POLICY PAGE

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$8.2 BILLION IS STILL NOT A SURPLUS

Comptroller's revised estimate raises unallocated revenue from $4.3 billion to $8.2 billion, but warns that current rates of economic growth "cannot continue much longer"

As the third special session of the 79th Legislature began yesterday, the Comptroller of Public Accounts revised the revenue estimate for the 2006-07 biennium, informing legislators that Texas could receive $8.2 billion more in General Revenue than is currently authorized to be spent. (Of this amount, $2.5 billion would be set aside for a constitutionally required transfer to the Rainy Day Fund.) This *Policy Page* explains why unused GR is so much higher than the $4.3 billion estimated in February 2006. It also explains why even $8.2 billion in unallocated revenue isn't enough to make significant long-term reductions in local school property taxes, cover supplemental budget needs through August 2007, rebuild the state's "rainy day fund", and leave enough room for future revenue growth to adequately fund other state priorities such as higher education, health care, and public safety.

Why the Revenue Picture Keeps Improving

The April 17th revenue estimate is the third one issued by the comptroller for the 2006-07 budget cycle; the other two are the February 2006 certification estimate and the January 2005 biennial revenue estimate.

The main difference in the latest forecast is that it uses a new, Spring 2006, economic forecast, rather than the Fall 2004 forecast used in the previous two estimates. Compared to the Fall 2004 forecast, the Spring 2006 outlook shows marked improvement in the Texas economy for 2005 and 2006, as measured by growth in Gross State Product, personal income, and nonfarm employment. Oil and natural gas prices are also much higher in the Spring 2006 forecast, helping to boost state tax collections—albeit at the expense of consumers and businesses unprepared for the recent jumps in gasoline prices and utility bills. Finally, inflation and interest rates are considerably higher than originally predicted, affecting consumer spending and home and construction-related industries. In 2007, growth in the Texas economy is expected to continue, but not as rapidly as in the current fiscal year.

The impact of rosier economic forecasts on annual General Revenue collections can be seen in the chart on the following page. (Prior-year fund balances are not included in the chart; only new money collected by the state during the fiscal year is shown.)

All three estimates start off with actual GR-related collections of $30.8 billion in 2004. The first, January 2005, estimate assumed that state revenue collections would continue to recover modestly from the declines of the prior (2002-03) biennium, although not enough to cover population growth and inflation of almost 4% a year: in 2005, the fiscal year that had not yet ended, GR collections were projected to grow by

1.5%, followed by a 0.6% **decline** in fiscal 2006 and 3.2% growth in 2007.

The February 2006 certification estimate, which reflected actual 2005 collections and legislated increases in state revenue (such as an extension of the Telecommunications Infrastructure Fund), reported a 5.9% increase in 2005, followed by a 2.3% decline in 2006 and 3.2% growth in 2007.

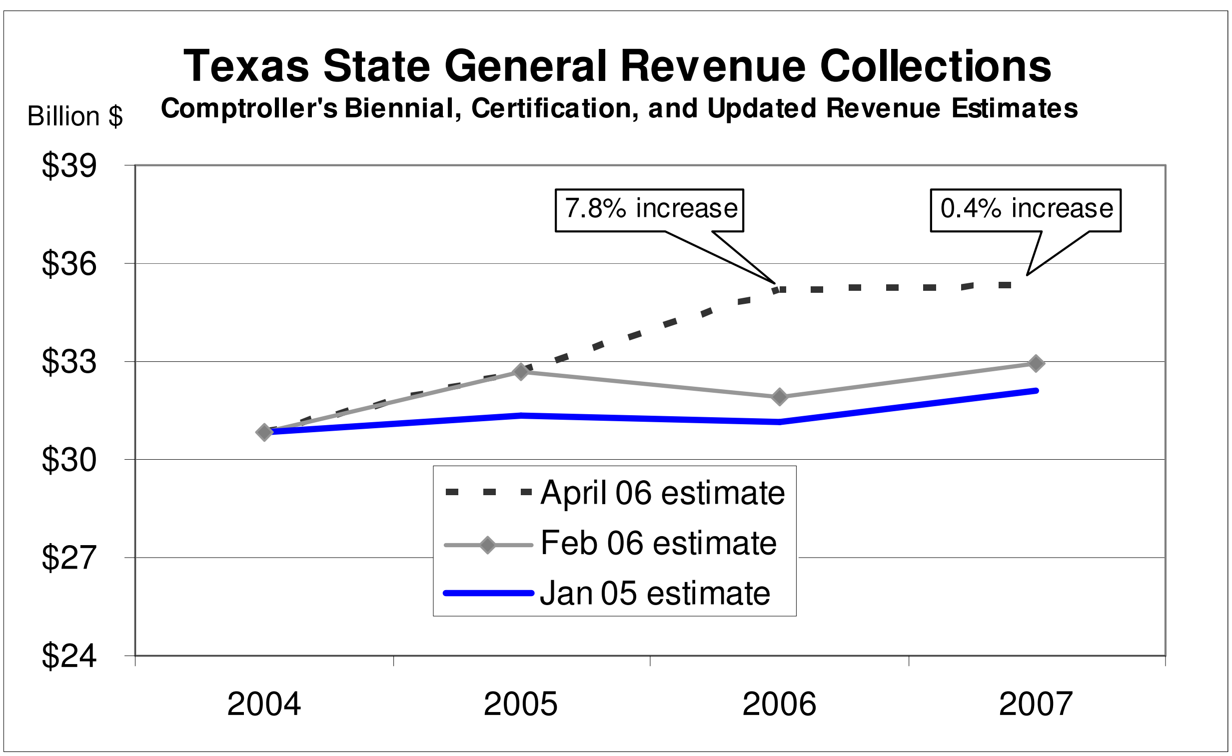
The latest estimate revises the 2006 and 2007 revenue forecasts to incorporate current, shorter-term economic conditions, rather than those that could only be guessed at almost two years ago. For 2006, a 7.8% increase in GR collections is expected. Note, however that in 2007 GR collections will barely grow by 0.4%, reflecting the cooling down of the state and national economies.

