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TEXAS FACES A STRUGGLE TO WRITE A BUDGET THAT MEETS THE STATE'S NEEDS FOR 2010-11

The state budget funds critical public systems upon which we all depend. Unfortunately, a realistic analysis of both sides of the state's balance sheet—income and expenses—shows that Texas faces another tight budget in 2010-11. While the state will probably have more available revenue than it did for 2008-09, it will also have more people and higher costs, quickly using up any additional funds. Recently, however, the Speaker suggested that the state might have a $15 billion "surplus" by the end of the biennium, with the Comptroller saying that her most recent estimate projects $10.7 billion. But neither is using the term "surplus" in its ordinary sense. In fact, both estimates include expected balances in the Property Tax Relief Fund, which is already committed to pay for previous tax cuts, and in the Rainy Day Fund, which is reserved for emergencies. In all likelihood, the state will again be unable to fund critical public systems without new sources of revenue.

Cash Balance:

The Comptroller projects a $2 billion ending cash balance for General Revenue, a mere 2.5% of the current budget.

Property Tax Relief Fund:

$3 billion will be in the Property Tax Relief Fund, dedicated to replacing school property tax revenue lost because of rate cuts enacted in 2006. This money is not available for anything else.

Rainy Day Fund:

$5.7 billion will be in the Rainy Day Fund, constitutionally dedicated for emergency spending. The Rainy Day Fund should not just be a "method of finance" for ongoing expenses.

Cash Balance at the End of Fiscal Year 2009

The Comptroller's November 2007 estimate certifying the 2008-09 state budget—the latest official revenue estimate—forecast that the state will end the current budget cycle with a General Revenue balance of $2 billion, a mere 2.5% of the current budget. The Speaker thinks this number may higher, but no one knows what the economy will do over the 15 months remaining in the current biennium. Sales tax collections—which make up about half of General Revenue—were lower in April 2008 than in April 2007, perhaps signaling a weakening in consumer spending.

The Property Tax Relief Fund

In the 2006 special session, legislators reduced local school property tax rates by one-third over two years. To partially replace the lost property tax revenue (totaling $14.2 billion in 2008-2009, and $14.9 billion in 2010-2011), legislators raised the cigarette tax by $1 a pack; made changes to the main state business tax—the franchise tax, now also called the "margins" tax—and changed the way used car sales are taxed. The increased revenue from these 2006 tax changes goes into the Property Tax Relief Fund and can be used only to replace school property tax revenue forgone because of the 2006 rate cuts.

For 2008-09, tax revenue deposited in the Fund is expected to total $7.6 billion, almost all of it ($6.1 billion) coming from the margins tax. But the first collections of the margins tax have been delayed from the originally scheduled date of May 2008, and it may be some time until it is clear how much money this tax will actually raise. For 2010-11, tax revenue into the Fund is expected to total $9.1 billion (according to the original estimate from 2006, which has not been updated). Since this is far short of the expected $14.9 billion cost of cutting property taxes, legislators will once again have to use almost $6 billion in General Revenue to fill the gap. So far, only $3 billion in General Revenue has been set aside for this, through a legislatively mandated transfer scheduled for August 2008.

The "Rainy Day" Fund

Formally named the Economic Stabilization Fund, the Rainy Day Fund was created by constitutional amendment in 1988 to help even out the "boom and bust" cycles in state revenue. Rainy Day Fund revenue comes from higher-than-1987 levels of oil and gas severance taxes, plus General Revenue remaining at the end of a biennium. In 2007 legislators wrote the state budget without using the Rainy Day Fund for ongoing programs (as they had done in 2003 and 2005). As a result, the balance of the Rainy Day Fund is expected to reach $5.7 billion by the end of fiscal 2009.

Although $5.7 billion is significantly more than the Rainy Day Fund has ever contained, it is still only about 7% of 2008-09 General Revenue spending, and well below the 10% constitutional cap on the size of the fund. Experts such as the Government Finance Officers' Association recommend that states have as much as 15% of their current general spending set aside in a Rainy Day or other reserve fund. The Rainy Day Fund should not just be a "method of finance" for ongoing expenses.

The Big Unknown: Future Tax Revenues

The outlook for the state economy and its effect on tax collections is unclear. In addition, no one is sure how the new margins tax will perform. The Comptroller does not have to issue a revenue estimate for 2010-11 until January 2009. But the economy is unlikely to grow so strong and the margins tax to collect so much that Texas will have a real "surplus" of money. More likely is that Texas will once again struggle to meet its needs.

Budget Instructions: Flat or Reduced Spending

In fact, state leaders are preparing for that very eventuality. The budget instructions for 2010-11 issued by the Legislative Budget Board and the Governor's Budget Office on May 5, 2008, to state agencies and institutions of higher education call for "flat funding," or a General Revenue "baseline" request restricted to GR spending levels for 2008-09. Some exceptions are allowed, such as enrollment growth in elementary and secondary public schools; caseload growth in Medicaid, foster care, and other social services entitlement programs; expected increases in adult inmates incarcerated in state prisons; and higher costs to the state because of state employee pensions. But for the most part, cost increases (such as those caused by rising energy or health care prices) cannot go in the baseline, and must be included as "exceptional items" that will compete for any unallocated revenue during the 2009 session. This is similar to what happened in 2007, when a proposed baseline budget did not include, among other things, the amounts of General Revenue needed to address higher Medicaid costs, or any increases in the state-paid premium for state employee group health insurance. In the May 5 budget instructions, agencies and universities were also told to describe the budgetary impact of a 10% **reduction** in General Revenue.

Wishful Thinking

In reality, our tax system, which ranks 45th among the states in tax collected as a percentage of total personal income, does not raise enough money to meet critical needs and certainly does not raise so much money that the state can write checks to individual taxpayers. To learn more, please read the recently released *Building Texas: The 2008 Tax and Budget Primer*, http://www.cppp.org/research.php?aid=763, which outlines the challenges ahead and suggests ways to increase revenue.