



SPENDING CAP

Constitutional Spending Limit and Dedication of New Tax Revenue Limit Ability to Meet Needs

Policy Page 263 described the spending needs that are still not a part of the state budget for 2006-07. The latest version of the supplemental appropriations bill, SB 16 by Ogden, identifies \$2.95 billion in immediate needs. The state's ability to respond to these needs, while reducing school property taxes and improving public education, has called into play a little-known restriction on state budgeting – the constitutional limit on spending – which limits the amount available for spending in the current biennium. An additional limit – the dedication of all revenue from tax changes made in the special session to further reducing property taxes – proposed by HB 2 by Pitts would further hamstring the next Legislature in writing the 2008-09 budget. This *Policy Page* explains the constitutional cap and the proposed dedication and the restrictions they would impose on the current special session and on future state budgets.

How Does the Spending Limit Work?

Article VIII, Section 22, of the Texas Constitution caps spending of state tax revenues that are not constitutionally dedicated. Spending that is supported by federal funds, nontax revenue such as fees, or constitutionally dedicated revenue such as state gasoline taxes does not count against the cap. Spending may not grow faster than the Legislative Budget Board's estimate of the biennial rate of growth in state personal income. The limit is adopted before each regular legislative session and can be exceeded only by a majority vote of the House and Senate.

The biennial growth limit adopted by the LBB for the 2006-07 budget is 11.34%. Applied to a base of \$50 billion in 2004-05 appropriations from tax revenue not dedicated by the Constitution, the growth rate produces a maximum spending level for 2006-07 of \$55.6 billion. The latest LBB estimate indicates that appropriations affected by the limit may increase by only \$3.6 billion before hitting the cap.

There is an additional \$300 million in nontax revenue, which is not affected by the cap, and is also available to be spent in this biennium. The Legislature can therefore increase state spending in the current biennium by up to \$3.9 billion.

How Will the Spending Limit Affect Spending in This Special Session?

Legislators are trying to reduce local school district property taxes in response to a ruling by the Texas Supreme Court that set a June 1 deadline for the state to repair unconstitutional defects in the current school-finance system.

The House has already passed a bill (HB 1) to cut school property taxes to no more than \$1.33 per \$100 of property value in 2007 and appropriated \$2.39 billion to cover the cost. This would leave only about \$1.5 billion to spend in this biennium for all other purposes, including the proposed supplemental appropriations, teacher pay raises, and any other spending. For instance, SB 1 would increase public education funding by \$1.44 billion in 2007 – absorbing the remaining dollars available under the cap. The Senate

Finance Committee is expected to roll provisions of SB 1 into HB 1 at its hearing on Monday.

How Will the Spending Limit Affect the 2008-09 State Budget?

The House has already passed three tax bills (HB 3, 4, and 5) that would raise a total of \$8.35 billion in 2008-09. However, the constitutional cap might prevent the Legislature from using all of this new revenue to fund the 2008-09 state budget.

The new tax revenue alone could fund a 15% increase in spending over the maximum allowed in the current biennium. Natural growth in current taxes could be expected to provide substantial additional revenue. However, it is unlikely that the LBB would adopt a personal-income-growth forecast large enough to permit the Legislature to use all available revenue to meet state needs.

The cap should be adjusted to accommodate the expanded role of state government in funding public education, accomplished by replacing school property taxes with state tax revenue. This is a large increase in state responsibility, but not actually an increase in the size of government, since state spending would only replace local revenue. The intent of the constitutional cap – to limit the rate of growth in government spending – would be maintained if the cap were re-set to take into account the new taxes.

How Would the Proposed Dedication of Future Tax Revenue Affect School Spending?

The House has passed HB 2, which would statutorily dedicate all new revenue from its tax bills to reducing school property taxes. The Senate Finance Committee version of the bill would dedicate this revenue to reducing property taxes until the average rate was \$1.00 per \$100 of property value. After this point, two-thirds of the revenue from this session's tax bills would continue to go to reduce property taxes, while one-third would go to increase certain elements of the school-funding formulas. If school property taxes were reduced to 75 cents, all revenue from

these bills would go to these school-funding elements.

The biggest problem with this dedication is that it would give first call on new tax revenue to just one purpose – cutting property taxes – without regard to other vital state needs, including higher education, health and human services, and prisons. In conjunction with the constitutional spending limit, the dedication would severely squeeze the rest of the budget or force further state tax increases (see below).

It should also be noted that the revenue currently projected for the three tax bills would be enough to reduce property taxes by about 35 cents, from \$1.50 to \$1.15. (Each penny of property tax requires about \$120 million to replace. The \$4.2 billion per year that the current tax bills would generate could offset about 35 cents of property taxes.) Only by spending all of the remaining “surplus,” reducing other state spending, or further raising state taxes could the state afford to replace sufficient school property taxes to reduce the rate to \$1.00.

How Would the Proposed Dedication of Tax Revenue Interact with the Spending Limit To Limit Future Budgets?

In conjunction with the spending cap, the dedication in HB 2 would force a severe contraction in spending for all other purposes in future state budgets.

This is because the cap would limit total spending, most likely to a level far below the total revenue that will be generated by the current tax system plus the new taxes created in this special session. But the dedication in HB 2 would set aside a substantial portion of the capped appropriations to support the new task of cutting property taxes. All existing state programs, which have required the entire state budget in the past, would have to be funded by the shrunken proportion of state revenue remaining.

Even if HB 2 were to fail, as long as a significant proportion of state revenue were devoted to supplanting local property taxes, rather than funding state services, the

spending cap would force a reduction in current budget items to make room for the new property-tax-replacement item.

This squeeze can be avoided only by resetting the spending cap to take into account the significant shift in school funding from local property taxes to state taxes, and by avoiding

giving property-tax reduction top priority in all future budgets.

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