POLICY PAGE

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# PRUDENT STEWARDSHIP OF THE STATE'S BUDGET

The Speaker has projected $15.5 billion in "surplus funds" for the 2008-09 budget cycle. If "surplus" means "more than we had," the Speaker may be right. If "surplus" means "more than we need," then, as this *Policy Page* explains, we do not have a surplus at all; we are $3 billion short. Indeed, our strong economy is masking a serious budget hole—the difference between the ongoing cost of local school property tax cuts enacted in the special session and the new state revenue to be raised. Prudent stewardship and conservative budget principles require more than a two-year view. Texas needs to meet vital needs, use dedicated funds properly, set aside an appropriate reserve, and fully fund the tax swap made in the special session.

**Why the Revenue Picture Keeps Improving**

The Legislature went into last April's special session with a forecast from the comptroller that Texas might receive $8.2 billion more in General Revenue than the Legislature had already appropriated in the regular session for the 2006-07 biennium. In the special session, legislators spent less than half of this $8.2 billion. HB 1, the school-finance bill passed during the special session, required $3.9 billion in spending in 2007, offset by new revenue of $430 million in 2007 from the increased tax on cigarettes and tobacco products, for a net cost of $3.5 billion in fiscal 2007. At the end of the special session, therefore, $4.7 billion in additional, unallocated revenue was anticipated for the current 2006-07 biennium.

The comptroller has not issued a revised revenue forecast since April. However, the House Speaker has circulated a budget outlook that projects the state will have $7.4 billion on hand at the end of fiscal 2007—an increase of $2.7 billion over the earlier forecast. This additional money comes from 2006 revenue that came in even higher than forecast in April, plus an expectation of continued higher levels through 2007. All-funds tax revenue for 2006 was $33.5 billion, $1.2 billion over the April estimate. A similar increase in 2007 would support an estimate of an ending balance of the size proposed by the Speaker.

The Speaker also includes vetoed appropriations from the 2006-07 budget as available for spending. Almost all of this General Revenue—$444 million—was intended to fund the Medicare prescription drug clawback. The Health and Human Services Commission has been making these payments out of General Revenue that has not been used by HHSC because of caseload drops in Children's Medicaid and CHIP due to enrollment problems with the new call centers.

In addition, the Speaker projects that 2008-09 revenue will be $7.6 billion higher than in 2006-07. This could be a reasonable forecast, in line with prior experience. However, forecasters are currently very uncertain about the national economic outlook. The latest economic forecast from the comptroller projects that the state economy will grow more slowly over the next three years than in 2005 and 2006. These early revenue forecasts must be taken as extremely speculative.

| **Speaker's "Surplus Funds" Estimates:** | |
|---|---|
| Projected 2007 Ending Balance | $7.4 |
| Vetoed 2006-07 Appropriations | 0.5 |
| Projected 2008-09 Revenue above 2006-07 | 7.6 |
| **Total (in billions)** | **$15.5** |

**Still Missing: Final Estimate of Supplemental Needs for 2006-07**

The Speaker's projections show a need for only $200 million in 2007 supplemental appropriations, considerably lower than estimates of supplemental needs produced during the special session. One reason for the lower estimate is that higher-than-anticipated property values in the 2006-07 biennium have reduced state aid needed for K-12, allowing already-appropriated state funds to cover textbooks and other supplemental needs. The payment of the Medicare clawback as discussed above is another reason. If needed, a supplemental spending bill for 2007 will be filed early in the 80th Session.

**Speaker's Estimate of $9.7 Billion More in Needs for 2008-09 Leaves Out Some Major Items**

For the next biennium, an additional $9.7 billion in needs is estimated by the Speaker's office, including $4.3 billion more for public K-12 and higher education; $1.9 billion more for health and human services; $200 million for public safety and criminal justice; and $600 million for state employee health and payroll costs. (The remaining $2.7 billion is the net amount that would be needed to pay for the property tax cuts approved in the special session, but not paid for by the revenue generated by the bills passed in the special session.)

However, CPPP's preliminary review of state agency budget requests indicates that the additional amount of General Revenue needed to fund current state services in 2008-09 is closer to $12.5 billion—nearly $3 billion more than the Speaker's. The main difference in CPPP's calculations is in budget items such as HHS entitlement caseloads and cost growth, requiring $3.7 billion more in General Revenue. For higher education, a "current services" budget would allow for inflation and enrollment, or almost $1.7 billion more; the Speaker's estimates cover only the cost of enrollment growth.

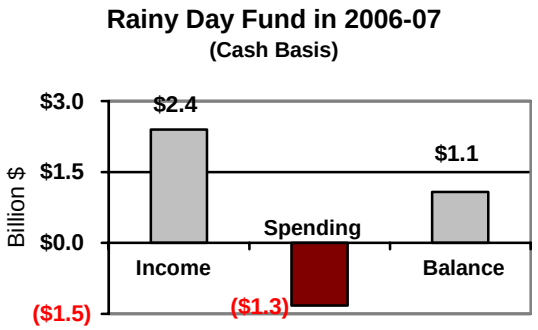
The Speaker's calculations also leave out budget priorities that other state officials have backed, such as restoring state park funding or avoiding massive layoffs in the state's child support enforcement workers.