The April 2006 revenue estimate also warns of developments that could result in slower economic growth and revenue collections, such as rising household debt, or the possibilities of a housing "bubble" bursting in major U.S. cities, sudden and long-lasting increases in world oil prices, or higher short-term interest rates in the U.S.

Still Missing from the New Estimate: Supplemental and Continuing Budget Needs

In estimating the amount of currently authorized GR spending, and subsequently the "unused" revenue that the state might have, the Comptroller cannot certify budget items for which appropriations have not yet been made by the legislature and approved by the Governor. This means that she cannot subtract major expenditures such as $295 million for school textbooks approved last fall, or $100 million for nursing home rates and residents' personal needs allowances, trauma care, and other health and human service items approved in mid-February 2006. Nor can she include $444 million for the Medicare "clawback" that Texas is disputing in a federal lawsuit. State officials have also identified the need for $52 million in tuition revenue bonds, and at least $100 million in potential Hurricane Katrina/Rita uncompensated costs.

Other budget items that are not part of GR certification include $940 million in education and child protective services programs currently funded by the "Rainy



Day Fund;" these items show up in the budget as being funded by "Other" funds, not General Revenue.

For the next budget cycle (2008-09), at least $4 billion in new General Revenue will be needed to cover general inflation and population growth. More would be needed to pay for increases in health care spending, which grows faster than consumer inflation. In addition, $3 billion is needed to rebuild the Rainy Day Fund itself so that it equals at least 5% of GR spending, the bare minimum recommended by state finance experts. The April 17th revenue estimate allows for only a $2.5 billion transfer to the Rainy Day Fund.

Remember 2003

Finally, part of the reason why revenues exceed spending is that approved spending levels are grossly inadequate, with many critical areas of state spending still reeling from $7.5 billion in GR cuts approved by the 2003 legislature, and costs shifted to school districts, cities, and counties. To restore state spending to pre-2002 levels (per person, inflation adjusted), $10 billion more in General Revenue would be needed.

Sharp Commission's Proposed Use of "Surplus" Creates Problems for Future State Budgets

After months of public hearings and testimony, the governor-appointed Sharp Commission recommended changes to the state's main business tax (the franchise tax), cigarette and other tobacco tax increases, and other minor state revenue increases to replace school property taxes that would be lost if rates were lowered from the current $1.50 per $100 of property valuation to $1.00. However, because the Sharp Commission's proposal would raise less money in new state taxes than the amount lost by cutting local taxes, $1.4 billion of additional state revenue would be needed to maintain school funding—money the Sharp Commission would take from the "surplus." In addition to $1.4 billion to replace school taxes in fiscal 2007, the Sharp plan would require another $4.2 billion in the 2008-09 budget cycle and $5 billion in 2010-11, according to the comptroller.

Some have called for using even more than $1.4 billion to reduce property taxes. If the legislature uses any unallocated revenue to reduce property taxes, it will be more difficult to write the next budget, and the more of the unallocated revenue the legislature uses, the more difficult it will be.

A Better Solution

Rather than reducing school taxes to $1.00 by the 2007 tax year, a more fiscally prudent solution would be to cut the tax rate by less, for instance to $1.20 or to $1.30 with an increased homestead exemption.

Tobacco tax increases, while initially generating new revenue, will raise less and less with every year that passes—a problem when it comes to funding growing schools.

The proposed changes to the franchise tax would accomplish the goal of getting more businesses to pay their "fair share" by considerably broadening the tax base, and the Sharp Commission's approach is worth a try. But revenue from the proposed new business tax is predicted to grow at a slightly slower rate than the property taxes it replaces would have grown. For this reason, a reformed business tax should not be considered the "silver bullet" to our school finance problems.

Enacting the Sharp Commission's proposals for the tobacco and franchise taxes but requiring smaller property tax reductions would provide school districts with the meaningful discretion required by the courts, generate enough revenue to actually increase education spending, and prevent the state from running a deficit and using too much of the "surplus."

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