation as enacted (Table 3).

Table 3
2006: House Bills 1-5 Combined Fiscal Effects
As Originally Estimated for the 2008-09 Biennium
($ billions)

	2008	2009	Biennium
Property Tax Relief	($6.6)	($6.9)	($13.4)
Franchise Tax	3.4	3.5	6.8
Cigarette Tax	0.7	0.7	1.4
Other	0.0	0.0	0.1
Total Tax Impacts	($2.5)	($2.8)	($5.3)
New School Spending	($2.1)	($3.2)[1]	($5.3)
Total	($4.6)	($6.0)	($10.6)

Notes: [1]Includes $800 million to finance a one-time shift in state payments to schools.

As designed, the package increased state aid by an amount sufficient for school districts to reduce their property taxes levied for maintenance and operations by one-third—at a cost to the state of roughly $7 billion annually. This was paid for <u>in part</u> by a $1.00 per pack increase in the cigarette tax and a restructuring of the state's franchise tax; the rest—<u>about $2.5 billion annually was to be a net tax cut paid for out of surplus state funds</u>. The package did not stop there, however. Another $2.0 to $3.0 billion of new spending each year was added to provide a $2,500 teacher salary increase and an additional allotment for high schools—an increased commitment from the state of $5 billion per biennium that had nothing to do with property tax relief.

With the state now suffering from severe budget challenges, there is a tendency to blame it on the 2006 initiative (with the focus on the tax relief piece while ignoring the new spending). The franchise tax has drawn particular attention because of its failure to meet the original revenue projections. As initially projected, the changes to the franchise tax (switching the base from profits to "taxable margin" and extending the tax to apply to many forms of partnerships) were estimated to generate $3.4 billion more than the old tax in 2008. In fact, the Comptroller now estimates those changes netted only $1.6 billion—*a whopping 46 percent increase in the tax*, but $1.8 billion below original estimates (cigarette taxes on the other hand *exceeded* estimates by over $200 million). For the initial biennium the taxes were in effect, 2008-09, they fell short of estimates by a net of $3.4 billion—an amount offset by an additional draw on the state's general revenue fund.

If the state's budget woes could be attributed to the shortfall in the new taxes, by the end of 2009 the state should have been worse off by that $3.4 billion. In fact, the state ended 2009 with a $2.4 billion general revenue cash *surplus*—$400 million *better* off than what the Comptroller had projected when she certified the 2008-09 budget. It turns out the lower-then expected franchise tax revenues were more than offset by higher-than-anticipated growth in other revenues and less-than-expected spending—a trend that would have continued if the economy had not gone into a tailspin.

The state's budget woes today are the result of the worst recession in modern times coupled with the loss of one-time federal stimulus funds and other one-time revenues, not the sudden manifestation of problems from legislation enacted 5 years ago.

Just What is a Tax Increase?

In the campaign season, candidates avoided discussing taxes, often simply saying they would oppose a "tax increase," or a "tax bill," or any "new taxes." Many actually signed pledges not to raise taxes. Unfortunately these statements and pledges are often vague, and there is no clear statement about what constitutes a tax increase. Is it passing a new tax? Raising a tax rate? Eliminating exemptions?

Fortunately, a clear guideline as to what constitutes a tax increase can be found in Article 8, Section 24 of the Texas Constitution—the "so-called "Bullock Amendment." This provision is sometimes erroneously referred to as the personal income tax prohibition; in fact, it simply requires that an income tax bill be approved by voters before it can take effect. The late Bob Bullock, as Lt. Governor, was concerned not only that the legislature might impose a personal income tax against the will of the people, but that once on the books, lawmakers might opt to raise the tax far beyond what voters intended. To counter that, the Bullock amendment requires voter approval not just for the imposition of a personal income tax, but also for any subsequent law that:

- increases the rate of the tax, or
- changes the tax, in a manner that results in an increase in the combined income tax liability of all persons subject to the tax.

By this constitutional definition, a tax increase is very simply any action that raises tax revenue—by either imposing a new tax, raising the rate of an existing tax, expanding the base of a tax, or denying or limiting existing deductions or credits.

As the legislature begins to tackle the very difficult policy choices in balancing the budget, ultimately there will be a discussion about taxes. TTARA's Statement on Fiscal Policy provides:

> *Taxes can cause economic harm by adding to the cost of doing business or living in Texas; however, that harm is offset if those taxes are used prudently to support public services and infrastructure that can create a positive foundation for long term economic growth.... Tax increases—provisions that either raise tax rates or expand existing tax bases by eliminating exemptions, deductions, or credits—should be considered only after all other options have been exhausted and it is determined that higher taxes would cause fewer undesirable economic or social consequences than other alternatives.*

There is little difference in the economic impact on the private sector from expanding the base of a tax versus raising the rate of the tax. Both increase the cost of doing business in Texas, shifting money from the private sector to the public sector.

At some point, the legislature may reach the conclusion that additional revenue needs to be raised. If lawmakers ultimately make that decision, hopefully the debate will be driven by the policy discussion of what revenue measures will do the least harm to the Texas economy, and not by playing semantic games over what is or isn't a "tax bill."

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