**Lack of "Truth in Spending" of Dedicated Taxes/Fees:** In addition, the Governor has raised the issue of the honest use of dedicated funds. A portion of General Revenue spending currently relies on dedicated revenue account balances that are not being spent on their intended purposes. The Speaker's budget calculations do not provide for straightening out dedicated accounts. For example, public alarm has been raised about state parks deteriorating while dedicated state park revenue is unspent, but counted to balance the budget. Other revenue sources being used to offset "pure" General Revenue spending include the Texas Emissions Reduction Plan fund, intended to fund air pollution prevention programs; and the System Benefit Fund, created to pay for utility discounts for low-income and other needy households. For the 2006-07 budget, over $2 billion in dedicated account balances was counted as part of the certification estimate. If legislators were to return these funds to their original purpose, or stop collecting the revenue, a "hole" of at least $2.5 billion would be created in the 2008-09 budget.

**Inadequate Reserves**: Nationally, budget experts have long recommend that states have a reserve equal to at least 5 percent of general fund spending; for Texas, that would mean about $3.5 billion for the 2006-07 budget. However, after the major and painful cuts made by states in the last economic downturn (2001-02), experts

recommend a reserve fund of 8 percent is now being recommended to tide states over through budget years in which economic recessions or slowdowns cause state revenues to stagnate or fall again.

Adding the school property tax cuts to a "bare bones" estimate of potential current services demands for General Revenue yields a biennial total of around $91 billion. Eight percent of $91 billion is about $7 billion, considerably beyond what the state's Rainy Day Fund would contain in 2008-09 if current revenue trends continue. Legislators would have to appropriate additional funds to reach the 8 percent goal.




**Remember 2003**

Part of the reason that anticipated revenues exceed current spending is that approved spending levels are grossly inadequate, with many critical areas of state spending still reeling from $7.5 billion in General Revenue cuts approved by the 2003 legislature, and costs shifted to school districts, cities, and counties. In its budget proposal for 2008-09, the Health and Human Service Commission is requesting over $500 million to undo the budget cuts of 2003, such as restoring Medicaid and CHIP provider rates.

**Proposed Property Tax Cuts are a Long-Term Drain on the Budget**

The property tax cuts passed in the special session will be a continuing drain on the state budget for the foreseeable future if school maintenance-and-operations (M&O) tax rates are cut by one-third permanently, i.e., rates are cut from $1.50 per $100 in property value to $1.00.

The cost of the property tax cuts in HB 1, the school-finance bill passed in the special session, were estimated at the time to be $13.4 billion for the 2008-09 biennium. (The Speaker's estimate now is $11.4 billion, based on higher-than-expected property values, which increases local revenue, decreasing the need for state matching aid.)

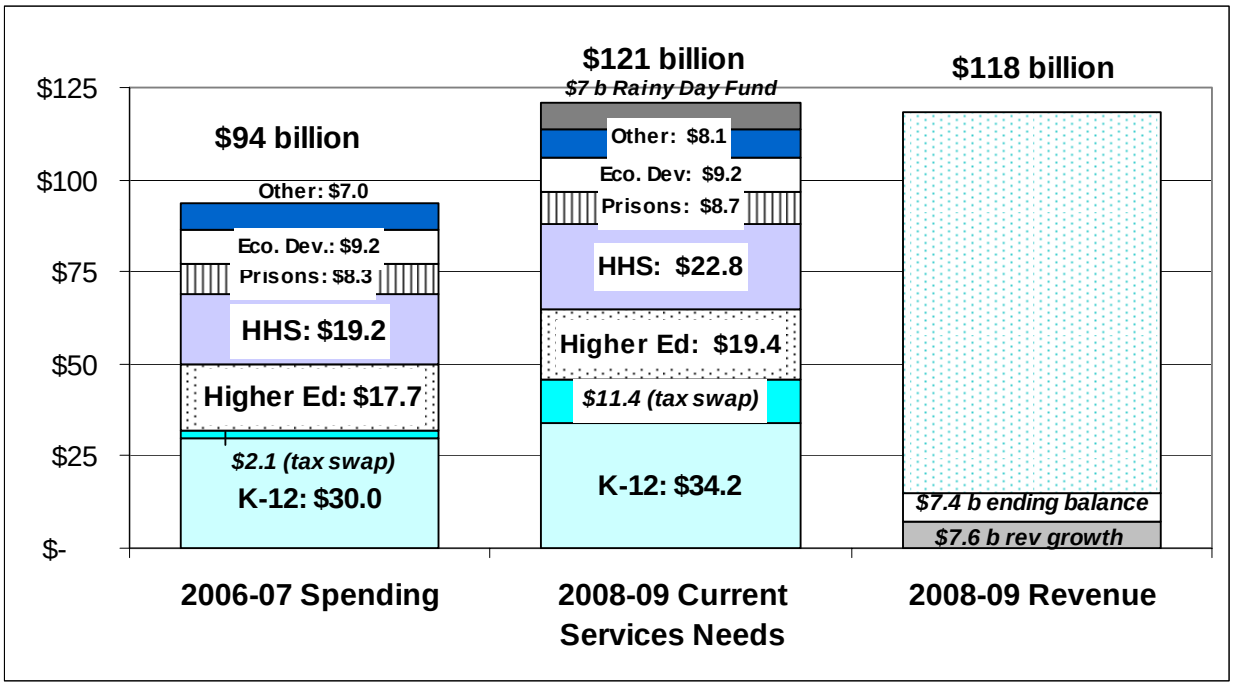
The special session tax increases were estimated by the Legislative Budget Board to generate $8.3 billion in 2008-09—enough to reduce M&O tax rates by roughly 30 cents, but not by 50 cents. This is the "hole" or "shortfall" created by the special session.

