

William P. Hobby  
F. Scott McCown

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Dear Business Leader:

We need your leadership to address a challenge facing Texas that imperils our economic recovery and future prosperity—how to cope with a devastating state revenue shortfall. Unless business leaders step up on behalf of a balanced approach to meeting the needs of Texas, rather than a cuts-only strategy, Texas will fall behind. Our problem is so big that—regardless of political party—we must act together as Texans for our common good.

### **How Big Is the Shortfall?**

Texas faces its largest revenue shortfall in decades. There are two ways to measure the depth of our hole: Texas is almost \$16 billion, about 17 percent, short of being able to maintain *spending* at its current level; and at least \$27 billion, about 27 percent, short of being able to provide *services* at their current level. Any way you look at it, this is a far larger shortfall than we faced in 2003 and even larger than we faced in 1987, until now the biggest shortfall in recent times.

To put the shortfall in perspective, if we closed 75 state government agencies, including the governor's office, legislature, and courts, plus the Departments of Public Safety and Criminal Justice, we *still* couldn't close the gap. Only through unprecedented cuts to public education, higher education, and health and human services, which make up three-fourths of our budget, could we balance the budget through cuts alone.

### **What Caused the Shortfall?**

Roughly two-thirds of the shortfall comes from a record-breaking collapse in state revenue caused by the devastating global recession. The sales tax is our major state revenue source, but with consumer and business spending way down, tax receipts are way down too. Our economy is recovering, but the recession has left us short for the next two years. About one-third of the shortfall comes from the 2006 tax swap when the state lowered property taxes and created a new business margins tax to offset the lost revenue. Even at the time, the swap was projected to be \$5.9 billion short of balancing each biennium, and ended up being at least \$9.3 billion short because the new business tax did not produce the projected revenue. Lt. Governor Dewhurst and others rightly say the 2006 tax swap created a structural deficit. The state only now faces the consequences of what it did in 2006. Up to now it covered the shortfall with one-time savings and federal Recovery Act money—all of which is gone.

### **What Does a Cuts-Only Strategy Look Like?**

We can tell you exactly what a cuts-only strategy looks like because that is the approach taken in the proposed House and Senate budgets. The two proposed budgets are very similar, but the House budget is closer to keeping spending within the comptroller's revenue estimate, so we will refer to the cuts in the House budget. With a 27 percent cut to state programs and services, we can provide an almost endless list of damaging consequences, but looking at the big three categories highlights the problems:

- **Public Education**

The proposed budget funds local school districts at \$9.8 billion *less* than what is required under school finance formulas. Among other things, it doesn't fully fund projected annual enrollment growth of 92,000 students. It eliminates funding for teacher incentive pay, high school

completion programs, technology, and pre-kindergarten grants. Think about what these cuts would mean in your community and for your business—and future workforce.

- **Higher Education**

The proposed budget cuts community college and state university formula funding by 10 percent, doesn't fund enrollment growth, cuts special item funding by 25 percent, cuts the state's contribution to community college health care and retirement and entirely eliminates funding for four community colleges. The budget dramatically reduces student financial aid. Cuts of this magnitude would choke off the economic engine fueled by our community colleges and our state universities.

- **Health and Human Services**

The proposed budget reduces already inadequate Medicaid payments for doctors, hospitals, nursing homes, and other providers by 10 percent (\$3.8 billion). Health care providers can't provide care at a loss. A decade ago, two-thirds of our doctors treated Medicaid patients; now less than half do. Hospitals and nursing homes operate on tight margins. With the proposed cuts, children, the elderly, and people with disabilities would not be able to get the care they need. The proposed budget also does not pay for caseload growth or higher costs (\$4.2 billion), and it leaves out the state dollars needed to replace the end of federal Recovery Act funding (\$4.3 billion). These three steps would cost Texas over \$10 billion in federal matching dollars for Medicaid. We would see increases in expensive emergency room use, as well as increases in both local taxes and our own insurance premiums to cover the cost of uncompensated care. None of this is good for business. The proposed budget also cuts health and human services in many other ways.

### **How Would a Cuts-Only Strategy Affect the Economy?**

A cuts-only strategy would undermine our economic recovery by increasing unemployment, thus reducing demand for goods and services. The proposed budget would eliminate over 9,000 state jobs, such as child protective services caseworkers. Because of reduced state aid to local governments and school districts, they too would be forced to eliminate jobs. One of the state's leading school finance experts has estimated that school districts would be forced to lay off as many as 100,000 employees, including teachers.

Of course, many Texas businesses have had to reduce employment during this recession, but dramatic state budget cuts would only make things worse for businesses and communities. In addition to public-sector job loss, Texas would suffer direct private-sector job loss because of reduced state spending on contracting, and we would suffer indirect private-sector job loss because direct job losses would further reduce demand for goods and services. Dr. Ray Perryman, a leading Texas economist, estimates that for every one job directly lost as a result of state budget reductions, roughly 1.5 jobs would be lost indirectly. Job loss of this magnitude would not be good for Texas businesses or our communities.

### **Texas Has a Revenue Problem, Not a Budget Problem**

We must get past rhetoric and grapple with reality. Texas is a conservative state that has budgeted carefully and tightly for years, ranking us near the bottom in state spending whether measured per resident or as a percentage of our economy. To put in perspective how tight Texas is with a dollar, Texas would have to increase current state spending by 28 percent just to reach *average* state spending per resident. Given how careful Texas has been, we can't balance our budget by modifying our priorities; eliminating waste, fraud, or abuse; or being smarter about how we run state government. Of course we should continue to look for opportunities to save money, but being more prudent won't balance our budget.