The strong economy is masking this hole. For the 2008-09 biennium, the state may be able to cover the cost of the last 20 cents with revenue carried over from the current 2007 fiscal year. But savings can only be spent once. By the 2010-11 biennium, there will be no "surplus" to be carried over and the revenue from the new taxes created in the special session will be unable to fully fund the property tax cuts.

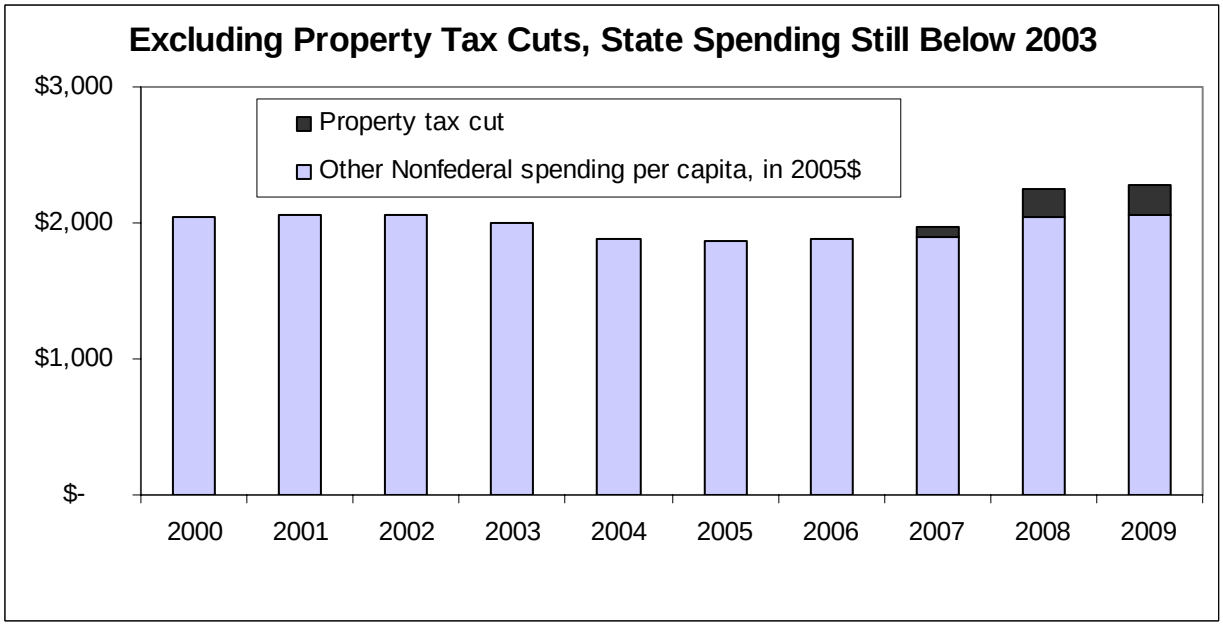
The state then will either have to compress property tax rates to only $1.20 or reduce other critical state services for the sake of meeting the property tax rate goal.

In fact, HB 1 requires a one-third tax cut for fiscal 2008 only. Starting in 2009, the commissioner of education will calculate a compression percentage based on the amount of state funds in the property tax relief fund, which receives the revenue raised from the tax changes made in the special session, "or from another funding source available for school district property tax relief." If no other funding is available—at least, not without cutting essential state services—property tax rates should be compressed only by the amount that is covered by the special session tax changes.

As the chart below shows, a "surplus" would not exist for 2008-09 if legislators budgeted for current services and an adequate reserve fund. ("Current services" is the cost of providing the same level of services as in the prior budget cycle with no policy changes, allowing for inflation or other uncontrollable cost increases. Student enrollment growth and mandatory [Medicaid and foster care] caseload growth are included in "current services.") Estimates of the cost of the tax swap cost, ending balance, and 2008-09 revenue growth are from the Speaker's Office.)




As the chart below shows, even if all available revenue were spent (with no reserve fund at all), state spending for purposes other than the new property tax cuts would still not restore inflation-adjusted, per-capita state spending to where it was before drastic cuts made in 2003.

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