Our budget grows because our population and costs grow. Over this decade, our population increased by about 20 percent, or 4 million people. Texas has the second youngest population of any state, which is great for our future, but means that today we have lots of children to educate. Education is the single biggest part of the state budget. Even so, state spending from all sources of revenue has remained steady at roughly 7 percent of our economy, as measured by Gross State Product, while spending from our state's own General Revenue has actually fallen. Our problem is the Great Recession and the 2006 tax cut, *not* overspending.

### **Texans Needs a Balanced Approach**

Where does this leave us? We simply can't balance the budget through cuts alone without doing terrible damage to our economy and our future. Instead, we must do what Texas families do. When families face tough times, before cutting spending in hurtful ways, they use their savings and look for ways to bring in more money. The Legislature should take a similar balanced approach.

### **A Balanced Approach Uses Our Rainy Day Fund**

The state's savings account (informally called the Rainy Day Fund but officially the Economic Stabilization Fund) will have \$9.4 billion we can use to balance the budget. The constitutional purpose of the fund is to maintain vital state services during economic downturns. As our economy recovers, state revenue will recover; in the meantime, the fund can help cover state costs. The fund automatically replenishes from dedicated oil and gas severance taxes.

Where one stands on using all of the Rainy Day Fund depends upon your assessment of the damage if we don't use it all and the risk if we do. On the one hand, if we don't use all of the Rainy Day Fund, the damage is great. On the other hand, if we use it all, the risk of not having the revenue in 2014-15 to replace Rainy Day Fund dollars spent now is slight. The Comptroller forecasts a growing economy, and Dr. Perryman estimates that the next time around state revenue should be \$11.4 billion higher. But if revenue doesn't recover, we can always cut *then*; we have no reason to cut so deeply *now*.

Finally, it is important to remember that the true reserve of Texas isn't the Rainy Day Fund, but rather the backing of the people of Texas whose total *annual* personal income comes to almost \$1,000 billion a year—of which the Rainy Day Fund is merely 1 percent.

### **A Balanced Approach Adds New Revenue**

Unfortunately, our revenue shortfall is so large, that a balanced approach also requires adding new revenue. No one is proposing a "tax-only" solution to our problem, but taxes must be part of the solution. Whether you measure taxes per resident or as a percentage of the economy, Texans pay less than almost any other state. That means we put less into education and the infrastructure we need to maintain our competitive business edge and ensure economic opportunity for our children.

Even in these tough times, we do have options preferred by the public over cuts. For example, we can adopt a Healthy Texas Revenue Package that 1) increases taxes on alcohol, 2) increases taxes on tobacco (raising the cigarette tax a dollar a pack generates \$1.9 billion a biennium), and 3) imposes a new one-cent-per-ounce excess tax on sugar-loaded beverages (generating \$2.5 billion a biennium). Or, we could eliminate unwarranted sales tax exemptions. Alternatively, we could temporarily increase our state sales tax by half a percent (with a rebate to protect low-income families) and raise about \$3 billion a biennium. And there are other possibilities.

State after state has confronted this same dilemma—some new taxes or all cuts. Overwhelmingly, they've chosen a balanced approach that includes new revenue, instead of relying on cuts alone. In over 30 states, including conservative states, the debate about how to cope with the recession began with the idea that new revenue would not be needed but ended with a balanced approach that included some

spending cuts, using reserves, and some new taxes. As business leaders in those states learned more about the revenue crisis and its possible solutions, their support for a balanced approach made the difference.

Historically, Texas has always chosen a balanced approach. In 1987, the last time we faced a revenue crisis approaching the magnitude of this one, Governor Bill Clements hoped he could deal with the problem without new taxes but ended up signing a tax increase. And it is important to note, during the following decade, Texas prospered. Smart investment from careful taxation strengthens, not weakens, an economy.

### **Business Leadership is Essential**

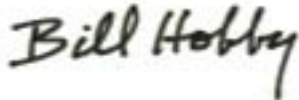
Texas has taken a balanced approach in the past in part because enlightened business leaders recognized the role of the public sector in creating a strong economy and spoke up for investments in education and other critical public infrastructure. An economy is like an ecosystem: Just as there is no bloom without the bee or bee without the bloom, there is no healthy private sector without a healthy public sector. Law and order, roads and bridges, emergency preparedness and disaster response, teaching, research, job training, economic development, and health and human services are all critically important to business.

If Texas business leaders speak up today in favor of a balanced approach, Texas can cope with the current recession and begin dealing with our structural deficit. But if legislators hear only from those who want a rigid cuts-only approach, then legislators will weaken public education, reduce access to higher education, and leave children, the elderly, and people with disabilities in our communities unprotected. We urge you to speak up for Texas.

The center is ready to help you in any way we can. We are hosting a conference call for business leaders who want to learn more. If you would like to participate in the call or just want more information, please e-mail [mccown@cphp.org](mailto:mccown@cphp.org). We hope you will circulate this letter to your membership; if you would like to do so electronically, we have posted it on our website, [www.cphp.org](http://www.cphp.org). We look forward to working with you for a balanced approach that protects the ongoing recovery and future prosperity of Texas.

Sincerely yours,

Center for Public Policy Priorities



By:  
William P. Hobby  
Lt. Governor, 1973-1991  
CPPP Board Member



By:  
F. Scott McCown  
District Judge, 1989-2002  
CPPP Executive Director